QV UPDATE
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Wendy Booker-Urban

QV Investors Inc.

## Bonds…not so boring after all

There has been a lot of talk recently about bonds in the news media. The CBC ran a headline news article on its website featuring actor Daniel Craig portraying the film character James Bond, and the headline, "The potential bond crisis no one has heard of". Not to be ignored, the Globe and Mail also attempted to spark interest in bonds, using the headline "Hotel California", and referencing the famous lyric in the Eagles song, "one could checkout…but never leave", to warn about the challenge facing bond investors if everyone exits their bond positions at the same time.

Pop culture references aside, "boring bonds" are garnering more media attention this year, primarily due to the large swings in global bond yields over a short period of time. The main Canadian benchmark bond index, the FTSE TMX Universal Bond Index, is down -1.5% over the past three months. This compares to a first quarter return of +4.2%. Elsewhere, the US 10-year Treasury bond yield has increased 72 basis points (0.72%) to 2.4%, since reaching a low of 1.68% in January. German government bond yields fell to a low of 0.05% in April, and now trade at 0.88%, representing a 7.4% price move in six weeks. This level of volatility is not unusual for the equity markets, but it is unusual for bonds. Our shorter term, defensive strategy has helped limit the volatility in our two main bond funds as the QV Canadian Income Fund is down 0.1% and the QV Canadian Bond Fund is down 0.5% for the three months ending May 31st. Year over year, our bond returns are positive at 3.6% and 6.1%, respectively.

The underlying causes for the volatility are varied and important to reflect upon after six years of unprecedented monetary stimulus policies. The liquidity concerns expressed in the financial media are warranted. Bonds are traded through investment dealers, typically owned by the major banks. The dealers act as intermediaries, linking buyers to sellers, and taking a spread between the price the bonds are bought and sold at. New rules governing banks since the financial crisis restricts the size of their inventory. This has the potential to limit their ability to facilitate large bond trading volumes to mitigate price moves, leading to reduced market liquidity.

Added to this issue is the fact that many investors are now in a position of risk in the bond market. Investors have been increasingly extending term and investing in corporate high yield bonds to boost income in this low interest rate environment. This has been one of the main objectives of the extraordinary stimulus policies- move investors into riskier positions to encourage lending and stimulate investment in the private sector. What happens when this "trade" reverses? We are starting to see the consequences with these large, short-term price swings.

The recent rise in yields in the US bond market can be explained by communications from the US Federal Reserve stating that the long anticipated rate hike may occur in 2015 if economic data continues to improve. May's encouraging employment report boosts the chances of a rate hike this year. All indications from the Fed stress a slow pace to this policy rate normalization. Therefore, the recent rate of change in the 10-year US Treasury Bond yield may not be justified given the prospect of a slow tightening cycle. However, one could also argue that the yield drop in January was not warranted in the first place. Regardless of the level, global economic uncertainty, coupled with reduced liquidity, equates to more volatility. Investors following the "Fed trade" are moving quickly out of market sectors that have benefitted from these low interest rate policies. They also may move quickly back in if economic data disappoints. The lack of bond liquidity exacerbates these moves.

Our bond strategy will continue to emphasise risk mitigation through our short term positioning. We were early in moving to this more defensive strategy, leading to weaker performance compared to the longer term benchmark in 2014. We held the view that long term bond yields were not attractive to compensate for the risk of rising interest rates. We are still of that view even with the recent increase in yields. Our long term focus and patient opportunism will guide us in navigating through this "shaken, not stirred" bond market.