PRIVATE CLIENT SOLUTIONS

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Insights & Strategies

Can the Consumer Continue to Drive Growth?

Please read domestic and foreign disclosure/risk information beginning on page 7. ; Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2. 2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

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Can the Consumer Continue to Drive Growth?

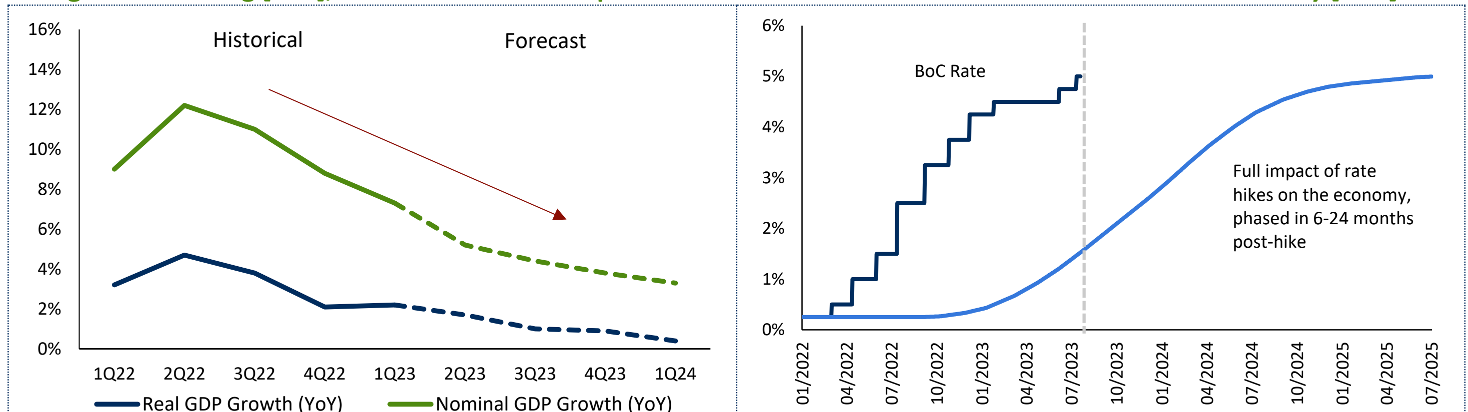
As we continue to debate if Canada, the U.S., and/or the rest of the world, is in, going in, or able to avoid recession, we would like to examine a key driver of economic growth: consumer spending. Household final consumption expenditure is a measure of spending on all goods and services by a country's citizens. In Canada, it represents ~56 per cent of the measure of gross domestic product (GDP), so has significant weight in recession determination, but also in how many companies will see their revenues, profits, and ultimately share prices be affected. What we really want to know here, is how much capacity does the consumer still have to support economic growth, as we consider previous pandemic-era fiscal stimulus efforts, against a global economy being slowed by generally tighter monetary policies.

How did we get here?

In order to protect Canadians and the economy from the negative impacts of the COVID pandemic, the federal government sent out $211 billion in aid to businesses and individuals. In addition, during the pandemic, lockdowns and other precautionary measures restricted spending on goods and services of approximately $180 billion. The Bank of Canada (BoC) estimated that Canadians had used some of these funds to pay down debts or do home improvements, but by the end of 2020, over $100 billion was still sitting in personal bank accounts than would otherwise have been expected. As pandemic restrictions eased this pent-up spending capacity was unleashed on an economy that was struggling to keep up with demand as goods supply chains were disrupted and many services had trouble find employees as workers had retired or shifted to other areas.

As we progress through 2H23, we see a generally acknowledged global economic slowdown. Locally, we have interest rate increases implemented to slow the economy to tackle inflation, specifically by bringing demand in balance with supply. While these efforts have been somewhat successful so far, still strong wage growth, with a tight labour market, low unemployment, and 'excess savings' left over from government aid programs have surprised many recession watchers, pushing forecasts of a decline in GDP first from late 2022 into 2023, and now into late 2023 and perhaps 2024. How much will consumers continue to spend as headwinds mount?

GDP growth slowing [LHS]; and could be further pressured as BOC rate hikes are absorbed into the economy [RHS]



Source: Capital Economics; Bank of Canada; Raymond James Ltd.; Date as of July 31, 2023.

