THE YIELD CURVE INVERTS

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Last week the yield curve inverted as 2-year bonds moved to a 3.25% yield and 10-year bonds moved to a 2.95% yield.

“Why does that matter?”, You ask. It’s important to know that financial markets (both bonds and stocks) adjust pricing in anticipation of future events.

For short term rates to move above long-term rates bond investors are selling 2-year bonds at 3.25% yield and buying 10 yrs at 2.95%. Why sell a higher yield to buy a lower yield? You ask. It’s because bond investors expect to make a higher return in the longer maturity. An inverted yield curve often foreshadows a recession, but it doesn’t create the recession. The bond market is looking beyond the economic slow down in anticipation of federal bankers lowering interest rates to stimulate our economy once again. When rates come down longer maturity bonds go up in value and enhance returns for bond investors.

Most retail investors don’t have enough capital to generate meaningful gains in the bond market. We use fixed income to generate interest income, provide liquidity and some safety as an asset class in our portfolio’s.

Canadians have the opportunity to own “Bond Proxies” to achieve higher yield and benefit from the tax efficiency of the dividend tax credit. “Bond Proxies” are simply high quality common or preferred shares that provide consistent dividend yields.

Common and preferred shares fluctuate in price dependant upon economic conditions and the strength of the business cycle, but much like bonds their pricing anticipates future events. The current correction in stock markets is a result of rising interest rates potentially weakening our economy. Central bankers are raising interest rates in a concerted effort to control inflation. It looks like they plan to err on the side of slowing the economy, which will negatively impact earnings for the stock market and hence the current correction in stocks.

The good news is the bond market is anticipating the beginning of the next business cycle. Stock markets tend to follow as the current lag in earnings turns to anticipation of lower interest rates and higher earnings.

In addition, stock markets tend to find the bottom of their correction at times of maximum pessimism. Bank of America just reported a poll that investors are showing “dire levels of pessimism, with expectations of global growth at all time lows, cash levels the highest since 9/11 and equity allocation the lowest since the financial crisis.”

It’s likely that we are at or close to the trough in some sectors of the stock market. We have some financial stocks trading at 8.5 times forward earnings with a 5.5% dividend yield.

Technology companies at 12 times forward earnings with at 2% dividend yield. Industrial real estate trusts valued at 5.5 times earnings with a 5.7% yield.

Don't forget financial markets move in anticipation of future events. The bond market is looking past the potential recession to a more stimulative central bank positioning. The stock market knows expansions follow recessions and will likely begin to look forward to higher growth and earnings.

High quality dividend paying stocks in our opinion are presenting a very good opportunity for long term investors requiring income and growth. For those of us already invested in "Bond Proxies" at a result of the prolonged low interest rate policy we can expect a resumption of positive portfolio returns, and for those with longer term investment horizons, and objectives of growth with tax efficient income, now is a good time to bargain hunt.

Another Point:

Housing start data came out in the US today. Single family starts weakening and multifamily a little stronger. My view is single family supply will continue to be tight and the trend will move towards multi family rental units from ownership. I have been of the opinion single family units would weaken with higher mortgage rates but we're starting to think lack of supply will support pricing in that sector.

Single family homes will become a luxury a lot of families will not be able to afford. However limited supply and our traditional idea of owning a home should protect home prices from any significant decline.

Hopefully we've covered some topics you find interesting and beneficial. Please feel free to call with any questions or comments.

All the best GB, AG, RL

Graham Burns & Andrew Gilchrist