TREASURIES YIELDING TO PRESSURE

US treasury bonds are commonly perceived as a safe haven asset class; providing a stable source of income, portfolio stability during turbulent times and a complementary ballast against equity risk. It didn't hurt that for the last 40 years, bonds have been in a structural bull market with few major disruptions. It is precisely this stellar track record that makes the losses incurred by treasuries so shocking. Per the chart below, treasury composites have sustained drawdowns of a magnitude larger than anything experienced in modern history. With bond yields surging anew in recent weeks, it is an opportune time to review what led us here and how to position looking forward.

As we've written about extensively in recent years, a confluence of factors have pushed the global economic trajectory away from the slow growth low inflation era post-2008. These include COVID-19 lockdowns, the unprecedented fiscal response from governments and the disruption of global supply chains caused by the pandemic, sanctions against Russia and an increasingly contentious rivalry between the US and China. The dominant market narrative has shifted wildly in recent years as investors, out of practice in gauging inflationary dynamics, struggled to find direction. The collective response has been akin the 5 stages of grief: denial (this is transitory!), anger (imminent recession!), bargaining (soft landing/peak Fed) and most recently depression (higher for longer rates and inflation). We're still waiting with bated breath for the acceptance stage.

It is this most recent consensus narrative that has been the dominant factor pressuring long-term treasury yields higher. A "normal" treasury yield curve slopes upwards as maturities get longer to incentivize investors with a "term premium". However, the curve has been inverted since mid-2022 as investors positioned for a recession and rate cuts. Viewed in this context, the recent treasury sell-off could be explained as a re-steepening of the yield curve in response to higher growth, inflation and central bank interest rate expectations. This adjustment could have further to go, as the curve is still modestly inverted. Additionally, with US government spending plans necessitating substantial debt issuance at a time when appetite for treasuries is waning from some key demand sources (namely the Federal Reserve, US banks and China), the supply/demand equation will likely work against treasuries over the coming years.

So with short-term treasuries still paying a slight premium versus longer maturities and some aforementioned notable risks, it's a no-brainer to keep duration short… right? This is where bond math must be considered. Longer-term treasuries now offer a favourable asymmetry in potential return outcomes. After the adjustment in prices sustained over the past few years, long-term treasuries would gain far more if yields went down than they would lose if yields went up by the same magnitude. Additionally, some of the supply/demand concerns may be overblown, as pensions and insurers are keen to lock in generationally high yields to offset their liabilities, while the carry offered by US bonds over other developed market peers should continue to attract foreign buyers.

Thankfully, this need not be a binary decision. Portfolio duration does not have to be 100% short or long, but can reside anywhere along the spectrum. Despite a challenging macro environment for longer-term bonds, their favourable risk/reward asymmetry and renewed ability to offset equity risk cannot be ignored. We remain short duration for the time being, but will be looking to incrementally lengthen the maturity profile in the coming months and quarters.

GLOBAL STRATEGY OVERVIEW

CASH

As near-term recession concerns ebb, money that was sitting on the sidelines should work its way back into risk asset markets. Professional investor surveys show this trend is well underway, with cash positions declining from near-historically high levels. We expect continued flow into global stock and bond markets and have reduced cash and equivalents exposure to neutral in client portfolios.

BONDS

Emerging market central banks, particularly in Latin America, have won some tough-earned credibility by not dismissing burgeoning inflationary pressure as transitory and proactively hiking interest rates well before their developed market peers. Now, with inflationary pressure decisively rolling over in most major EM nations, emerging market bond yields have significant room to decline as central banks embark upon rate cutting cycles. Emerging market bonds remain overweight this quarter.

EQUITIES

Investors have a lot to digest these days, as tightening monetary policy and rising energy costs are offset by resilient corporate profits and fiscal expansion. On balance, the outlook for equities remains favourable as fiscal stimulus has a more potent "real economy" impact and corporations opportunistically extended liabilities when interest rates were low. We remain overweight equity exposure in client portfolios.

OPPORTUNITIES

The transition away from fossil fuel-derived energy sources will intensify the reliance on "bridge" fuels such as natural gas and nuclear (uranium), as renewable sources including solar and wind will take time to scale up. Natural gas looks particularly attractive at present as Europe remains vulnerable to a harsh winter, global supply/demand conditions are tight and the Henry Hub price appears to be bottoming. A position in natural gas equities has been initiated in balanced and growth-oriented strategies this quarter.

FORSTRONG STRATEGIES	INCEPTION DATE	1 MONTH	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEARS	SINCE INCEPTION
BALANCED								
Global Income	30/06/08	-0.12%	1.13%	5.68%	1.27%	3.08%	5.34%	6.94%
Global Balanced	30/06/03	-0.50%	1.59%	8.21%	3.29%	4.80%	6.47%	6.54%
Global Growth	30/06/03	-1.11%	1.78%	7.85%	5.47%	6.12%	7.63%	7.59%
Core Income	30/06/08	-0.44%	0.63%	3.84%	1.56%	3.29%	4.44%	5.64%
Core Balanced	30/06/03	-0.94%	0.93%	5.81%	4.39%	5.29%	5.92%	6.59%
Core Growth	30/06/03	-1.65%	0.51%	4.69%	6.41%	6.26%	6.75%	7.43%
GLOBAL EQUITY								
Emerging Markets Equity Focus	31/01/19	-2.31%	-3.26%	9.87%	0.58%	-	-	0.64%
Global Ex-North America Equity Focus	31/12/19	-0.81%	2.30%	15.04%	4.62%	-	-	2.06%
ALTERNATIVE INCOME								
High Income Opportunities	30/06/22	-0.79%	2.42%	10.78%	-	-	-	8.92%

* Performance as of October 31st, 2023

Performance statistics for ETF Managed Portfolios are calculated from documented actual investment strategies as set by Forstrong's Investment Committee and applied to its portfolios mandates, and are intended to provide an approximation of composite results for separately managed accounts. Actual performance of individual separate accounts may vary with average gross "composite" performance statistics presented here due to client-specific portfolio differences with respect to size, inflow/outflow history, and inception dates, as well as intra-day market volatilities versus daily closing prices. Performance numbers are net of total ETF expense ratios and custody fees, but before withholding taxes, transaction costs and other investment management and advisor fees. Past investment results provide no indication of future performance. Future returns are dependent on the general investment environment, the nature of the investment mandate and specific portfolio risks. A rate of return for one year or less is not annualized.