Scotia Wealth Management.

HERE'S WHAT WE'RE THINKING

DECEMBER 21, 2023

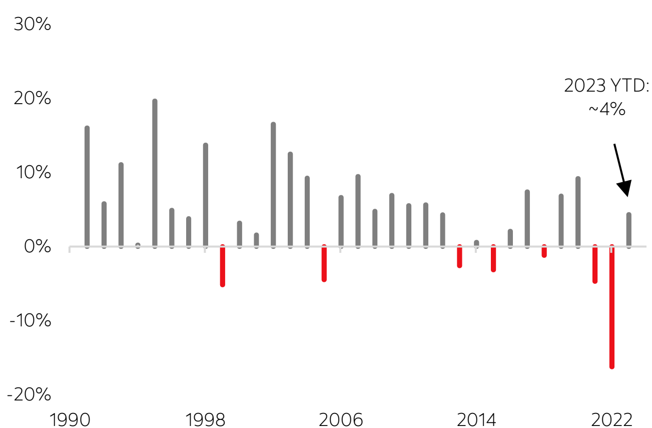
INVESTMENT STRATEGY

FIXED INCOME INVESTORS RECEIVED AN EARLY HOLIDAY PRESENT IN NOVEMBER

During the pandemic, major central banks slashed their policy rates to near zero and began purchasing large quantities of bonds, driving their prices higher and yields lower. For some bonds, yields-to-maturity even fell into negative territory. By the end of 2020, the value of global debt with a sub-zero yield ballooned to over US$18 trillion. Ironically, the "income" in "fixed income" was nowhere to be found during that time, causing investors to look elsewhere for yield.

The swift unwinding of pandemic-era stimulus has caused bond yields to surge from their depressed levels. Today, the yield on a 10-year U.S. Treasury bond is hovering around the 4% mark versus its post-pandemic low of ~0.5%. Amid the rapid upturn in bond yields (which move inversely to prices), fixed-income investors have had to endure a tough couple of years. An index of global investment-grade (IG) debt posted negative returns in the 2021 and 2022 calendar years (Fig. 1).

Fig. 1: Global IG bonds struggled in the last two years but are on track to rebound in 2023



Sources: Bloomberg, Scotia Wealth Management | Bars represent calendar year returns for Bloomberg Global Aggregate Bond Index. YTD return as at Dec. 18, 2023.

As of the end of October, global IG debt was on course for a third straight negative year. Thankfully, the holidays arrived early for fixed income investors as bonds rallied in November, helping the asset class shed its year-to-date (YTD) losses. The 10-year U.S. government bond yield began its descent from its October peak after the November U.S. Consumer Price Index (CPI) report showed further progress toward the U.S. Federal Reserve's (Fed) inflation target. A smaller-than-anticipated uptick in long-term debt sales announced by the U.S. Treasury also helped matters, somewhat easing concerns about fiscal sustainability.

The bond rally continued into December after the Fed extended its policy rate pause and forecasted a higher number of rate cuts compared to the previous set of projections. As a result, fixed income is now on pace to finish the year in positive territory, assuming YTD returns (as at December 18) persist.

Looking ahead, the asset class is poised to deliver healthy returns in 2024, in our view. There remains considerable debate about whether monetary policymakers will successfully engineer a soft landing (i.e., restoring price stability without inducing a recession). However, most agree that gross domestic product growth will shift lower from its current level. Whether an economic slowdown is severe enough to tip the economy into a recession remains to be seen; however, a slowdown should cause inflation to drift lower, all else being equal. As growth and inflation recede and central banks normalize monetary policy, bond yields should fall in tandem.

That said, the journey toward lower yields may prove to be rocky. Ongoing economic resilience could sustain consumer spending, leading to sticky inflation. Potential supply-side disruptions brought on by geopolitical factors could also exert upward pressure on prices. These potential risks could keep central banks on their toes and cause them to refrain from easing monetary policy settings prematurely, leading to bouts of interest rate volatility.

Given the broad range of potential economic outcomes and ongoing uncertainty, we continue to advocate for diversification and a high-quality bias. High interest rates, tighter lending standards, and excess global indebtedness could still spark a recession. Should this occur, high-quality debt could offset declines in riskier assets like equities.

Conversely, if central banks successfully engineer a so-called soft landing for the economy, ongoing equity exposure should allow investors to participate in the upside. Overall, the upturn in bond yields from the depressed levels seen in early 2022 has improved the attractiveness of fixed income, making it easier to construct high-quality, diversified portfolios.

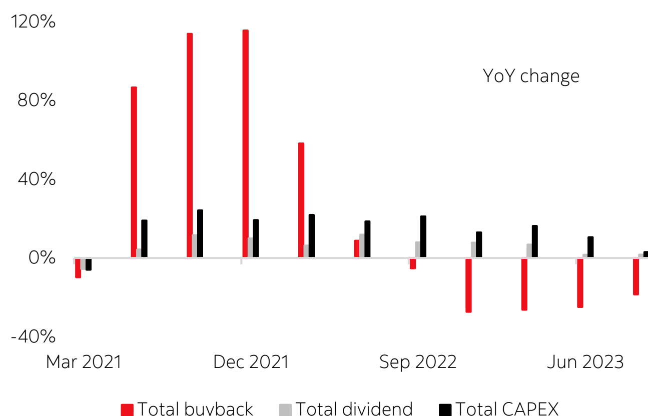
EQUITIES

S&P 500 COMPANIES ARE TIGHTENING THEIR PURSE STRINGS ON SHARE BUYBACKS

S&P 500 companies are pulling back on deploying capital despite rising free cash flow levels as higher interest rates alter capital allocation preferences. In 3Q23, cash and cash equivalents for the index (excluding the financials, real estate, and utilities sectors) rose to their highest level since 4Q20 amid a recovery in free cash flow and a slowdown in capital expenditures (capex).

