GLOBE INVESTOR

Diversification never really goes out of style

No, the 60/40 portfolio isn't dead – but here's an even better idea

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OPINION

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Better long-term risk-adjusted returns with Treasuries in the mix
For U.S. market

Portfolio (equity/Treasuries)	Excess returns (annualized) 5 Yr.	10 Yr.	20 Yr.	30 Yr.	Sharpe ratio 5 Yr.	10 Yr.	20 Yr.	30 Yr.
100% / 0%	8.1%	11.7%	8.4%	7.1%	0.43	0.79	0.57	0.47
90% / 10%	7.3	10.6	7.8	6.7	0.43	0.80	0.59	0.50
80% / 20%	6.4	9.4	7.2	6.2	0.43	0.80	0.61	0.52
70% / 30%	5.6	8.3	6.5	5.8	0.42	0.80	0.64	0.55
60% / 40%	4.7	7.1	5.8	5.3	0.41	0.79	0.66	0.59
50% / 50%	3.7	5.9	5.1	4.7	0.38	0.77	0.69	0.63

THE GLOBE AND MAIL, SOURCE: BLOOMBERG; ROSENBERG RESEARCH

With 2022 in the rear-view mirror, most investors are likely aware that last year represented the worst year for U.S. Treasuries on record, falling 12.5 per cent in aggregate based on Bloomberg data back to 1974.

Despite what some are saying, we disagree with any notion that the strategy of holding a 60/40 asset mix is dead. In fact, our work shows that having bond exposure provides superior risk-adjusted returns over time. (That is revealed in a higher Sharpe ratio, an indicator that measures return relative to overall risk).

The investing landscape in 2022 was unique, with the ultra-low starting point for the bond yield and uber-inflated multiples in the stock market. These have at least partially been resolved in last year's dual bear phases.

What we found in our analysis is that a portfolio made up of 60 per cent stocks and 40 per cent bonds may not even be the most appropriate benchmark asset mix – a blend of 50 per cent equities and 50 per cent Treasuries scored better in terms of delivering risk-adjusted total returns.

To suggest abandoning a 60/40 (or 50/50) strategy is to say diversification is out of style – but diversification never really goes out of style. It remains a prudent risk-management tool, notwithstanding the reality that overall expected returns are far lower today than they have been historically.

When looking at some of the reasons behind the down-year for Treasuries, there were a number of factors at play. There was a palpable distaste for bonds as 2022 began – sentiment was decisively bearish, and investors were shedding positions at seemingly every opportunity. Inflationary pressures were building as supply chain bottlenecks that presented themselves from the pandemic were exacerbated by the Russia-Ukraine war. All eyes were on the Fed to react as it was increasingly viewed as being behind the curve; it responded by unleashing the fastest rate-hiking cycle since the 1980s.

That said, the reasons behind the down year in bond markets are to be viewed as more idiosyncratic than the beginning of a new era when it comes to inflation and the Treasury market. Already we are seeing supporting signals of this in many survey-based measures of inflation expectations, alongside other signs of cooling price pressures. In short, the primary reason behind the 12.5-per-cent decline for the Treasury market in 2022 is heading in reverse.

> The fact is that successful investors do not just focus on potential returns, but also the need to protect capital and manage their downside risk. The simplest way to evaluate a portfolio on this basis is to look at risk-adjusted returns.

The economic backdrop and market conditions affecting the Treasury market will normalize going forward and there are benefits to continuing to hold Treasuries in one's portfolio.

First, when compared with equity-market valuations, they are more attractive on a relative basis. For example, the equity risk premium (which measures how much extra compensation investors are obtaining relative to bonds for the extra risk) is at levels last seen in 2007.

Additionally, given the prior run-up in interest rates, coupon payments on newly issued Treasuries have risen accordingly. Indeed, while the coupon on the 10-year and 30-year was 1.375 per cent and 1.875 per cent, respectively, prior to the sell-off in 2022, the most recent issue for each maturity pays 4.125 per cent and 4 per cent, respectively – two to three times higher and offering more of a cushion against potential price declines should the Fed keep interest rates at elevated levels, as it says it intends to do.