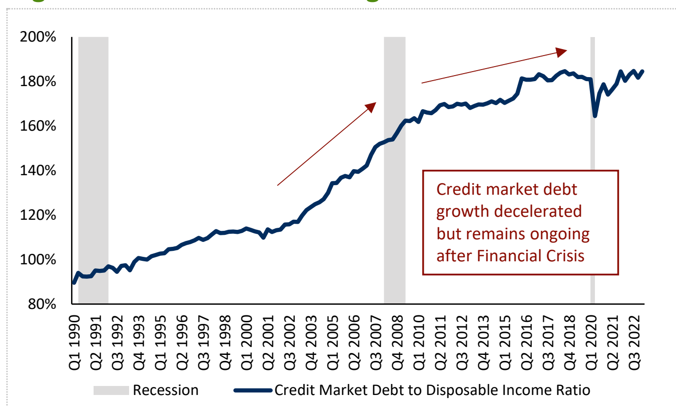
Headwinds are mounting

The BoC rate hikes continue to be absorbed by the economy, impacting a broader cross-section of the population and more of their spending decisions. As mortgages come up for renewals at higher rates, and as Canadians consider loans to replace things like cars or major appliances, the cost of borrowing can become a significant consideration. Additionally, inflation can factor into the cost of a vacation or even a night out, while consumers might also be evaluating the security of their employment. Fiscal stimulus measures may have somewhat muted these concerns, but as the impacts of the global economic slowdown start to become more apparent, and as interest rate increases and savings start to have more influence on spending patterns, we could start to see an impact on GDP figures.

Canadian consumers maintaining high debt levels

Canadians have generally been holding high levels of total debt (including loans and mortgages), representing 184 per cent of their annual disposable income. This is higher than the 137 per cent average in the U.S., although we have been fluctuating around this level since 2016. The difference now is that the cost of carrying this debt is becoming more painful as borrowing costs rise.

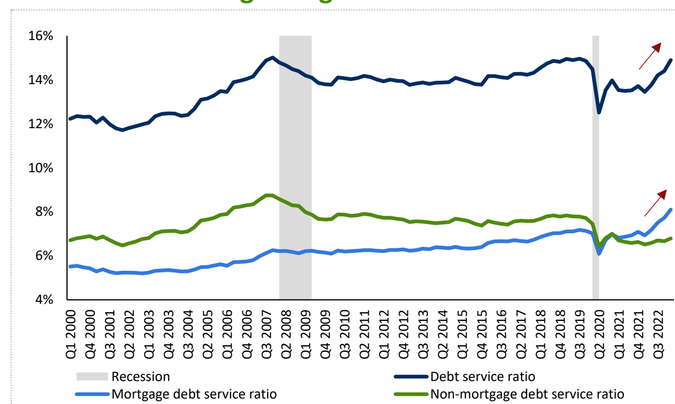
High Debt Levels: The Looming Pain of Rate Hikes



Source: Statistics Canada; Raymond James Ltd.; Data as of March 31, 2023.

As we pointed out already, government support payments and lack of spending opportunities through the pandemic resulted in consumer credit balances declining. This measure went from just over $600 billion in 4Q19 to as low as $560 billion in 2Q21. At the end of 1Q23 we were back up to $594 billion, but still below where we would otherwise have expected to be if the pandemic had not occurred. Overall, this has helped to keep non-mortgage debt service costs from increasing materially despite the increases in mortgage costs. If we consider that total debt service costs are now reaching previous highs, we could see more reluctance to take on more consumer debt for items such as vehicles, and we could expect more cautiousness in other discretionary spending habits.

Total Debt Servicing Rising for Canadians

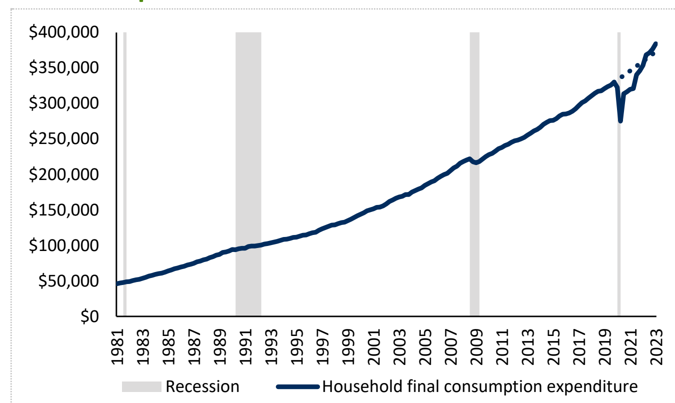


Source: Statistics Canada, Raymond James Ltd.; Data as of March 31, 2023.

We do also want to consider how household spending may have been thrown off by the pandemic. As such, we tracked the major components of household final consumption expenditure, which works into the GDP calculation, to see how each segment fared against expectations had the pandemic not occurred.

Over the 10-year period preceding the pandemic, we had consumption growing at an average annualized pace of ~3.8 per cent. As we can see in the following chart, that spending dropped dramatically at the onset of the pandemic but has now recovered back to expected spending levels.

Current Expenditure Has Exceeded Its 10Y Trend



Source: Statistics Canada; Raymond James Ltd.; Data as of March 31, 2023; in millions of CAD

What is of particular interest is if certain categories of spending over the past couple of years have grown at an excessive rate, we should expect them to come back down to more normalized rates. Similarly, other sectors recovered more slowly, such that we should expect relative strength out of certain sectors as behaviour normalizes.