The capex slowdown has not translated into an increase in share buybacks. On a year-over-year (YoY) basis, share buybacks have declined for five consecutive quarters and were down 18.4% to US$176 billion in 3Q23 (Fig. 2). Meanwhile, dividend payouts were up 1.7% YoY in the same period. Combined with share buybacks, the two payouts were down 10% YoY in 3Q23 to the lowest level (US$327 billion) since 1Q21. Mergers and acquisitions activity also remains subdued, with the number of deals quarter-to-date down over 30% from 4Q21's peak.

Fig. 2: YoY change in share buybacks has contracted for five consecutive quarters



Sources: Scotia Wealth Management, Bloomberg

The downturn in share buybacks could pose challenges for earnings per share growth going forward. In FY22, buybacks contributed nearly a full percentage point to EPS growth.

Higher interest rates may be one of the reasons why businesses are reducing spending on buybacks. During the low interest rate regime that existed prior to last year, businesses often funded share buybacks through debt issuance, but today's high interest rate environment has made this a less desirable option. Additionally, while capex has slowed in recent quarters, businesses are gearing up for investment in artificial intelligence and reconfiguring supply chains. This has resulted in capex as a percentage of sales recovering to its pre-pandemic average and could keep share buyback plans on the back burner for the foreseeable future.

FIXED INCOME

FAVOURABLE FUNDING COSTS MAY BOOST CORPORATE BOND SUPPLY NEXT YEAR

Funding costs for IG and high-yield (HY) debt issuers have decreased since October due to lower rates. This has sparked higher demand for debt and tightened credit spreads to 20-month lows across the credit rating spectrum. Favourable financing conditions have made it easier for businesses to issue new debt, particularly for HY issuers.

The HY primary market has seen an increase in supply over the last two months. The month-to-date total is currently sitting at US$12.5 billion, five times the volume observed in December 2022, while YTD supply is running 73% ahead of last year's tally. Additional HY supply could come online next year as some of the record amount of debt issued between 2020 and 2021 comes due. Like this year, 2024's issuance could be dominated by refinancing deals. Not to be left behind, IG debt supply is expected to rise to US$160 billion in January 2024, above the average of US$128 billion observed in all Januarys over the last decade.

Even with a spike in demand across the credit rating spectrum, we prefer high-quality issuers as they are better positioned to weather economic uncertainty and because their securities tend to be more liquid than those of their high-yield counterparts.

ECONOMICS

CANADA'S INFLATION RATE REMAINED STICKY IN NOVEMBER

Canada's CPI rose 3.1% YoY in November, unchanged from October's reading but above the median consensus estimate of 2.9%. The month-over-month (MoM) advance also matched October's reading of 0.1% but was higher than expectations for a 0.1% drop.

Canadians continued to feel the pinch of mortgage interest costs (+29.8% YoY), the largest contributor to the annual inflation increase. Higher debt servicing costs, directly resulting from the Bank of Canada's (BoC) rate hikes, may appear counterintuitive to restoring price stability. However, monetary policymakers pay close attention to the core trim and core median measures as an operational guide to achieving the long-term inflation target. Mortgage interest costs are not being captured in these measures. In November, the average of the two gauges rose ~3.5% YoY but was slightly north of expectations of ~3.4% and well above the 2% target. This suggests that underlying inflation, excluding volatile categories like mortgage

interest costs, is still elevated.

Although the futures market is not pricing further BoC policy rate increases, the upside inflation surprise will likely cause the bank to remain patient and resist a near-term policy pivot until inflation is fully tamed.

GEOPOLITICS

INFLATION REMAINS VULNERABLE TO SUPPLY-SIDE DISRUPTIONS

The recent missile strikes by Yemen's Houthi rebels in the Red Sea, motivated by the Houthis' opposition to Israel's actions in Gaza, have heightened fears of the Red Sea becoming a high-risk zone. This waterway is the main route to the Suez Canal, a key channel for Europe-Asia trade. More than 10% of global trade travels through this passage. Several shipping companies are avoiding the troubled waters, but the detour has tacked on additional travel time, leading to delays and higher costs.

The resilience of global supply chains is again being tested, harkening back to the 2021 Suez Canal blockage that obstructed travel. Stressed supply chains could raise the cost of goods globally. A similar scenario also played out during the pandemic and was further exacerbated by the war in Ukraine.

Ultimately, the duration and severity of this blockade will determine the extent to which supply chains are stressed and the potential knock-on effects on global inflation. The conflict is a reminder that heightened geopolitical uncertainty and supply chain disruptions do not bode well for restoring price stability. Should a geopolitical flare-up cause inflation to remain sticky, central banks may be required to keep monetary policy settings restrictive for longer.

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