The fact is that successful investors do not just focus on potential returns, but also the need to protect capital and manage their downside risk. The simplest way to evaluate a portfolio on this basis is to look at risk-adjusted returns (the Sharpe ratio). How much excess returns (over and above the risk-free rate, which we defined as short-term Treasuries) is a portfolio generating per unit of volatility? The higher the number, the better the result on this front.

We wanted to demonstrate how adding Treasuries to the asset mix can improve the risk-adjusted return, thus showing how bonds can be a ballast in the portfolio.

To do so, we looked at annualized excess returns from the past five, 10, 20 and 30 years of a simple mix of 100 per cent stocks, 90 per cent stocks/10 per cent Treasuries, 80/20, 70/30, 60/40, 50/50 and divided each by their respective volatilities over the same timeframe. Take a look at the accompanying table for the results.

Historically, when Treasuries are added to a portfolio in any meaningful amount (40 per cent or more), there is a notable uptick in Sharpe ratios – particularly over longer time horizons of 20 years or more, which smooth out this most recent hiccup.

Ultimately, a portfolio heavily weighted toward stocks will obviously have a better return, but it actually performs worse in its Sharpe ratio over the long term compared to when more Treasuries are added to the mix. This is the basic trade-off investors need to make – balancing risk against reward, depending on their personal financial situation and investment horizon.

While 2022 unfortunately resulted in a breakdown of the stock-bond relationship, as mentioned previously there are reasons to believe that this was a unique year and not the beginning of a new era.

Despite the popular narrative, bonds are not dead – they have an appropriate long-term place in the portfolio from a risk perspective.

'End of inflation panic': CIBC deputy chief economist shares his outlook for 2023

JENNIFER DOWTY

The World Bank released its Global Economic Prospects report this month, calling for a "sharp, long-lasting slowdown" and slashed its global growth forecast for this year to 1.7 per cent from its mid-2022 prediction of 3 per cent.

To gauge the potential weakness for the Canadian economy, I recently spoke with Benjamin Tal, deputy chief economist at CIBC World Markets, who shared his 2023 perspectives on inflation, interest rates, the labour market and economic growth.

What are your expectations for the Bank of Canada's next rate announcement on Jan. 25?

Our call is that the Bank of Canada will raise rates by 25 basis points to 4.5 per cent. [A basis point is one-hundredth of a percentage point.] Although there is a real risk that they will raise by 50 basis points, given the still very tight labour market as was reflected in the much stronger-than-expected job creation in December, 2022. So one more rate hike by 25 or 50 basis points, and then they will rest.

Now, let's talk about overshooting. Inflation is a lagging indicator, which means that the risk of overshooting is real. You can raise interest rates way too much, the way it happened in the past. I believe that we are starting to enter this zone. If rates go to 5, 5.5 per cent for some reason, then we're talking about the more significant recession where the labour market will be suffering and the unemployment rate will rise significantly.

In your economic models, what's the probability of a more significant recession?

I would put about a 25- to 30-per-cent probability of this occurring.

The reasons why we are starting for a mild recession or a soft landing is because there are two buffers that might protect us from a more significant recession. One is the amount of money held by individuals – excess savings that will allow the consumer to be stronger than expected. The other is the job vacancy rate, which is relatively strong. These two forces can protect the economy from a more significant decline, assuming interest rates will be peaking very soon.

Where do you see the unemployment rate headed?

By the end of 2023, about 5.9 per cent, and then going down to about 5.6 per cent by the end of 2024. (In December, it was at 5 per cent.) We see both years to be relatively weak. 2024 will not be a recovery year because interest rates will remain high for a long period of time. I think that's important to communicate.

We forecast 0.7-per-cent GDP growth in 2023 and 0.9 per cent in 2024 – not a big recovery.

The recovery will start at the end of 2024. By 2024, after two years of slowing down, you will be able to close the output gap and we'll reach inflation of 2 per cent.

I know that this sounds a bit optimistic, but remember the move from 7-per-cent inflation to 4 per cent will be relatively easy, mostly due to supply chain improvements and commodities. The challenge will be to move from 4 per cent to 2 per cent.

I think that there will be enough slowing in the economy to bring inflation back to around 2 per cent by the end of 2024, and if we are wrong, it would be mid-2025, but it will not be dramatically after that.

When do you believe the Bank of Canada may begin to cut rates?

