Canadian Bond Investors Should Consider Going Global

Investing in foreign bonds could boost yields and reduce volatility.

March 2021

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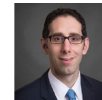

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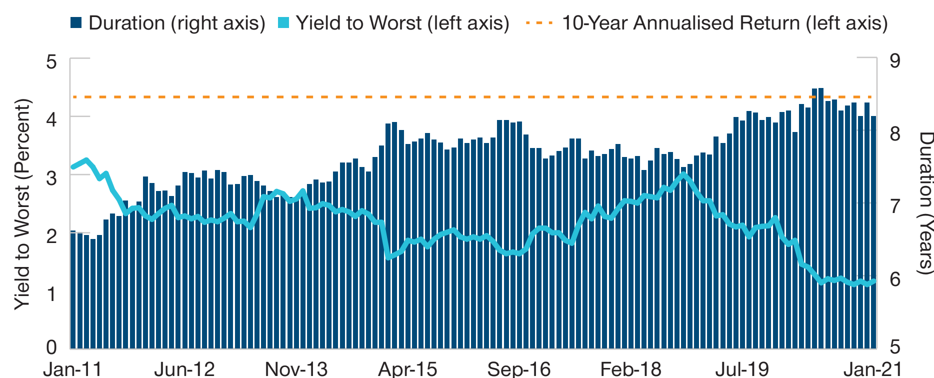
KEY INSIGHTS

- With yields on Canadian government bonds having recently been close to record lows, Canadian investors need to cast a wider net for returns.
- Investing across global corporate bonds, emerging market local debt, securitized bonds and high yield debt could boost returns and improve diversification.
- Managing currency risk—for example, through liquid currency options or forward contracts—is a key requirement of a global fixed income strategy.

Canadian investors have traditionally displayed strong home bias in their fixed income portfolios, for understandable reasons: investing in domestic bonds is seen as simpler, cheaper and less risky than venturing into foreign markets, and the yields available from Canadian government bonds have been attractive enough to avoid forcing the issue. However, with Canadian bond yields having recently been close to record lows, investors may need to consider broadening their horizons to gain higher yields and/or diversify away from the local interest rate cycle.

Canadian Bond Yields Were Recently Close to Record Lows

(Fig. 1) Bloomberg Barclays Canada Aggregate Bond Index yields just over 1%



Past performance is not a reliable indicator of future performance.
As of 31 January 2021.
Source: Barclays Live (see Additional Disclosures). Analysis by T. Rowe Price.

> “…sovereign bonds begin to lose their diversification benefits when yields fall close to zero.…
>
> — **Ken Orchard**
> *Portfolio Manager, Fixed Income Division*

The tendency of Canadian investors to avoid straying too far from home is hardly unique: Investors across the world typically prefer to stick to what they know, particularly if there is no compelling reason for them to do otherwise. Compared with domestic bonds, foreign bond markets will usually seem more complex, less transparent and riskier. Media reports on other countries invariably focus on bad news, adding to the impression that overseas markets are unpredictable, volatile and difficult to comprehend.

Investing in foreign bonds brings currency risk, potentially increasing the volatility of a portfolio, and hedging this risk through derivatives may seem a daunting prospect for many investors. The sheer breadth and heterogeneity of the global bond market mean there are innumerable different ways to build a global fixed income portfolio—and in the absence of a universally accepted benchmark, it can be difficult to compare the approaches and styles of different managers. Faced with these challenges, it is little wonder that many Canadian investors have decided that the incremental benefit of adding global fixed income to their bond portfolios does not justify the perceived additional risk—especially when the yields on many foreign developed market bonds have been very low or negative.

Yields May Rise, but Are Likely to Remain Low

Times have changed, though. Like most countries, Canada has suffered a significant economic decline because of the coronavirus. Quantitative easing from the Bank of Canada (BoC) has driven the yields on Canadian bonds to very low levels (Canadian 10-year bonds were yielding around 0.8% in mid-January), while the country’s budget deficit has ballooned to a historic high of more than 16% of gross domestic product. The BoC has said that it will hold the policy interest rate at its current level of 0.25% until the economy recovers, the labour market tightens and inflation reaches a consistent 2%. However, Tiff Macklem, the bank’s governor, has admitted that he believes the economy “will still be operating below its potential into 2023.” As such, while it is possible that rates will rise as life slowly returns to normal after the coronavirus, we expect Canadian yields to remain lower than historical averages for an extended period.