Recovery of Expenditures Varies Across Different Categories

Expenditure Category	% Weight As of 03/2023	% Change (12/2019 vs. 06/2020)	Annualized % Change (06/2020 vs. 03/2023)	Compare to Pre-Covid Trend
Household final consumption expenditure	100.0%	-16.7%	12.9%	Dipped but then exceed the trend line
Food, beverage and accommodation	7.3%	-52.2%	38.6%	Dipped but then exceed the trend line
Clothing and footwear	3.9%	-43.6%	29.9%	Dipped but back to the trend line
Transport	14.7%	-43.2%	29.0%	Dipped but back to the trend line
Health	4.2%	-23.4%	15.2%	Dipped but back to the trend line
Recreation and culture	8.0%	-19.5%	15.2%	Dipped but then exceed the trend line
Miscellaneous goods and services	5.1%	-23.2%	15.1%	Dipped but back to the trend line
Furnishings and household equipment	5.5%	-6.1%	9.7%	Dipped but then exceed the trend line
Housing, water, electricity, gas and other	25.1%	1.0%	6.6%	Exceed the trend line
Education	1.7%	-2.3%	5.5%	Dipped but back to the trend line
Food and non-alcoholic beverages	9.6%	8.1%	4.9%	Exceed the trend line
Communications	2.5%	-1.6%	3.7%	Follow the trend line
Insurance and financial services	8.4%	0.4%	3.7%	Exceeded but back to the trend line
Alcoholic beverages, tobacco and cannabis	3.6%	5.1%	3.1%	Follow the trend line

Source: Statistics Canada; Raymond James Ltd.; Data as of March 31, 2023. Ranked by annualized percentage change (06/2020 vs. 03/2023), descending.

Using available data from Statistics Canada, we can see in the above table how significant of a pullback we saw through the beginning of the pandemic to mid-2020. In the almost three years since, we rank the annualized growth and how overall spending fares against the previous trend line. Of note, housing has increased as rental costs have climbed, food & beverage has been encountering inflation that is not only higher than that of other categories but also higher than its own previous level, and furnishings have exceeded the trend line but is seeing modest signs of slowdown, as is overall retail sales.

Watching for a slowdown

We are now starting to see growing signs that the long-awaited economic slowdown will occur through the end of 2023 and into 2024, as those previous rate hikes take hold on consumer behaviour. Looking at retail sales values in Canada, May numbers were relatively flat from April, up only 0.2 per cent, and volumes were only up 0.1 per cent. This was a downward revision from the preliminary estimate of 0.5 per cent. The preliminary estimate implies that retail sales values in June will be unchanged from May, although given that gasoline prices picked up over that time, we could be looking at retail sales volumes declining. Overall, we remain cautious as we watch the data come out.

Neil Linsdell, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

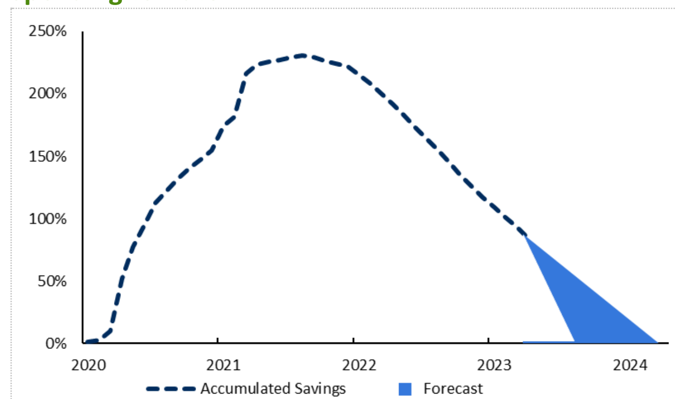
U.S. Consumers And The Economy

Government efforts during the COVID-19 pandemic to prevent an even more serious economic crisis produced one of the largest fiscal efforts in recorded history, perhaps only behind the fiscal efforts delivered during the Great Depression with the implementation of the New Deal, and the efforts delivered during the Second World War, as the U.S. government 'guided' the U.S. economy in the production of war/military goods rather than consumer goods/services.

In this case, the Trump administration (and later, the Biden administration) engineered an expansion in fiscal policy that gave direct subsidies (in the form of direct checks as well as extra monies for those collecting unemployment insurance) to individuals and businesses (in the form of PPP loans, i.e., grants). This was along side other efforts that included cash grants to airlines (US$25 billion), cargo carriers (US$4 billion), airline contractors (US$3 billion), hospitals, health care systems and providers (US$130 billion), and billions in loans to state and local governments (US$150 billion), etc[1]. The direct check program was somewhat reminiscent of the one signed by George W. Bush during the 2008 financial crisis, or Great Recession, but it was much larger in scope, reach, as well as in terms of the size of income transfers to individuals and businesses.

This fiscal expansion through income transfers produced an immense surge in disposable personal income during a time when consumers were limited in their mobility by the effects of the COVID-19 pandemic, generating an impressive accumulation of savings that consumers/businesses have been deploying since the end of the pandemic recession.

