

Market Spotlight—September 2024

What lower interest rates mean for fixed income and equity investors





Why fixed income continues claiming its rightful place during rate cuts

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We've shared a lot about the opportunities in fixed income investing during periods of high interest rates. But what happens when rates start to drop—do those opportunities still exist? Until recently, in the context of a [well-balanced investment portfolio](#), bonds and other fixed income investments were likely absent for some time. Near-zero interest rates and extremely small risk premiums eliminated many of the factors that make fixed income an attractive part of a well-balanced investment portfolio. But today, fixed income is back in its rightful place and proving its worth against short-term spikes in market volatility.

The two key elements that are the most attractive to fixed income investors are income generation and a hedge against riskier parts of an investment portfolio. These elements were near impossible to fulfill in a zero-interest rate world. And while it was painful to get to where we are today, fixed income now offers both attractions for investors.

Despite initial [cuts in policy rates from the Bank of Canada](#) and with the first US Federal Reserve rate cut likely on the horizon, yields in fixed income markets remain extremely attractive relative to history. According to Bloomberg, as of July 31, 2024, Canadian bonds between one to five years

offered investors an all-in yield of 4%—that's a full percentage point above the 25-year average of 3%. That's also nearly 2% above the average yield available after the global financial crisis (GFC) in 2008-2009. Although potential continued rate cuts will bring yields lower, fixed income investors are seeing some return potential realized with falling interest rates.

Given yields now have room to drop, [fixed income investments](#) also offer a hedge against market volatility in riskier parts of an investment portfolio. In 2022, this relationship failed because near-zero interest rates left bond yields nowhere to go but up. However, more recent bouts in market volatility have shown fixed income investments' reclaimed ability to hedge as fears of economic slowdowns trigger selloffs in riskier assets. The S&P 500 lost 6% in the first three trading days of August, while Treasuries posted gains of 2%. Volatility in the early trading days of this month is real-time proof that fixed income investments such as bonds continue to benefit as rates are expected to continue lowering.

Bonds are clearly reclaiming their rightful place in well-balanced investment portfolios and we're glad they've showed up.



What to expect from equity markets if interest rates continue to decline

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Back in June, the Bank of Canada (BoC) took the lead among G7 nations and lowered its benchmark interest rate to 4.75%. The BoC [lowered the rate again](#) in July to 4.50%. Though it may take a few quarters to feel the impacts, these rate reductions are being viewed positively by investors and consumers alike.

Generally speaking, a lower interest rate environment should be positive for equity markets. High quality stocks with sustainable and predictable dividends should see an improvement in their valuations, and longer duration growth equities should also benefit.

Let's consider Canadian banks as an example. When Canadian banks announced earnings earlier this year, by and large they were better than expected. Although the banks continued to add to loan loss provisions, overall credit conditions remained stable. And while we don't see any significant concerns in their loan books, we feel the lower rates will provide a relief valve for the banks. Canadian bank capital positions remain strong and provide confidence that they can weather any economic uncertainty or surprises going forward.

Lower interest rates and investment portfolio positioning

When we position our investment portfolios across equity management styles, we try to construct them with a bias

to overweighting companies generally less affected by changing interest rates. These resilient companies tend to be service-oriented, have high quality characteristics, strong balance sheets and superior pricing power. These attributes should empower them to outperform through the cycle. That being said, there will be some Canadian companies that will be more impacted by rate cuts than others—especially if Canada continues to lead the US in making the cuts. For example, small-cap and expensive high-growth companies tend to see their valuations get rated higher as the lower-discount rate boosts long-term cash flows.

The Boc's decision to cut rates will impact the valuations of many interest-sensitive stocks and sectors. This has historically contributed to a rotation in sector leadership in the market. Traditionally, real estate, utilities, telecom, pipelines and [financial services benefit from falling rates](#). In the US, the Federal Reserve is moving to cut rates (likely later this year) which will also be an important event for market sentiment.

Our dividend focused and value strategies seek out high quality businesses with attractive valuations and strong dividend yields. In the current market the best total return opportunities have been in many of the interest-sensitive sectors. In a falling interest rate environment, that steady and predictable dividend yield and growth will become more attractive to income investors.



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We provide our clients with our research insights and expertise on industry issues and themes that matter most to them.

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