Persistently low yields will pose several challenges for investors with heavy allocations to Canadian government bonds. For example, sovereign bonds begin to lose their diversification benefits when yields fall close to zero, rendering them less effective as a hedge against equity market volatility.

Bond volatility also rises when yields are very low as duration effects increase, which is a headache for portfolios that target volatility as part of their risk management. Figure 1 shows that duration on the Bloomberg Barclays Canada Aggregate Bond Index has risen from 6.6 years 10 years ago to 8.4 years today—meaning that a 100bp increase in rates will now result in a price loss of approximately 8.4%, as opposed to an approximate 6.6% loss a decade ago.

Finally, while the BoC is not expected to raise its policy rate anytime soon, portfolios with heavy concentrations of low-yielding sovereign bonds will be vulnerable to rising long maturity interest rates or even rate hikes when they eventually occur. If Canadian bond yields were to rise significantly due to a combination of fiscal stimulus and vaccine distribution leading to a post-COVID normalization, investors may want to diversify away from their local interest rate cycle to find countries whose interest rates may not be increasing at the same pace.

For these reasons, Canadian investors seeking higher yields and more effective diversification over the next few years will almost certainly need to reduce their exposure to Canadian government bonds and increase their holdings of other assets.

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> *Portfolio Manager, Fixed Income Division*

Some have already sought to do this by investing more heavily in private assets, which can seem to offer compelling risk/return characteristics. However, not all investors will be able to tolerate the illiquidity that private assets bring and may be put off by their complexity and the extra due diligence required to oversee them. It is also worth mentioning that while private assets may seem to offer relatively smooth return profiles, this is often simply because they are traded so infrequently.

Now Is the Time for a More Global Approach

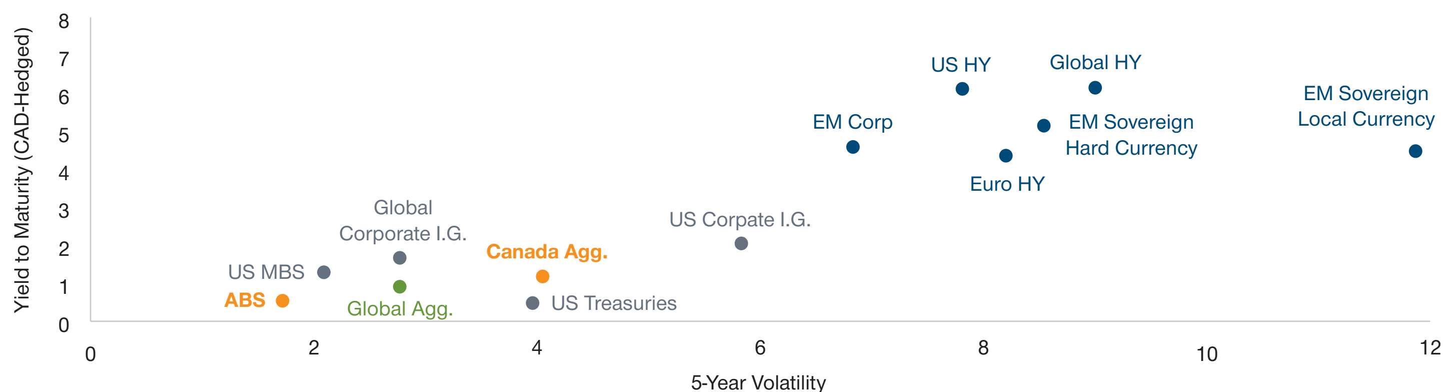
A more effective way for Canadian investors to diversify their fixed income portfolios—in our view—is to increase their allocations to global bonds. Experienced managers with a less constrained, flexible investment approach are well positioned to find inefficiencies by looking across credit, currency and rate markets to identify assets with the most attractive risk/return profiles. Differences in interest rates and economic cycles between countries create a rich environment for country and security selection, bringing significant diversification benefits.

In a low-yield environment, managers who invest across regions and include assets such as corporate bonds, emerging market local debt, securitized bonds and high yield debt can construct diversified portfolios with strong total return prospects. However, investing in a wider range of markets and instruments also brings additional risks, which means that credit, rates and currency exposures must be carefully managed.

