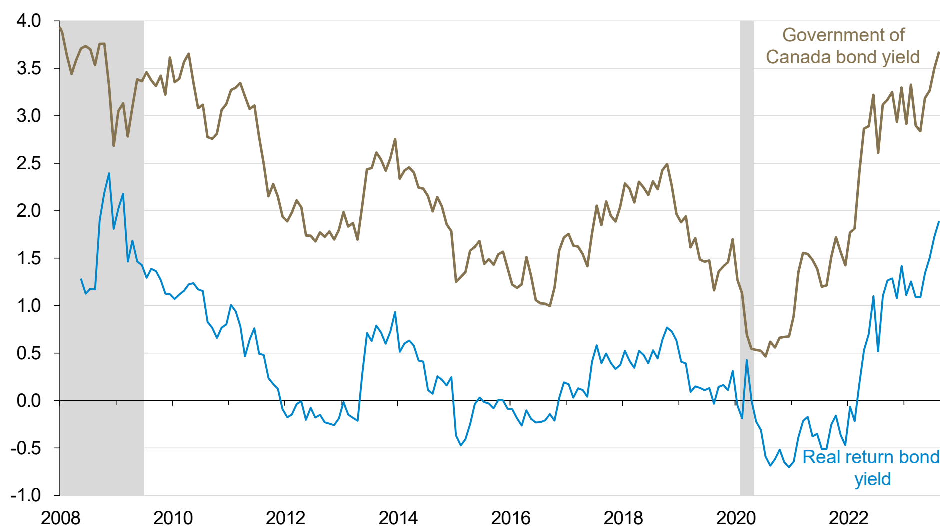
Money Making Real Money

One of the goals of putting idle (i.e., not needed right now) money into financial markets is to generate a return that, at minimum, retains the purchasing power of that capital in the future. Due to the tendency for prices to rise over time, it is unlikely that one dollar placed under a mattress today will be able to buy the same amount of goods and services in a year.

Thus, this need to compensate investors for the lost "real" value of money due to inflation is a key underpinning of the incentive structure of financial markets. After all, why would anyone invest if they ultimately end up worse off in inflation-adjusted terms?

For much of the last decade, central banks' zero interest rate policies and intervention in financial markets have kept bond yields at historically low levels. While Canada did not see negative nominal yields like in Europe and Japan, rates were still below (both actual and expected) inflation, which meant that real yields were less than zero (the average yield on a 10-year Government of Canada real return bond was -0.45% for the decade ended December 2022).

Bonds offer real value again
(10-year bond yield; percent)



Shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to August 28, 2023

Negative real yields on government bonds meant that these safe investments were guaranteed to lose real value if held to maturity and, as a result, investors were forced out into riskier segments of the market (such as equities and lower credit quality bonds) to have any prospect of making adequate returns accounting for inflation over their investment horizons.

The aggressive shift from central banks over the last year in the face of multi-decade high price pressures, however, has spurred on a sharp increase in rates that, combined with normalizing longer-term inflation expectations, has seen real yields move meaningfully into positive territory and touch their highest levels since 2009.

While there are clear negatives to this development — borrowing has become more expensive, just ask anybody that has had to renew their mortgage recently — it is beneficial for savers since it means there are more opportunities to earn an adequate return on cash while taking on less risk.

What this means is that for the first time in the adult lives of the millennial generation — and the higher income earning and investing years of older cohorts — there actually is a real alternative to stocks when it comes to saving for the future.

Accordingly, this represents an important opportunity to review investment portfolios with a particular focus on risk exposures that have likely drifted higher over time. Fixed income assets that have often been overlooked by investors now offer compelling risk/reward trade-offs while also providing the added value of a diversifier in balanced portfolios.

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2023 PERSPECTIVES

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