Record Cash in Accounts Has Supported Consumer Spending to Date

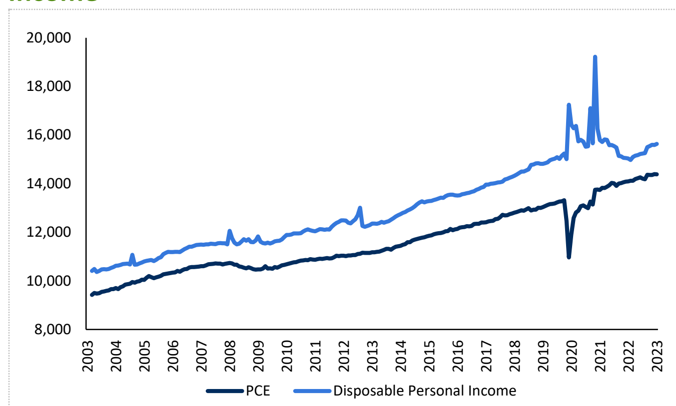


Source: FactSet; Raymond James & Associates; Raymond James Ltd.; Data as of April 30, 2023. Accumulated savings as a percentage above the pre-COVID trend line.

[1] "History of Stimulus Packages," Center Forward, Center Forward Basics, July 2020, https://center-forward.org/wp-content/uploads/2020/07/Final-History-of-Stimulus-Packages.pdf

However, these monies are being depleted and consumers/businesses are, once again, depending more and more on 'old-fashioned' increases in income from jobs/earnings from businesses to continue to spend going forward. Thus, the ability of the U.S. economy to grow during the rest of the year, as well as into next year, depends fundamentally on the ability of firms to continue to create jobs, but more importantly, on their ability to keep those already employed in their jobs. That is, for individuals to continue to consume today they need to count on the flow of disposable personal incomes generated by having jobs.

Personal Consumption Expenditure vs. Disposable Income



Source: FactSet; Raymond James Research; Raymond James Ltd.; Data as of May 31, 2023.

The stock of monies accumulated during the pandemic are no longer available for the majority of Americans. Thus, going forward, the fate of the American consumer will be inextricably linked to the flow of incomes from jobs and less so to access to credit, as interest rates continue to go higher, and lending continues to dry up. Furthermore, because employment has remained strong and inflation is coming down, i.e., the disinflationary process has continued unabated, real disposable personal incomes, that is, the purchasing power of the flow of income, has started to improve, which will come in handy as excess savings continue to be depleted.

However, what we saw with the June nonfarm payroll employment release was, perhaps, the first sign of weakness in U.S. employment creation that was masked by an increase of 60,000 new jobs at the government level, mostly created by state and local governments. Job growth in the private sector slowed down to 'only' 149,000, with almost half of those jobs created by the health care and social assistance sector (up 65,2000 jobs in June). This is a sector that, typically, does well during a weak economy. Furthermore, the leisure and hospitality sector, a sector that still lags compared to pre-pandemic levels, added another 21,000 jobs during the month of June, the same number as those added by the professional and business services sector while other services added 17,000 jobs.

However, some of the most important service sectors, retail trade, transportation and warehousing, wholesalers trade, and temporary help services within the professional and business services sector, etc., subtracted jobs during the month and could be the first sign that the service sector, while still not falling apart, is starting to slow. Furthermore, the weakness in consumer prices during June is probably another good indicator that the economy, but especially the service side of the economy, is starting to slow, which is what the Fed has been looking to achieve for a while.

To conclude, the fate of the U.S. economy during the second half of the year depends on the fate of the U.S. consumer while the U.S. consumer's fate depends on the ability for jobs to continue to grow and for those employed to continue to earn an income. Thus, any weakness or reversal in job creation will create problems for the American consumer as well as for the U.S. economy.

Eugenio J. Alemán, Ph.D.
Chief Economist (RJA)

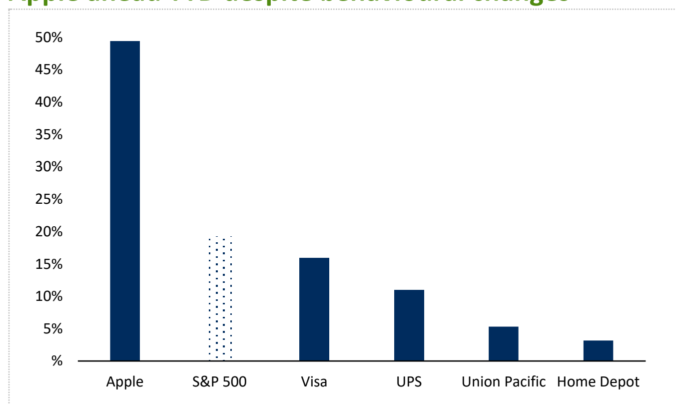
A "Boots-on-the-Ground" Perspective

In the ever-evolving post-pandemic economic environment, the spending habits of the North American consumer play an important role. Fiscal measures taken during the pandemic swelled bank accounts and provided a cushion for excess spending. Yet, the lingering question remains: how sustainable is this trend? To gain insight into the consumer's pulse, we've analyzed recent quarterly earnings calls from select US and Canadian companies within retail, tech, finance, and logistics, that have mentioned the health of the consumer on their calls.

