No Time to Yield

Insights from BlackRock

iShares by BlackRock

Key takeaways

- Yields are higher today than they were 20 years ago. If inflation indicators continue to fall, the time of elevated cash rates may be drawing to a close.
- We believe investors may want to consider moving back into fixed income because, historically, the market has tended to price in rate actions before they occur.
- ETFs can be a powerful tool for investors as they recalibrate their fixed income allocations. We explore three macro scenarios, and how bond ETFs can help.

Seek to capture higher rates

Promising trends are popping up for investors who are looking past the clouds of uncertainty on timing. Bond yields are higher today than they were 20 years ago (Figure 1). Relative to both recent history and even 20 years ago, investors are able to lock in highly attractive yield levels.

Figure 1 – Yields today are at decades-highs

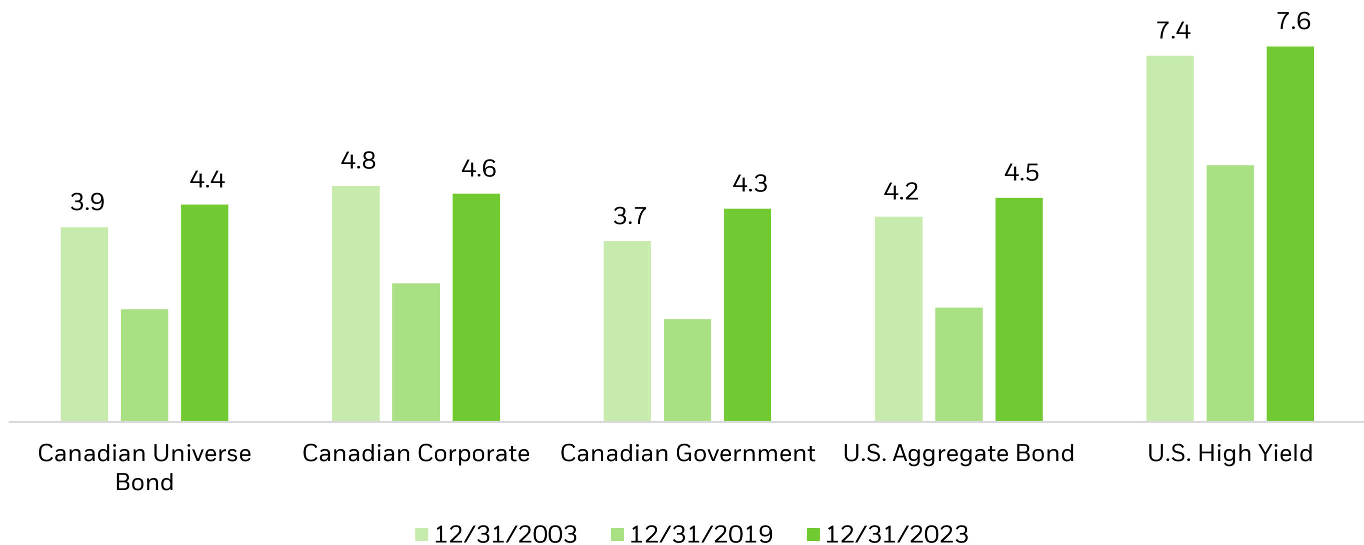

Figure 1 shows the yield-to-maturity levels (for Canadian segments) and yield-to-worst levels (for U.S. segments) on different indices at year-end 2003 (before the 2008 financial crisis), 2019 (ahead of the COVID-19 pandemic in 2020) and 2023. Chart source: Source: Bloomberg and FTSE Russell, as of April. 30, 2024. Indices used: Canadian Universe Bond: FTSE Canada Universe Bond Index; Canadian Corporate: FTSE Canada All Corporate Bond Index; Canadian Government: FTSE Canada All Government Bond Index; US Aggregate Bond: Bloomberg US Aggregate Bond Index; U.S. High Yield: Markit iBoxx USD Liquid High Yield Index. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

With inflation indicators generally still falling (albeit haltingly and unevenly, depending on the region), the time of elevated cash rates may ultimately be coming to an end. We believe this means investors may want to consider moving back to fixed income.