In the past, the distance between the last hike and the first cut was relatively short. This time, we believe it will be relatively long, namely a year. We don't see the bank cutting rates until early 2024 to make sure that inflation is dead.

Do you expect the overnight rate will return to below 2 per cent where it was pre-COVID or do you see a shift to higher rates going forward?

I believe the Bank of Canada will cut to 3 per cent. Why three? Because there are four inflationary forces in the background. We have deglobalization – that is inflationary. We have just-in-case inventory because of COVID. We have a labour market that is definitely not cheap and available. The environment is inflationary because of the extra costs related to environmental regulations.

The inflation target of the Bank of Canada is 2 per cent. That target is not going to change. The only way to keep the target at 2 per cent is to have interest rates higher than they were before. That's why we believe that the Bank of Canada will cut to 3 per cent and stop.

As the earnings season kicks off, what are your thoughts on earnings? More specifically, do you believe companies won't be able to pass rising costs on to the consumer, resulting in margin compression?

The short answer is yes.

We talk to many CEOs when we discuss the economy and more and more of them say it's more difficult to pass through costs to the consumer. The consumer is starting to resist, the consumer's changing its behaviour. While the supply chain is improving, the ability to pass through costs is getting more and more difficult.

If you look at earnings expectations, they are still relatively elevated compared to where we are in the economic cycle. So I think that we are now in the process of adjusting expectations downward and that's why the market is still unable to take off.

I think when we have fully priced in higher interest rates and there are more realistic earnings expectations reflecting the inability to pass through costs, that's when the stock market will be able to improve in a more sustainable way. We're not there yet.

When could we be there?

It's very difficult to say but I think that the second half of the year can be much better than the first half of the year, reflecting the fact that the stock market and the adjustment in earnings will be completed.

In December, 2021, I asked you what phrase you believed would characterize 2022 and you said, "the transition of pandemic to endemic." What phrase do you believe will characterize 2023?

I would say end of inflation panic.

This interview has been edited and condensed. An extended version is available online at tgam.ca/inside-the-market

Analysts expect retail demand for gold bars and coins to remain strong this year as economic growth revives in China, the biggest consumer market. LEONHARD FOEGER/REUTERS

Gold seen hitting record highs as rate hikes ease

PETER HOBSON LONDON

Gold prices are expected to rise toward record highs above US$2,000 an ounce this year, albeit with a little turbulence, as the United States slows the pace of rate hikes and eventually stops increasing them, according to industry analysts.

Spot prices of the precious metal have shot above US$1,900 an ounce, surging by about 18 per cent since early November as inflationary pressures recede and markets anticipate less aggressive monetary policy from the U.S. Federal Reserve.

Fast-rising interest rates hammered gold prices last year, kicking them as low as US$1,613.60 in September from a high of US$2,069.89 in March – just shy of a record peak in 2020.

Higher rates lifted returns on bonds, making non-yielding gold less desirable for financial investors, and pushed the dollar to its strongest in 20 years, making dollar-priced gold costlier for many buyers.

The weakening U.S. currency and bond yields "will become macro tailwinds for the yellow metal, pushing gold above $2,000/oz in the coming months," said analysts at Bank of America.

With less pressure from the dollar and bonds, investors are likely to buy bullion as a hedge against inflation and economic turbulence, said WisdomTree analyst Nitesh Shah, adding that prices could easily move above US$2,100 an ounce by year-end.

Gold is traditionally seen as a safe place to store wealth. "The risk of central banks overdoing it and pushing their economies into recession is high," said Mr. Shah.

Speculators who in November were betting gold prices would fall have amassed a net long position in COMEX futures of 8.3 million ounces of gold, worth US$16-billion, helping push up prices.

Analysts expect central banks to continue stockpiling gold after buying more metal in the first nine months of 2022 than in any year in half a century, according to the World Gold Council.

Retail demand for gold bars and coins should also remain strong, boosted by a revival of economic growth in China, the biggest consumer market, said analysts at ANZ.

But gold may have gone too far too fast in the short term and needs to correct lower, analysts said.

"Should prices fall from current levels to the $1,870–1,900 an ounce range, we expect the [upward] trend to reverse," the bank said, adding that if gold falls below US$1,800, it could slip to US$1,730.

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