American consumer

Diving into the vast U.S. market, we discern a multifaceted narrative from management teams in Q1/23. Tech giant Apple (AAPL-US) saw consistent customer behaviour amidst macroeconomic pressures, noting a surge in services such as Apple Pay and Apple Card. Payments company Visa (V-US) presents a nuanced view. Despite spending dips in categories like fuel, there's robust expenditure in sectors like travel and entertainment, which hints at a re-emergence of experience-driven spending. Building materials and home improvement products retailer Home Depot (HD-US) highlighted a trend of customers shifting from larger to smaller projects, with decreased demand for big-ticket items. However, logistics company United Parcel Service (UPS-US) paints a more cautious picture, with a deteriorating volume environment so far this year driven by a challenging macro landscape and an evident consumer pivot from goods to services, the latter also echoed by railroad company Union Pacific (UNP-US). In essence, these firms showcase a US consumer whose priorities are evolving in a post-pandemic world amid the current macroeconomic setting. While some sectors like technology and services are seeing growth, others hint at more restrained spending.

Apple ahead YTD despite behavioural changes

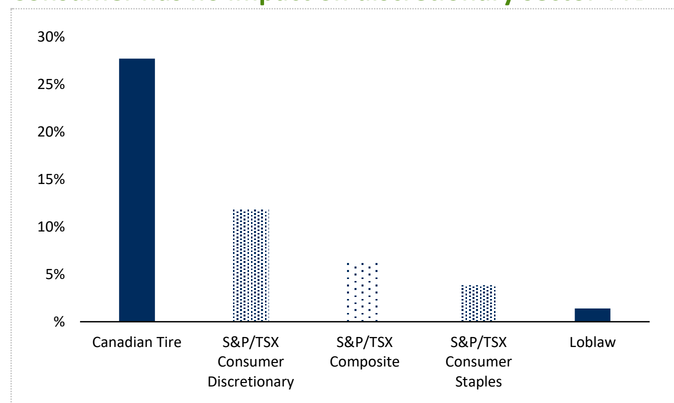


Source: FactSet. Raymond James Ltd. As at July 21, 2023

Canadian viewpoint

In Canada, we see a more cautious consumer narrative emerge. General merchandise retailer Canadian Tire (CTC.A-CA) highlighted a slowdown in credit card spending, the first since 2020, hinting at a more discerning shopper, with consumers remaining circumspect about where they splash their cash. This trend is further emphasized by some banners, like Mark's and SportChek, seeing boosted sales through increased promotional efforts. This suggests Canadians are recalibrating their spending priorities, especially with activities like travel and dining out becoming more prevalent. Grocer Loblaw (L-CA) observed a move towards discount brands and private labels. Interestingly, while the restaurant sector remains strong, Loblaw notes a trend of Canadians opting for value-added food, possibly replacing regular restaurant visits with premium home dining. In essence, the Canadian consumer is becoming more careful, prioritizing value in their purchases. It seems the pandemic's windfall of savings is encountering economic realities.

Consumer has no impact on discretionary sector YTD



Source: FactSet. Raymond James Ltd. As at July 21, 2023

Defensive gameplan

The snapshot provided by corporate America and Canada reveals a North American consumer that's evolving, becoming more selective, and adapting to economic pressures. Both U.S. and Canadian corporations are navigating uncertain waters, with inflationary concerns being a consistent theme on earnings calls. For investors, this environment suggests a game plan that leans towards defense, including sectors such as consumer staples, communication services, and utilities within portfolios, whilst also remaining focused on quality companies, names that have clear competitive advantages, strong management teams, resilient balance sheets and a solid runway for growth opportunities ahead.

Larbi Moumni, CFA
Head of Portfolio Advisory & Portfolio Manager

ETF & Mutual Fund Flows

To gain a better sense of market sentiment and behaviour for each asset class and sector, analyzing fund flows can help investors understand which asset classes are popular and how investors are positioning their investments. Over the previous three months (April 1 – June 30, 2023), the top inflows were led by fixed income categories and were aligned for each investment vehicle. For ETFs, the top categories include **Canadian money market**, **emerging markets equity** and **Canadian fixed income.** Whereas for mutual funds, the top categories were **Canadian money market, Canadian fixed income** and **global fixed income**.

ETF flows

As interest rates continue to climb higher in 2023, the money market category continued to lead flows across the board. While HISA ETFs led flows again, given the recent OSFI review of liquidity treatment for wholesale funding sources with retail-like characteristics, we have also seen a rise in traditional (non-HISA) money market strategies. Below are some notable money market strategies outside of HISA ETFs that have experienced strong inflows over the past three months.

Notable "Non-HISA ETF" Money Market 3-Mth Flows

ETF:	Ticker	Inception Date:	Flows ($M)
Horizons 0-3 Month T-Bill ETF CAD	**CBIL**	4/12/2023	317
BMO Money Market Fund ETF Series	**ZMMK**	11/29/2021	251
Purpose Cash Management ETF	**MNY**	9/14/2022	108
iShares Premium Money Market ETF	**CMR**	2/19/2008	95

Source: Morningstar, Raymond James Ltd. Data as of June 30, 2023.