Historically, longer term yields have moved ahead of policy shifts (Figure 2). Investors who wait for a definitive answer may miss the opportunity to capture yields at these levels.

Figure 2 – Historically certain bond rates have tended to fall before the Bank of Canada starts to cut

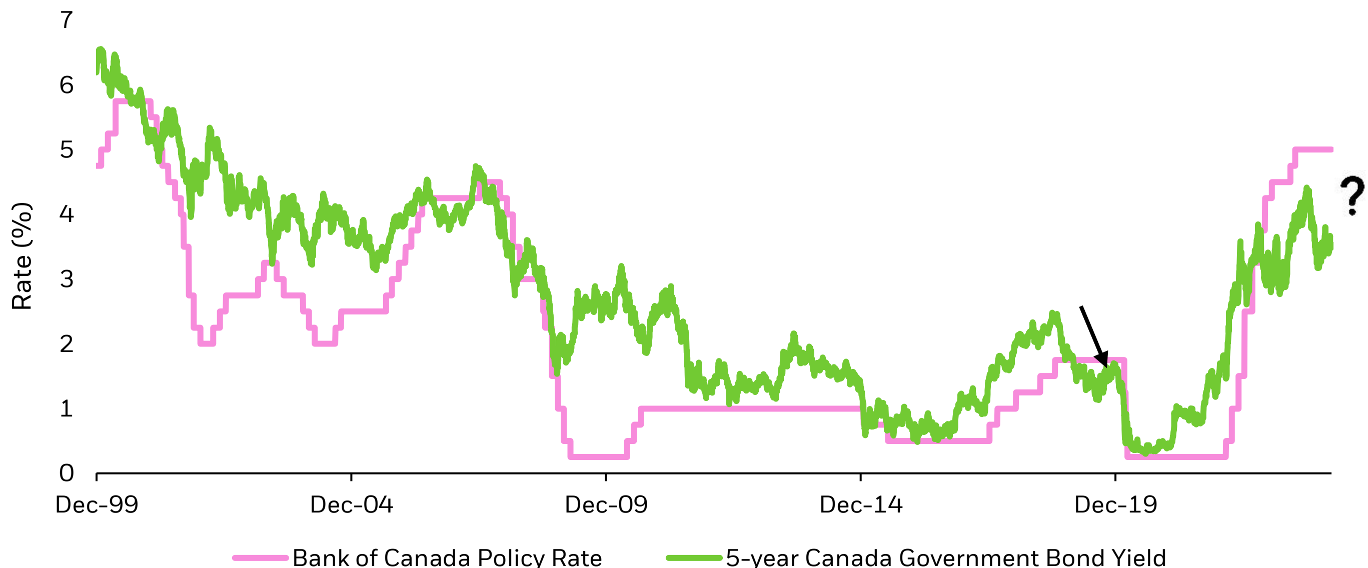

Figure 2 shows the five-year Canadian Government Bond yield compared to Bank of Canada Policy Rate (%), 2000-2024. Source: Bloomberg, March 31, 2024. Past performance does not guarantee future results.

Time to get off the sidelines?

The volatile markets of the past few years caused many investors to, understandably, move money into a less volatile asset – cash. Rising interest rates on the back of Central Bank's aggressive rate hikes in 2022 and 2023 rewarded investors for holding cash. Over US$1 trillion poured into money market funds globally in 2023, and the amount of cash held worldwide in money market funds sat at US$9.2 trillion to end the year, up 19% from 2022.[1]

While cash has provided income temporarily during this tightening cycle, over the long-term, cash has not provided the same level of potential ballast and portfolio diversification against riskier assets such as equities. Figure 3 highlights how quickly cash yields can fall, by looking at the 2001 rate cut cycle in Canada. Money market fund 12-month returns fell from 3.4% in December 2000 to 2.2% by June 2001 and down to 1.6% by December 2001 (Figure 3). Similarly, in the U.S., money market fund 12-month returns fell from 5.8% in March 2001 to 2.6% by March 2002 and down to 1.8% by July 2002.[2]

[1] Source: Simfund for U.S. money market funds Broadridge for non-U.S. money market funds, both as of as of Dec. 31 2023; Total funds for 2023 using all sources were $9.283 trillion, while total funds for 2022 were $7.747 trillion.

