

BOND MARKET OUTLOOK: Where we see opportunity

[Soft music plays]

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This summer the bond market appears to be wrestling with two key themes: One, how aggressive the central banks need to be with hiking rates to cool inflation.

[Bond Market Key Themes:

1. How aggressive will central banks be to cool inflation?
2. Will being too aggressive cause a recession?]

And two, are these actions being too aggressive, and will these efforts put the economy into recession?

[Computer-generated (CG) images of market data.]

And what we've seen has been an extremely volatile market, as both themes fight for dominance. If we look to the bond market today, we can see that the market is pricing in both of these themes.

[The path of interest rates]

First, there are still multiple rate hikes priced into the futures market, as more efforts are still likely needed to cool demand and ultimately bring down inflation. And two, the yield curve, which is the difference in the 30-year bond yields and two-year bond yields, it's inverted. And historically, the yield curve has had a solid track record of predicting a recession.

[The Federal Reserve building in Washington.]

This likely means that the bond market believes that the central banks are running the risk of causing something in the market to break over the medium term. And this will lead them to eventually potentially start cutting rates. So, it's predicting that the Fed won't be able to orchestrate the soft economic landing it's hoping to achieve. And I don't really think this comes as a surprise to anyone, as rates have already sharply moved higher this year.

[A credit card is swiped. An empty restaurant. A residential neighbourhood. The New York Federal Reserve building.]

And we are already seeing an impact on the consumer, businesses and the housing market.

So much so, that in the U.S. we've already experienced two contracted quarters of GDP, which can be interpreted as a loose definition of a recession.

[An industrial painter polishes a chrome beam. Three men in hard hats take a tour of a warehouse.]

But this is somewhat debated as the U.S. is still in job creation mode.

[The Federal Reserve building in Washington. The Federal Reserve building in St. Louis]

Now, in terms of timing, it's hard to predict, but if we look at the Fed funds futures market, we can see expectations are for the Fed to continue to hike rates over the next six months.

[A person looks at stock market data on a laptop. A person looks at stock market data on a large transparent touch screen. A person looks at stock market data on a cellular phone.]

And after that, the market has already started pricing cuts. Now, what does this mean for risk markets?

[The Bank of Canada.]

Well, risk markets, such as stocks, corporate bonds, and high yield appear to be liking this, especially over the past month, as they see this as the light at the end of the tunnel, where eventually central banks are no longer trying to slow the economy.

[A large hydroelectric facility. A residential neighbourhood.]

How this unfolds will depend on how fast inflation continues to cool, and we are already seeing that in some commodities such as energy and real estate.

[12-month bond market forecast]

Now, over the next 12 months, our expectations are for GDP to materially slow to less than 1% for both Canada and the U.S.

[Low angle view of the Peace Tower in Ottawa. A person shops online using their phone.]

And this is really a reflection of stimulus being pulled away and consumer demand materially weakening thanks to higher rates and elevated inflation.

[Sheets of Canadian \$100 bills being printed. The Bank of Canada Building.]

And for inflation, we do see it peaking, if it hasn't already, but we still expect it's going to remain elevated above central bank targets of 2%, and above historical norms. Within our forecast, we see it still remaining above 5% over the next 12 months. But the good news is we do see the bulk of the move in interest rates higher has already happened.

[Bond documents being signed.]

And in terms of corporate bonds, obviously a recession would imply wider credit spreads, meaning higher corporate bond yields. But a large part of that move has likely already happened.

[Where we see opportunity]

In Canada, we've already seen spreads move materially wider over the past 12 months. With large moves already experiencing some of the highest quality, shorter dated financial bonds, such as bank bail-in securities, which are also some of the most liquid securities in the corporate bond market.

[Timelapse view of the financial district in Toronto at night. CG images of market data.]

And on a yield basis, many of these are trading close to their highest levels since the great financial crisis of 2008, 2009. So we do see shorter dated, high quality credits as being attractive, especially since investors are getting yields between 4% and 5%.

High yield is a different story, and while we do see opportunities in the market, spreads are not at historically cheap levels and in a recession, we could see high yield underperform.

[Two people analyze at stock market data on a large transparent touch screen.]

Still, that doesn't mean there aren't opportunities for investors, especially with proper analysis and focusing on good quality companies.

[Conclusions]

Overall, I'd say I'm a lot more optimistic about the bond market today than at the beginning of the year for two reasons.

[Yields likely already pricing in significant moves by the Fed]

[Images of glass office buildings.]

Again, yields have moved materially higher and have likely already priced in significant moves by the Fed.

[Corporate bonds are cheaper]

[A man on a headset analyzes market data.]

And two, corporate bonds, especially investment grade, has gotten a lot cheaper, offering investors more attractive return opportunities on their fixed income investment holdings, especially in shorter-dated high quality assets.

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