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Embrace Duration in Rising Rates?

Let's re-visit conventional thinking

When it comes to fixed income investing, the conventional thought suggests that as the economy progresses through a recovery, interest rates rise to reflect a more robust growth and inflationary backdrop. In response to the improving environment, central bankers gear up to endeavour on a rate hike campaign to prevent the economy from overheating. While we do not typically know exactly when rate hikes will begin, and how high policy rates will ultimately settle, the market is in constant re-calibration of expectations.

This year has been one of those re-calibration years for bond investors. As the cycle progresses at warp speed, compared to cycles past, the bond market has been active in repricing rates across the curve, accounting for growth, inflation and policy path expectations. It has undoubtedly been challenging in 2021.

Central bankers, too, are turning more hawkish and signaling their time to act may be sooner than anticipated. Markets interpret the recent rhetoric from the Bank of Canada to mean some time in the middle-quarters of 2022. Are Canadian fixed income markets destined for a lost year of returns?

History does not repeat, but it often rhymes

Although conventional thinking associates a rate hike campaign with rising rates, it is important to note that not all rates are made the same.

The beauty of bond market dynamics is that different factors affect different segments of the yield curve. While some rates rise, others may fall when it is the same new information being disseminated. For example, a flattening yield curve may be driven by short-term rates rising in anticipation of policy rate hikes. Conversely, longer-term rates may remain steady or fall as longer-term inflation expectations are adjusted.

With respect to potential performance in the lead up to rate hikes, longer term rates generate higher yields and have an outsized benefit to falling rates relative to the headwinds faced from rising short-term rates. This is due to higher sensitivity to interest rate changes of the former. As many investors seek to remove duration by moving into short-term bonds or reducing fixed income exposure to proactively protect capital, they may be missing out on market opportunities. Duration has historically been a very valuable tool at this point of the cycle.

Short- and long-term rates eventually converge

Chart 1 highlights the 30-Year Government of Canada bond yield and the Bank of Canada policy rate dating back to the early 1990's, when the Bank of Canada formally adopted an inflation targeting mandate. There have been 7 Bank of Canada rate-hike cycles over the past three decades, highlighted by the shaded area in the chart and further detailed in **Table 1**. Leading into most rate hike cycles, the 30-year yield has fallen in all but one instance. This is typically a reflection of the market re-calibrating expectations and expressing a view of where policy rates may ultimately settle at the end of the rate hike cycle. The one exception was in 1999, where 30-year yields were rising in response to a modest easing cycle brought on by an emerging markets debt crisis earlier in the year. As can be seen however, there is a clear convergence that occurs between rising policy rates and falling long bond yields in all seven rate-hike cycles.

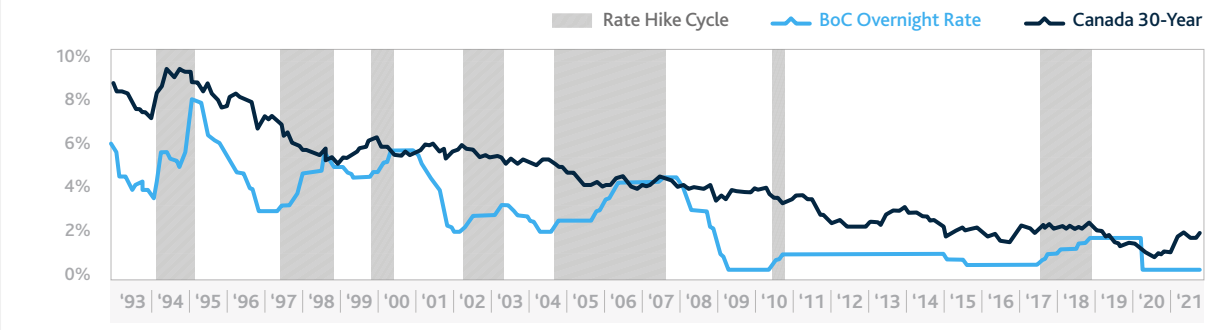
For bond investors that means not all is lost. In fact, duration has been a boon for investors willing to go against conventional thinking as rate hikes come into view.

Given the guidance from the Bank of Canada, there is potential that the first-rate hike could be initiated at some point in Q2/Q3 2022 or about 6 to 9 months from now. If we review how various segments of the fixed income market performed six months prior to the first-rate hike historically, we may gain insights on what to expect from bond markets over this lead in period.