[2] Source: Morningstar, as of March 31, 2024. Money market fund returns represented by the Morningstar Prime Money Market Fund Category from March 2001 to July 2002. Average annualized return is the average annual rate of return over a given period. Past performance does not guarantee or indicate future results.

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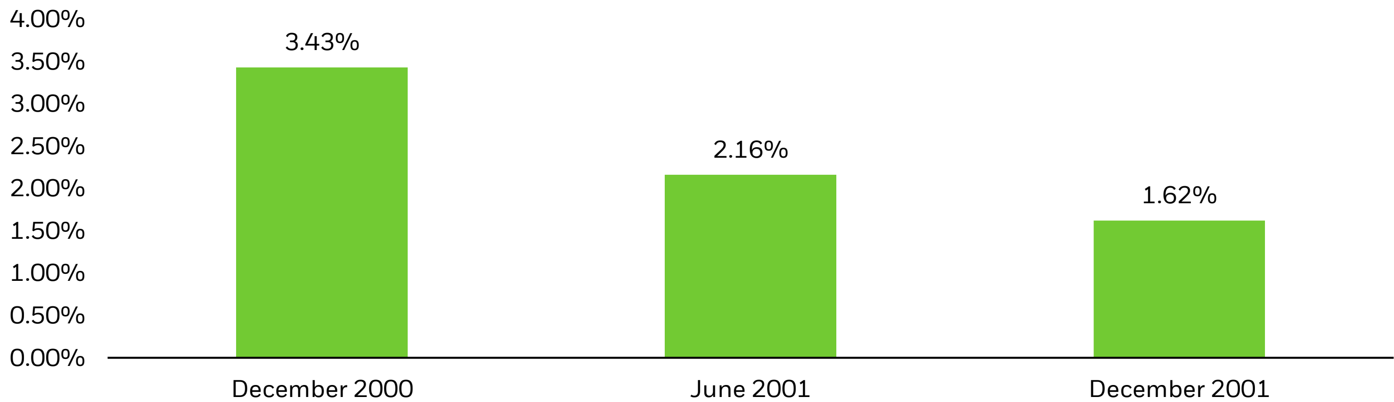
Figure 3 – Canadian money market 1-year returns



Source: Morningstar, as of April 30, 2024. Money market fund returns represented by the Morningstar Canada Fund Canadian Money Market Category. Past performance does not guarantee or indicate future results.

From history, we also know that when central banks implement pauses and during rate cuts, bond markets have tended to outperform cash (Figure 4). We believe investors could benefit from getting ahead of potential interest rate cuts.

Figure 4 – Bonds have historically delivered strong performance during "Hold" and "Cut" periods.