Corporate bonds, for example, offer additional yield over sovereign bonds and can be a useful source of long-term returns. Bond investors whose mandates exclude corporate bonds missed out on a huge opportunity last March, when spreads widened dramatically during the initial coronavirus shock, resulting in high-quality credit instruments becoming available at heavily reduced prices. However, corporate bonds also bring greater default risk, placing a greater emphasis on intensive research, careful selection and rigorous risk management.

The Global Bond Market Is a Broad Universe

(Fig. 2) Yields and volatility vary significantly



As of 31 December 2020.
All indices used are Bloomberg Barclays except for the Emerging Markets indices. Source for EM Indices: EM Sovereign Hard Currency: J.P. Morgan Emerging Market Global Diversified Bond Index; EM Corporates: J.P. Morgan CEMBI Broad Diversified; EM Sovereign Local Currency: J.P. Morgan GBI EM GD Index. Yields are hedged using 3-month forward implied yields. EM Local yield is unhedged. Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright© 2020, Bloomberg Index Services Ltd. Used with permission. Volatility is standard deviation of monthly returns over the 5-year period.
Sources: Bloomberg Index Services Limited, J.P. Morgan Chase & Co. (see Additional Disclosures), and T. Rowe Price.

> Managing currency risk is a key requirement of a global fixed income strategy.
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Like corporate debt, emerging market (EM) bonds offer higher yields than developed market sovereign debt. Historically, EM debt was considered by many investors to be difficult to analyse and therefore risky and was subsequently used sparingly as a tactical allocation—if at all. However, this has changed over the years as improving fundamentals and increasing liquidity has improved the credit quality of the asset class. Many emerging market countries have introduced inflation targeting, made their central banks independent and have strengthened their banking systems. They also often have higher growth and lower debt levels than their developed market counterparts.

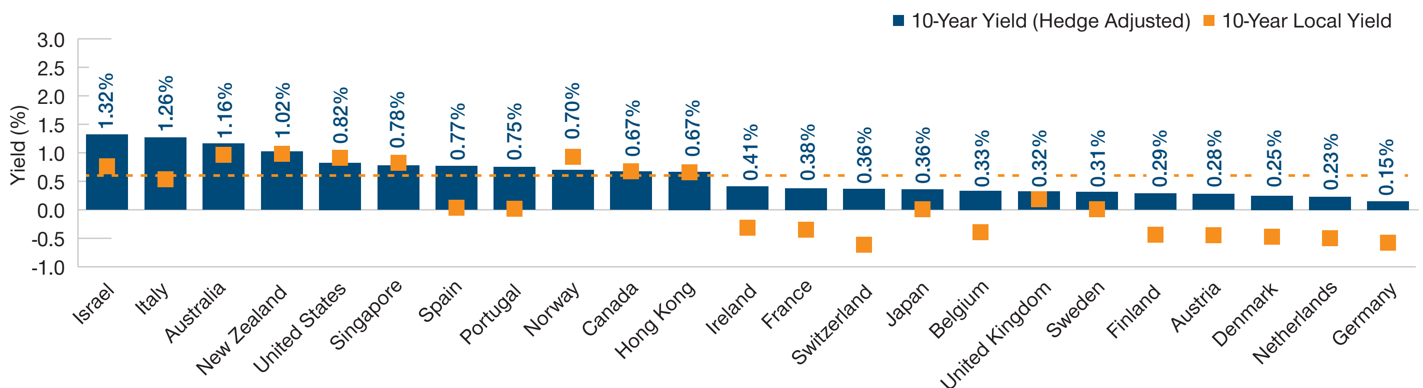
The breadth of the EM debt market may seem daunting. This one asset class comprises three distinct markets: US dollar sovereign bonds, local currency sovereign bonds and corporate bonds. Local currency sovereign debt is by far the largest of these pillars and dominates EM sovereign debt issuance. EM local bonds have negligible default risk but do carry exchange rate risk, which can be managed through currency hedging. The EM corporate bond market is growing rapidly but is less well researched than the sovereign debt market, creating the opportunity to add value through fundamental research.

Developed market sovereign bonds may seem unattractive to Canadian investors because they offer very low or negative yields. However, it is worth remembering that many of the perceived drawbacks of investing in foreign bonds can be overcome by currency hedging. In the current environment, hedging lower-yielding global bonds back to the Canadian dollar can bring additional yield—meaning that Canadian investors are effectively paid to hedge the currency risk of some global bonds.