TABLE 1 | Canadian Rate Hike Periods

Period	Month of First Hike	No. Months for Full-cycle	Total Rate Increase
Period 1	March 1994	12	4.57%
Period 2	June 1997	17	2.25%
Period 3	November 1999	7	1.25%
Period 4	April 2002	13	1.25%
Period 5	September 2004	35	2.50%
Period 6	June 2010	4	0.75%
Period 7	July 2017	16	1.25%
Average Since 1990		**14.9**	**1.97%**
Average Since 2000		**17.0**	**1.44%**

CHART 1 | 30-Year Government of Canada Bond Yield and the Bank of Canada Policy Rate



Source: Fiera Capital and Bloomberg Financial LP

The long and short of it

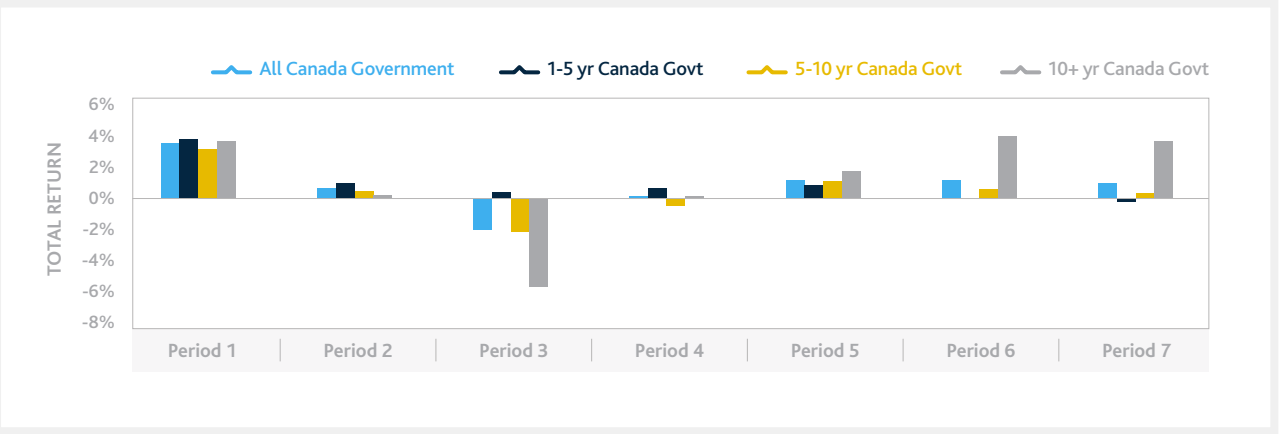
To make the distinction that various segments of the market may react differently to a rate hike cycle, we dissected the Canadian bond market into it's conventional maturity buckets of 1-5 years (short), 5-10 years (mid) and 10+ years (long) for Government of Canada bonds.

In 6 of 7 periods, Government of Canada bonds produced a positive return over the 6-month period leading into the first-rate hike **(Chart 2)**. Interestingly, over the past three lead-in periods, long bonds (10+ years) were not only positive performers, they were the highest performing segment of the market.

Returns for bonds with greater interest rate sensitivity, 10+ years Government bonds, have provided the best returns relative to shorter duration alternatives in the 6-month lead in to the initial rate hike.

Table 2 compares the average returns across the common maturity segments over the 6-month periods. As observed, long bonds have historically been the best performer in these periods over the past three decades.

CHART 2 | 6 Months Prior to First Rate Hike



Source: Fiera Capital and BofA Merrill Lynch Canada Bond Indices

When focusing on the more recent experiences, beginning in 2000 and thereafter, the conventional flight to shorten portfolio duration has not paid off for investors. As can be seen in **Table 2**, over the past two decades, and past four rate-hike cycles, 10+ years Government bonds have outperformed its short- and mid-term counterparts by over 2%, on average. This performance differential reflects non-parallel shifts across the yield curve, as changing expectations affect short- and long-term interest rates in different ways.

TABLE 2 | Average returns across the common maturity segments over the 6-month periods

Average Six-Month Returns Prior to First Rate Hike	All Government	1-5yr Government	5-10yr Government	10+ yr Government
Average since 1993	0.86%	0.97%	0.49%	1.16%
Average since 2000	0.91%	0.36%	0.44%	2.46%

Source: Fiera Capital and BofA Merrill Lynch Canada Bond Indices

Bottom line

Thinking unconventionally during a period of market flux and volatility can have profound outcomes. Investors that embrace duration during these periods, where most associate rising policy rates with falling bond prices, may be rewarded. In addition, as financial conditions tighten in the wake of high valuations across corporate and equity securities alike, the hedging benefits that long bonds (duration) offer in a period of pricing re-calibration and volatility has the potential to provide ballast to portfolios.

Active management can help to identify these market opportunities and may lead to further portfolio adjustments across sectors to help improve outcomes. Rising rates does not always mean falling bond prices, investors just need to know where to look.

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