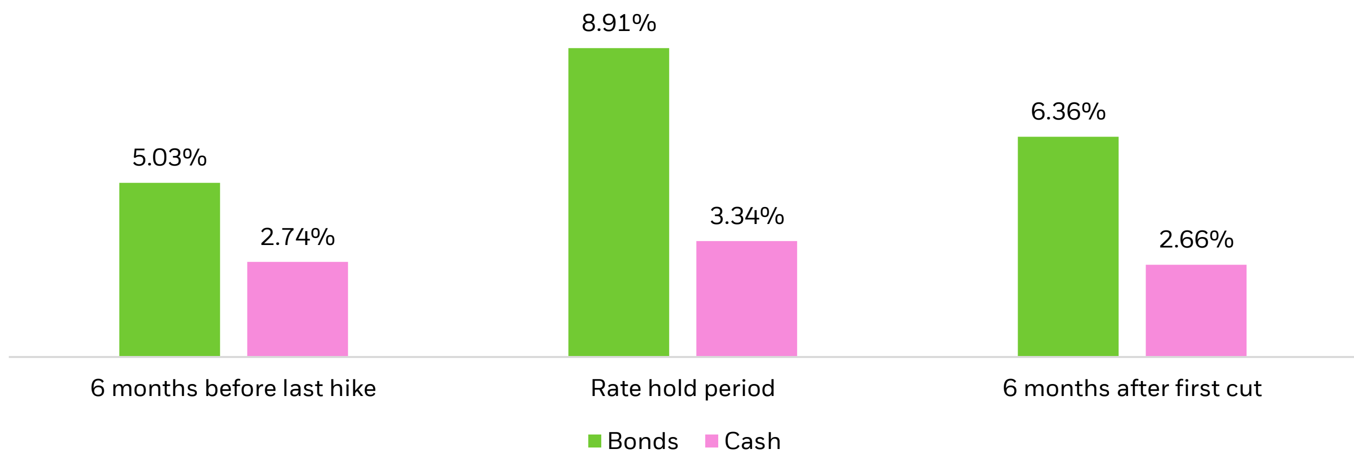


Figure 4 shows the historical average annualized returns of the FTSE Canada Universe Bond Index (bonds) and the FTSE TMX Canada 91 Day Treasury Bill Index (cash) over different time periods. The dates used for the last rate hike of a cycle are: Feb. 1, 1995, March 25, 1997, May 16, 2000, June 29, 2006, Dec. 19, 2018. Dates used for the first-rate cut are: July 7, 1995, Sept. 29, 1998, Jan. 3, 2001, Sept. 18, 2007, Aug. 1, 2019. Source: Bloomberg and FTSE Russell as of April. 30, 2024. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

How to get back into bonds

Harnessing the power of bond ETFs

For investors considering bonds again, how could they implement their fixed income allocation?

1. **Utilize a bond investing toolkit.** There are many ways to invest in fixed income including: individual bonds themselves, mutual funds, closed-end funds, separately managed accounts, and bond ETFs. An investor's specific circumstances, including investment objectives, holding period, tax position and investing platform (e.g., brokerage account vs. retirement account), can help determine the ultimate choice of exposure.

2. **Adopt a portfolio mindset.** The new yield landscape means that there are now many opportunities in fixed income for investors to pursue. In an effort to build durable, resilient portfolios, investors are now able to use low-cost index exposures at the core, while employing active strategies to seek enhanced returns. For example, index bond ETFs are liquid, transparent, and efficient, making them good building blocks for the core of a portfolio. At the same time, active bond ETFs can augment this portfolio by providing the potential for enhanced return and diversification of opportunities.

Investors who are calibrating their bond portfolios may be confronted with a range of macro environments going forward. Will central banks keep policy restrictive for too long and tip the economy into a hard landing and recession? Or will they actually "land the plane" in the idealistic soft-landing scenario?

We explore three macro scenarios below. We believe that in each of these scenarios, at least some movement out of cash and into longer maturities is warranted. We also consider different ETFs that investors may wish to explore depending on their market views.

Scenario 1: Central banks engineer a soft landing

In this 'goldilocks' scenario, we see falling inflation and central banks starting to gradually cut rates and re-steepen/normalize the yield curve to become upward sloping once again.

In this scenario, investors could consider balancing the belly of the curve with high-quality, longer-duration bonds and higher income asset classes. We look to duration exposures in a range of 3-7 years, which may offer a good trade-off between current yield and potential upside valuation gains as rates fall. Additionally, for investors seeking higher income, high yield credit and risk assets in general could become much more attractive with lower refinancing risk and positive economic growth helping to contain default risk.

Figure 5 – Scenario 1 related iShares ETFs

Exposure	Name	Ticker	MER[1]
Core Bond	iShares Core Canadian Universe Bond Index ETF	XBB	0.10%
High Yield	iShares Canadian HYBrid Corporate Bond Index ETF	XHB	0.50%
High Yield	iShares U.S. High Yield Bond Index ETF (CAD-Hedged)	XHY	0.56%
EM Debt	iShares J.P. Morgan USD Emerging Markets Bond Index ETF (CAD-Hedged)	XEB	0.53%

Source: BlackRock; Data as of 4/30/2024. [1]As reported in the fund's most recent Semi-Annual or Annual Management Report of Fund Performance. MER includes all management fees and GST/HST paid by the fund for the period, and includes the fund's proportionate share of the MER, if any, of any underlying fund in which the fund has invested. [2] Newly launched. Management fee 0.40%.