Managing currency risk is a key requirement of a global fixed income strategy. Because currencies are typically more volatile than bonds themselves, most global bond portfolios are typically hedged back to the Canadian dollar. But there can be well-researched opportunities to add value or even hedge macro risks by utilizing small currency positions; thus, managers need to be very selective when adding exposure. International bond managers often hedge their foreign exchange risk through liquid currency options or forward contracts, although the cost of hedging will need to be factored into risk/return calculations.

Currency Hedging Could Boost Yields

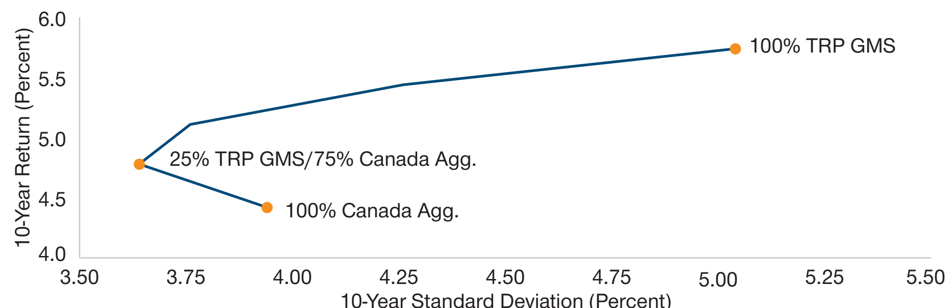
(Fig. 3) 10-year Canadian-hedged sovereign bond yields



As of 31 December 2020.
Hedged with 3-month forward implied yields.
Source: Bloomberg Index Services Limited (see Additional Disclosures).

Combining Global Bonds With Canada Agg. Could Boost Returns

(Fig. 4) How a sample portfolio might work



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Hypothetical Results: The information provided above reflects data for hypothetical portfolios composed of a blend of the Bloomberg Barclays Canada Aggregate Bond Index and the T. Rowe Price Global Multi-Sector Bond Composite (TRP GMS) using 10-year history. Results shown for blended portfolios are hypothetical, do not reflect actual investment results and are not a guarantee of future results. Hypothetical results were developed with the benefit of hindsight and have inherent limitations. Hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Results do not include management fees, advisory fees, trading costs and other related fees. Results have been adjusted to reflect the reinvestment of dividend and capital gains. Actual returns may differ significantly from the results shown above. It is not possible to invest in an index.

Source for Bloomberg Barclays Index Data: Bloomberg Index Services Limited. Please see Additional Disclosures for more information about this Bloomberg information. Analysis by T. Rowe Price. Statistics based on monthly gross returns. Returns would have been lower as the result of the deduction of applicable fees. Total returns in non-US dollar currencies are calculated by adjusting US dollar performance by the percent change in the US dollar/foreign currency exchange rate (as determined by an independent third party) for the time periods selected.

Overall, though, an active, highly selective and flexible approach to managing currency can add considerable value to global bond portfolios.

A Compelling Opportunity

We believe that Canadian investors looking to extract greater yield and more effective diversification from their bond portfolios would benefit from increasing their exposure to global fixed income. A highly selective, well-diversified, rigorously managed international bond portfolio can provide a reliable source of uncorrelated returns, helping portfolios to diversify from risk assets and gain some protection against Canadian inflation and interest rate risk. Although the breadth and complexity of the global fixed market may seem daunting for investors who are accustomed to mainly buying local bonds, the opportunities that arise from adopting a more international approach more than compensate for this, in our view.

Figure 4 shows how combining an allocation to the Bloomberg Barclays Canada Aggregate Bond Index with an allocation to a theoretical, global multi-sector bond strategy could boost returns. It shows that a portfolio comprising a 75% allocation to the Bloomberg Barclays Canada Aggregate Bond Index and 25% allocation to the global bond strategy would have boosted returns and lowered volatility compared with a 100% allocation to the Bloomberg Barclays Canada Aggregate Bond Index.

With Canadian bond yields—like those of other developed market bonds—historically low and either set to remain lower than historical averages for an extended period or possibly rise with stimulus and vaccine distributions, the global fixed income market offers a compelling opportunity to strengthen core bond portfolios at a time when yields are hard to come by and risks remain elevated.

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ID0003927 (03/2021)
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