Lastly, the emerging markets equity category experienced a high volume of ETF investor interest, principally driven by institutional trading activity in the **iShares ESG Aware MSCI Emerging Markets ETF (XSEM.TO)** - receiving over $1.4 billion in inflows over the previous three months.

Leading Categories for 3-Mth ETF Flows vs. Comparable 3-Mth Mutual Fund Flows

Rank	Category	ETFs ($M)	Funds ($M)
1	Canadian Money Market	3,326	3,006
2	Emerging Markets Equity	1,917	(140)
3	Canadian Fixed Income	1,873	2,710

Source: Morningstar, Raymond James Ltd. Data as of June 30, 2023.

Mutual fund flows

Fixed income mutual funds continued to top the inflow leaderboard with money market strategies playing out as a persistent theme throughout 2023. While there are many passive ETF strategies one can leverage to construct a fixed income portfolio, it can also be valuable to outsource this sleeve to a dedicated and experienced fixed income manager with capabilities across a wide range of fixed income sectors.

Many Canadian investors appear to be leveraging these active mutual fund strategies within this rapidly changing interest rate market environment as shown below.

Leading Categories for 3-Mth Mutual Fund Flows vs. Comparable 3-Mth ETF Flows

Rank	Category	Funds ($M)	ETFs ($M)
1	Canadian Money Market	3,006	3,326
2	Canadian Fixed Income	2,710	1,873
3	Global Fixed Income	1,644	814

Source: Morningstar, Raymond James Ltd. Data as of June 30, 2023.

ETF & Mutual Fund Flows (April 1 – June 30, 2023)

Category	ETFs ($M)	Funds ($M)	Combined ($M)
Canadian Money Market	3,326	3,006	6,332
Canadian Fixed Income	1,873	2,710	4,584
Global Fixed Income	814	1,644	2,458
Multi-Sector Fixed Income	579	1,374	1,952
Emerging Markets Equity	1,917	(140)	1,777
Global Corporate Fixed Income	687	740	1,427
Canadian Long Term Fixed Income	530	519	1,049
Global Equity	1,060	(309)	751
US Money Market	248	334	582
Canadian Equity	210	291	501
Financial Services Equity	419	11	430
Geographic Equity	778	(378)	400
Sector Equity	206	(102)	104
Emerging Markets Fixed Income	71	12	83
Preferred Share Fixed Income	(207)	258	51
Asia Pacific Equity	1	(17)	(16)
Global Small/Mid Cap Equity	107	(152)	(45)
North American Equity	(9)	(54)	(63)
Commodity	(55)	(20)	(75)
Greater China Equity	(105)	4	(101)
Global Infrastructure Equity	(15)	(116)	(131)
Canadian Inflation-Protected Fixed Inc	(28)	(105)	(134)
Real Estate Equity	(145)	(7)	(152)
Natural Resources Equity	(78)	(97)	(174)
Precious Metals Equity	(110)	(73)	(182)
Canadian Small/Mid Cap Equity	16	(282)	(266)
Canadian Dividend & Income Equity	186	(465)	(279)
Energy Equity	(162)	(143)	(305)
European Equity	(46)	(275)	(321)
Canadian Short Term Fixed Income	(84)	(274)	(358)
Floating Rate Loans	(166)	(202)	(368)
International Equity	533	(927)	(394)
US Small/Mid Cap Equity	(87)	(413)	(501)
Canadian Equity Balanced	(19)	(659)	(678)
Canadian Corporate Fixed Income	143	(829)	(686)
High Yield Fixed Income	(249)	(440)	(689)
Global Equity Balanced	192	(1,051)	(860)
Canadian Neutral Balanced	20	(997)	(977)
Canadian Focused Equity	135	(1,161)	(1,027)
Canadian Fixed Income Balanced	(11)	(1,639)	(1,650)
Global Fixed Income Balanced	42	(2,630)	(2,588)
Global Neutral Balanced	203	(3,805)	(3,602)
US Equity	(1,113)	(2,666)	(3,780)

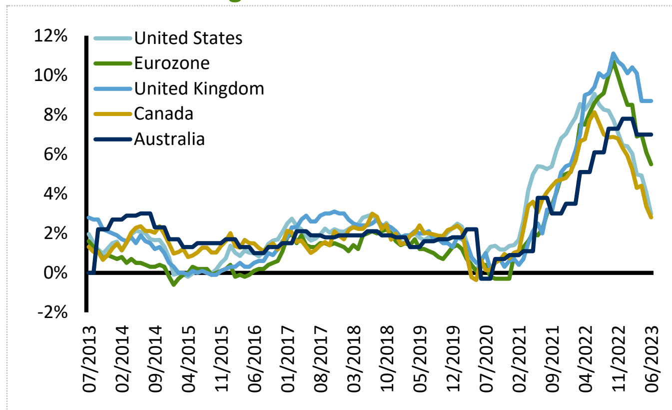
Source: Morningstar, Raymond James Ltd. Data as of June 30, 2023.

