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Why fixed-income investments are the better option than equities in this new financial era

TOM CZITRON || MAY 30, 2023

Bank of Canada Governor Tiff Macklem warned recently that the low interest rate era that began during the Great Financial Crisis probably ended in 2021. He argued that the jump in inflation over the past two years, followed by the central bank's aggressive ramping up of interest rates, have put the economy on a path on which borrowing costs will be persistently higher.

Investors should take heed. If he's right – and I think he will be – it should mean years of weak performance in equity markets. On the bright side, it should mean decent returns in fixed income.

Over the past 300 years, bond yields in the United States and Britain – the world's dominant financial powers over that period – generally fell within a 2-per-cent to 6-per-cent range, and averaged about 4 per cent. This range held during severe economic depressions and periods of double-digit inflation.

There were, however, two major outliers of this range.

The first was during the high inflation period from the late 1960s to the early 1980s, culminating in August, 1981, when the Canadian prime lending rate peaked at 22.75 per cent. During the 1970s, rates were well above inflation much of the time and inflation rates themselves were volatile and difficult to forecast.

The second was the period between 2008 and 2021, when bond yields traded well below the 4-per-cent historical average.

During those years, bonds, which typically are a low-risk asset class, largely became a return-free and high-risk asset. Consider that between 2013 and 2022, 10-year Treasuries annually generated just 0.1 per cent on a total return basis.

Near the end of that period, the riskiness of bonds was on full display when long-term prices collapsed as inflation skyrocketed and yields, which move inversely, spiked.

Those yields aren't going to decline in a hurry. The period of unusually low nominal rates, where long-term bond investors endured rates at or below inflation, now appears to be over. We're back to the more normal yields of the past three centuries.

It should be noted that when Mr. Macklem was referring to the end of the low interest rate era, he was referring to nominal rates and not real rates, which subtracts expected inflation from current rates.

The Bank of Canada has indicated that 2 per cent to 3 per cent is the neutral rate – the range its trend-setting overnight rate can fluctuate within and be neither stimulating nor restricting economic growth. Canadian annualized one-year inflation is currently 4.4 per cent and economists and traders widely expect it to decline. It's expected, however, to remain above the central bank's target of 2 per cent for quite some time.

In the post-2007 era, interest rates have been at far lower levels justified by inflation. This has been deliberate and wholly intentional as the central banks ran the bond vigilantes out of town during the 2007 to 2009 recession. At that time, the consensus was that the financial crisis was so grave that if central bankers did not force rates to zero, an era that would make the 1930s look prosperous would begin.

After that, any restoration of normal interest rates would create a massive credit crisis that would doom society, or so we were told. Yet again history teaches us that a consensus belief birthed out of irrational fear instead of reason usually leads to negative outcomes.

There have been winners and losers during this era of low interest rates. The largest borrowers of cheap debt are large debtor nations, the United States being the largest. The debt to gross domestic product ratio rose from about 60 per cent before the financial crisis to 120 per cent today. In nominal dollar terms, total debt increased from just over US$9-trillion to about US$32-trillion. Despite this massive increase in debt, the real economy has very little to show for this. Real GDP growth has barely been above 1.5 per cent annualized. In contrast, during the period after the 1982 recession to 1990, GDP grew almost 3.5 per cent annualized, despite bond yields being generous relative to inflation.

Equity investors had benefitted enormously from artificially low rates as price-earnings multiples rose and corporations could raise funds at ridiculously low costs. This made corporations less disciplined in their capital spending.

From 2009 to 2021, the S&P 500 returned investors 13.77 per cent, annualized. Three-month bills provided a return of 0.46 per cent while longer-term Treasury bonds returned 3.66 per cent. Stocks returning 10 percentage points a year over bonds for this long a period of time is rare. Between 1959 and 2008, inclusive, the S&P 500 returned 8.88 per cent while bonds returned 6.89 per cent and even bills returned 5.29 per cent a year. Given risks, stocks should return at least 2 per cent above bonds and 3 per cent to 4 per cent above T-bills.

Not everyone believes that the era of low interest rates is over. In contrast with the Bank of Canada, New York Fed Chairman John Williams recently cited research that found the era of low rates is not necessarily over. Indeed, with the U.S. 10-year Treasury yield in a range from 3.25 per cent to 3.75 per cent and a consumer price index of 4.9 per cent, one could argue that we are still in an era of low rates and certainly low bond yield to inflation spreads. The most significant change has really been a dramatic rise in inflation caused by pandemic money creation.

Regardless, the 2009 to 2021 period of high stock returns relative to bonds will be seen as a bubble. Equity investors will be lucky to achieve the same return as bonds over the next decade or two, and even that will be at far higher volatility than fixed income.

Effective long-term valuation models that include the Buffett Indicator (a ratio of total stock market capitalization to GDP) and the Shiller P/E ratio (which looks at equity prices and earnings relative to the past 10 years) are pointing to an overly expensive stock market. Meanwhile, the economic growth outlook is weak. The outlook for stocks – especially low dividend payers – is poor.

Fixed income may not be exciting but a strategy of saving and investing in an income-oriented approach and income vehicles will outperform stock investing.

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