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Weekly Commentary

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The Bond Market Conundrum

Historically, bonds have acted as a stabilizing force when equity markets are weak. In “normal” times, bond prices will move counter to stock prices, and this has held true throughout history. This is the basis of the underlying principle that diversifying across different asset classes (i.e. stocks, bonds and alternatives) makes sense: when stocks fall, bonds prices tend to rise. This hasn’t happened in 2022 as both stocks and bonds have fallen. It’s looking very much like 2022 will go on record as the worst year ever for bond holders.

While there are several culprits for the bond market’s poor performance, we believe a brief refresher on how the bond markets function will be helpful. The first principle is to understand that when interest rates rise, bond prices fall. The rationale for this inverse relationship is in “the math”. When interest rates are rising, fixed-income money managers and bond investors will sell lower yielding bonds to purchase higher yielding bonds. This is a basic fact inherent in bond markets. Prices and interest rates move in opposite directions.

Other factors impact the price of a bond: quality (risk of default), time to maturity (long versus short duration) and the bond’s currency and issuer credibility. For example, U.S. government bonds are less risky than bonds issued by an emerging economy country like Brazil or India. There are also differences between government issued bonds and corporate bonds as the default risk of investment grade government debt is generally much lower than that of a corporation. At the corporate level, companies that are viewed as “high risk” must issue bonds that pay a higher rate of return compared to higher quality corporations. For example, a Canadian chartered bank is a less risky investment compared to a typical “startup” technology company that may never become profitable.

What makes bonds so attractive is that they provide investors with a steady stream of income. This is particularly important to pension fund managers and individuals who rely on bonds for income. However, it’s equally important to consider that the market value of any security will impact the market value of a portfolio. The overriding challenge that bond investors currently face is as follows: the **rapid rise in interest rates** on the heels of artificially low rates that central bankers used to support the economy during the pandemic, and the **rapid rise in inflation** attributed to historically low interest rates prior to this year, supply chain disruptions caused by the pandemic, and the impact of the Ukraine crisis on rising food and energy prices.

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Let's remember that interest rates approached zero during the lows of the pandemic and in fact, went into negative territory in some countries (Germany and Japan). The crux of the problem lies in the speed at which central bankers have raised rates in 2022. In the U.S., the "Fed" has increased rates by 75 basis points (0.75%) at three consecutive policy meetings and a fourth increase of 75 basis points is expected next week. This equates to a sixteen-fold increase between March (0.25%) and November (4.00%). It's no wonder why bond investors have paid such a hefty price!

The second conundrum is inflation. Fed Chairman Jerome Powell has been very clear about the Fed's trajectory of raising interest rates and has been forceful in his determination to continue with the Fed's aggressive policy until economic data shows signs that rapidly rising inflation is tempered. The concern amongst investors is that an overly aggressive Fed policy will lead us into a recession. Current Fed policy has been purposefully designed to inflict economic pain through higher mortgage rates, falling asset prices, lower employment numbers, reduced consumer spending, a postponement of capital spending, and hiring by businesses. The jury is out as to whether a significant recession is inevitable.

Interestingly, we are presently in the midst of a scenario where bad news on the economy is good news for the markets. Chairman Powell is resolved to being data-dependent concerning future rate decisions. In the interim, investors have become reliant on economic headlines as indicators regarding future interest rate decisions. Rising unemployment, falling house prices, lower spending, and the rising cost of credit are being viewed as good news when rates, and thus inflation, are showing signs of peaking. Eventually the bad news will be absorbed into the data the Fed is determined to rely on and that a softening of the Fed's aggressiveness will imply that a bottom in the markets is on the horizon.

This year has been the worst in memory for both stocks and bonds. The silver lining is that aggressively rising interest rates cannot persist for much longer without creating economic consequences. Eventually, inflation data will improve, and interest rates will peak. Equity and bond markets, which have historically outperformed in a falling rate environment, should respond favourably once central bankers begin signalling that rates have topped.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$7.95	-12.14%
Palos Equity Income Fund - RRSP	PAL101	$6.23	-12.06%
Palos Merchant Fund L.P. (Dec 31, 2021) [2]	PAL500	$1.16	24.67%
Palos WP Growth Fund - RRSP	PAL213	$12.39	-37.02%
Palos-Mitchell Alpha Fund [3]	PAL300	$8.35	-22.89%
S&P TSX Composite (Total Return with dividends reinvested)			-8.95%
S&P 500 (Total Return with dividends reinvested)			-20.27%
S&P TSX Venture (Total Return with dividends reinvested)			-36.80%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.22%
Canadian Government 10-Year			3.62%
Crude Oil Spot			US $85.05
Gold Spot			US $1,651.00
US Gov't10-Year/Moody BAA Corp. Spread			225 bps
USD/CAD Exchange Rate Spot			US $0.7332

[1] Period ending October 21st, 2022. Data extracted from Bloomberg
[2] Fund is priced annually
[3] Fund is priced weekly on Tuesdays

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