Luke Kahnert, MBA, CIM
Mutual Fund & ETF Specialist

The Proximity to Terminal Rates in View

While persistent price pressures across the developed world continue to show signs of deceleration, thanks in large part to an unprecedented global rate hiking cycle, central banks continue to fight the good fight and may have to wait a bit further before having their hands raised in victory. What is true however, is that we may finally have a glimmer of terminal policy rates in sight. But do not pop the champagne just yet.

Economies Shifting into Disinflation Gear

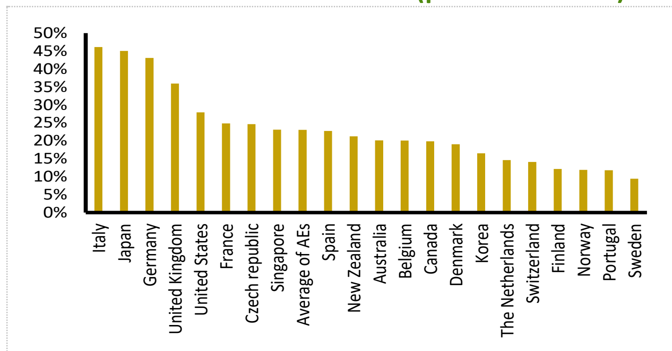


Source: FactSet; Raymond James, Ltd.; Data as of July 19, 2023

A stimulus party for the ages

The sheer size and scope of global fiscal and monetary stimulus policies aimed at mitigating some of the early pandemic shocks, reverberated through markets and, with supply chain disruptions, sent inflation soaring. The DXY US Dollar Index slid around 13 per cent during 2020 when the Fed slashed rates to near zero, buoying investor appetite for risk. In 2021, a relatively robust U.S. economy and apparent "American exceptionalism" theme began to lift the U.S. dollar higher on the heels of the Fed's monetary policy tightening cycle, which kicked off in early 2022. This quickly reintroduced the monetary policy divergence play between the Fed and other key central banks, further fueling U.S. dollar strength in the process.

A Global Fiscal Stimulus Bazooka (per cent of GDP)

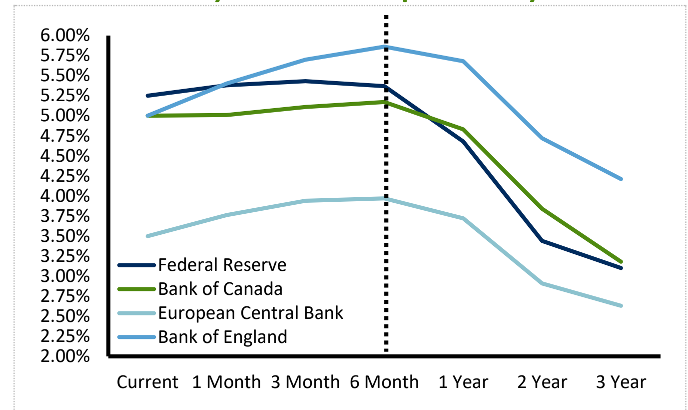


Source: IMF.org; Raymond James, Ltd.; Data as of September 27, 2021

Feeling enough pain?

The U.S. dollar has been feeling the weight of inflationary data, showing a cooling of price pressures. As a result, the market has been busy tweaking their expectations and trying to call the eventual top to the Fed's rate-hiking cycle and the timing and breadth of subsequent rate cuts. As it stands, the market expects the Fed to "out-dove" other major central banks over the course of the next one-to-two years, with rate-cutting cycles from some of the major central banks set to kick off as early as next year according to market implied policy rates.

The Market's Crystal Ball for Implied Policy Rates



Source FactSet; Raymond James, Ltd.; Data as of July 19, 2023

We believe market pricing for the Fed's eventual terminal rate will be of little concern for the broader U.S. dollar at this stage. Instead, the extent of rate cuts following the Fed hitting its terminal rate will be of more importance going forward. The same goes for the BoC, especially with both central banks expected to begin easing around the same time next year. Prior to that however, we anticipate a holding period to allow officials the time to assess the still-developing effects of previous hikes on the real economy. At the time of writing, the market is calling for one additional rate hike from each of the Fed and BoC, by the end of this year. However, the real trick will be to ensure that policy rates are not too restrictive when accounting for inflation to stick a "soft" landing.

Meanwhile, as inflationary pressures across Europe have proven to be more painfully resilient than anticipated, both the ECB and BoE are expected to continue pressing on the gas, inevitably kicking their respective rate-cutting cans a bit further down the road. This just adds further fuel to the U.S. dollar weakness theme to follow once the Fed hits the breaks.