Scenario 2: Central banks cut rates given fears of recession

In a hard landing / recessionary scenario, both growth and inflation may recede rapidly, which may lead to a sudden decrease in policy rates. Such a scenario could harm risk assets and historically has triggered a flight to quality in which the longest maturity instruments should benefit from falling yields.

Investors may not want to abandon ballast just because short-term rates are higher. Cash likely will not provide the same potential ballast as bonds, so investors believing that such a scenario is more likely could consider at a minimum "barbelling" their current cash allocation with long duration instruments to help cushion risk assets and provide equity diversification. Investors may consider holding high quality assets like government bonds and higher quality credit exposures.

Figure 6 – Scenario 2 related iShares ETFs

Exposure	Name	Ticker	MER[1]
Core Bond	iShares Core Canadian Universe Bond Index ETF	XBB	0.10
Long bond	iShares Core Canadian 15+ Year Federal Bond Index ETF	XFLB	0.17
Long bond	iShares Core Canadian Long Term Bond Index ETF	XLB	0.20
Corporate bond	iShares Core Canadian Corporate Bond Index ETF	XCB	0.17
Corporate bond	iShares U.S. IG Corporate Bond Index ETF (CAD-Hedged)	XIG	0.32

Source: BlackRock; Data as of 4/30/2024. [1]As reported in the fund's most recent Semi-Annual or Annual Management Report of Fund Performance. MER includes all management fees and GST/HST paid by the fund for the period, and includes the fund's proportionate share of the MER, if any, of any underlying fund in which the fund has invested.

Scenario 3: Central banks hike again

For those investors who believe that inflation will persist and that central banks will maintain or even enhance restrictive monetary policy – even at the cost of deteriorating economic growth – it may make sense to continue owning shorter maturity instruments (both nominal and inflation protected). This may help insulate investors from further increases in policy rates and stickier inflation.

With current inverted yield curves, where short-term interest rates are higher than long-term interest rates, we believe shorter-duration maturities could offer attractive yields versus cash and could support those seeking capital preservation. Like the prior scenario, investors may want to consider holding high quality assets like government bonds and higher quality credit exposures.

Figure 7 – Scenario 3 related iShares ETFs

Exposure	Name	Ticker	MER[1]
Floating rate	iShares Floating Rate Index ETF	XFR	0.14
Inflation-linked	iShares 0-5 Year TIPS Bond Index ETF (CAD-Hedged)	XSTH	0.16
Short term bond	iShares Core Canadian Short Term Bond Index ETF	XSB	0.10
Short term bond	iShares Core Canadian Short Term Corporate Bond Index ETF	XSH	0.10

Source: BlackRock; Data as of 4/30/2024. [1]As reported in the fund's most recent Semi-Annual or Annual Management Report of Fund Performance. MER includes all management fees and GST/HST paid by the fund for the period, and includes the fund's proportionate share of the MER, if any, of any underlying fund in which the fund has invested.

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Conclusion

After a profoundly challenging period in the bond market brought on by global inflation and resulting aggressive central bank tightening, we believe that there is a compelling case for moving off the sidelines and back into fixed income for the long-term. While yields may continue to oscillate with changing economic conditions, they remain at attractive levels not seen in decades and therefore now provide investors with a tremendous opportunity to retool, rebalance, and reduce risk in portfolios for the future. The granularity, efficiency, and versatility of fixed income ETFs make them an effective tool for fortifying portfolios with fixed income exposure.

Authors

Stephen Laipply
Global Co-Head of iShares
Fixed Income ETFs

Karen Veraa
U.S. Head of iShares Fixed Income Product Strategy

Rachel Siu
Hersi Shima
Ross Pastman
Pat Sproule
BlackRock Canada Fixed Income Strategy

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