Therefore, we recommend taking advantage of any rallies in the U.S. dollar to layer-off some exposure in anticipation of the Fed nearing the end of its rate-hiking cycle.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Higher for Longer

The resilience of the post-COVID consumer is undeniable at this point, with consumer spending a key driver through the recovery. We've seen this translate to high inflation (though falling fast) and more recently, elevated volatility in yields. This has made it more difficult for bondholders. However, more challenging does not equate to opportunity-free, as we continue to see areas of value in the Canadian fixed income market. We believe that the higher-for-longer narrative will translate to potential risks for reinvestment, but presents an opportunity to capitalize on higher yields today, especially for buy-and-hold investors.

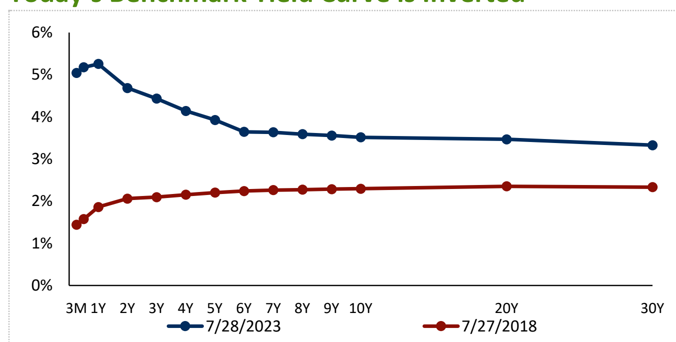
Central banking, centre stage

The BoC kicked off the year with a rate hike at its January meeting, but then held steady for the following two announcements. We see this hold underlining the bank's willingness to let higher rates work their way into the economy, but evidently, inflation lingered at a level too high for comfort, as they increased the overnight rate in both June and July. The BoC remains committed to combatting inflation with the most recent (largely expected) rate hike, accompanied by a statement that was seen as more hawkish than anticipated. In the monetary policy report (MPR), the BoC extended its timeline for returning to the targeted two per cent inflation rate by six months to mid-2025. To us, this suggests that higher rates should stick around for longer as well. Consensus is a coin flip for another rate hike in 2023, further supporting that although rates may not climb much higher, they are not expected to fall.

Inversion continues

Inversion describes an environment where front-end yields are higher than those with longer maturities. This is the current state of the Canadian benchmark yield curve, comprised of Government of Canada on-the-run bonds. The difference between 2-year and 10-year treasury notes is 117 basis points, with the 2-year yielding more. A normal sloping yield curve has short-end yields that are lower than longer-dated ones.

Today's Benchmark Yield Curve is Inverted



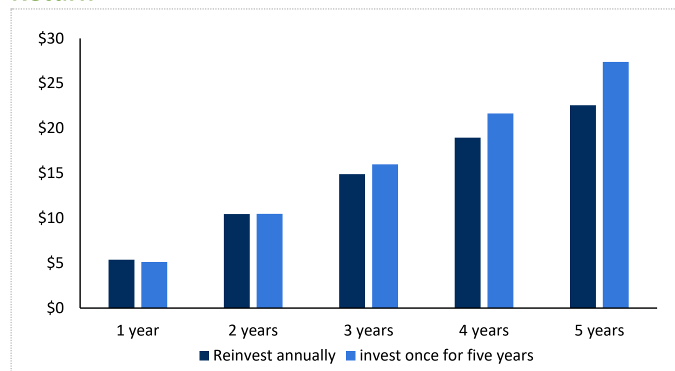
Source: Bloomberg; Raymond James Ltd.

Despite still sporting inversion, Canadian corporate securities have a flatter yield curve (taken as a whole) and offer a substantial pick up in yield, so the penalty for extending term is not as severe as GoC issues. We do recommend that investors focus on higher-quality names when investing in the corporate space, especially when buying individual bonds directly. Though we almost always recommend this approach, it is even more noteworthy as recession concerns rise.

Increase duration

As we approach the conceivable end of this hiking cycle, one of the biggest risks for buy-and-hold investors, in our view, is the rate they may receive when they reinvest their proceeds. In rising-rate environments, investors who reinvest coupon cashflows benefit from this risk, as they receive a higher rate of return than initially anticipated. However, in falling-rate environments, the opposite holds true; proceeds from a fixed income investment (coupon or principal) may be re-invested at a lower interest rate.

Buying a Longer-term Bond May Provide a Higher Return



Source: FactSet; Raymond James Ltd. Assumes prevailing 1-yr rates of 5.30 per cent, 4.75 per cent, 4.00 per cent, 3.50 per cent, then 3.00 per cent. Cumulative return (minus principal) displayed.

We suggest that investors consider a few different approaches to best position themselves today:

- **Extend term**. Although a shorter bond may offer a higher rate in today's environment, there are benefits to investing for a longer period. Holding a longer-maturity bond means elevated yields for longer and reduces the frequency of principal reinvestment. Even when taking account of prevailing interest rates for coupon cashflows, investing in a five-year bond could result in a higher total return.
- **Avoid cashflows.** If cashflow is not required by the client, consider strips or compound GICs. As these products do not pay coupons during their life, the implied yield to maturity will match return if held until maturity.

Charlotte Jakubowicz, CMT, CIM
Vice President, Fixed Income and Currencies

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