

# Markets Made Simple

Chan and Brown Wealth Management



Wealth Management  
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## THE NAME IS BONDS...JUST BONDS

Movies have disclaimers for language, violence, and explicit content. They do not provide warning that it may encourage some individuals to participate in activities that are hazardous to their health. They probably should... at least for me.

Six months after seeing *Top Gun: Maverick* I was upside down and blacked out in the cockpit of a plane from extreme G-forces flying with a former F-16 fighter pilot, recreating the same maneuvers from the movie. Less than a year later, after watching *Fury*, I was crashing through sand dunes in the Texas desert driving a reconditioned WWII Sherman tank and happily firing main gun shells the size of my arm to destroy various derelict cars standing in for German panzers.

Not long after that, I watched *F1: The Movie*. Not surprisingly, I soon found myself behind the wheel of a 500-horsepower Corvette ready to take on one of the most challenging racetracks in Canada at speeds north of 200 km/h. Up until then the only racing experience I had was in the video game, Gran Turismo on the first PlayStation where a crash only resulted in having to reset the game. A crash on this track would probably reset my whole life. Being a calculated risk taker, I decided it would be prudent to enlist the services of a professional race car driver.

We started in the classroom learning braking, accelerating, cornering, and weight-shifting techniques. Next came a track walk, studying each turn, the angle of approach, where to brake and how to exit. My instructor also pointed out the 13 fire extinguishers stationed around the course just in case a car spontaneously combusted, which wasn't super comforting. Finally, he highlighted the many tire marks from cars that had lost control before slamming into the track walls and barriers. I am glad he didn't explain the details of the stains left from the crashes.

At that point, a small voice of caution began whispering that I may have taken the movie-to-life experience a bit too far. I was about to learn a valuable lesson about how quickly a thoughtful, limited risk can turn into something with much more serious consequences in literally, a heartbeat. This is a lesson many investors may soon learn the hard way.

### ***The Start of 2025***

As 2024 wrapped up, things looked promising. Inflation was falling, interest rates were dropping, and miracle of miracles, the Canucks were on track to make the playoffs for the second consecutive year. Eleven rate hikes in 2022-2023 had brought interest rates to their highest in decades, yet the economy remained more resilient than Vancouver's resistance to trade Elias Petterson. The economy was still squeezing out growth despite high rates and jobs were so abundant that even Justin Trudeau was able to (temporarily) keep his.

Then 2025 arrived like Hurricane Katrina. Before anyone could even open their Christmas credit card bills, we were blown away by high, random tariffs and trade wars leading to economic uncertainty. Investors, consumers, and businesses all froze like hikers running into a grizzly bear. Global trade tensions loomed large and hairy, threatening inflation, job losses, a recession, and most terrifying of all, our US booze supply.

## The Weakening Economy

Our ‘indestructible’ economy could only handle so much. Add a trade war to already high interest rates, and the economy began to crack like Elon and Trump’s friendship. Job losses mounted, leading indicators soured, and central banks scrambled to slam the big green *PLAY* button on rate cuts.

### The Yield Curve

The bond market is nearly three times the size of the stock market, and in the world of Bond, it is not shaken martinis but the shaken yield curve that matters. The yield curve shows interest rates that investors receive for bonds, with varying maturities. The chart below shows yields for US Treasury bonds at the start of each year since 2021, the start of September and at end of the most recent quarter. Draw a line through the yields from each year, and voilà, you have the yield curve.

US Treasury Yields							
Date	3 Month	1 Year	2 Year	5 Year	10 Year	20 Year	30 Year
January 1, 2021	0.08%	0.10%	0.12%	0.36%	0.92%	1.44%	1.65%
January 1, 2022	0.05%	0.38%	0.73%	1.26%	1.51%	1.94%	1.90%
January 1, 2023	4.41%	4.73%	4.42%	4.00%	3.88%	4.14%	3.97%
January 1, 2024	5.35%	4.78%	4.25%	3.85%	3.88%	4.19%	4.03%
January 1, 2025	4.32%	4.15%	4.24%	4.38%	4.57%	4.86%	4.78%
September 1, 2025	4.14%	3.84%	3.61%	3.69%	4.22%	4.87%	4.92%
September 30, 2025	3.94%	3.62%	3.61%	3.74%	4.15%	4.70%	4.73%

### A Normal Yield Curve

In a healthy and expanding economy investors expect current economic growth to continue. As the economy operates at full capacity, inflation is expected to rise which pushes long-term interest rates higher. This is known as a *normal yield curve* and when this occurs, short-term rates are lower than long-term rates. At the start of 2021 and 2022, the economy was strong, calling for a gradual rise in inflation, and yields were higher over the long-term.

### Government Bonds

To some investors, government bonds sound as exciting as watching the movie *Out of Africa*, (a classic film with the late Robert Redford and Meryl Streep, although it moves at a glacial pace), but they have an important place in portfolios. During times of turbulence frightened and uneasy investors rush to these assets for safety as they tend to hold steady or even rise when risky assets fall. Owning government bonds (at least the right ones as we will outline later in this newsletter), not only provides stability during times of volatility, but also allows you to trade them at attractive prices for other investments that get marked down like ‘The Bay’ ...no, not their merchandise, their whole store.

In 2020, from March 1<sup>st</sup> to the bottom of the market sell-off on March 23<sup>rd</sup>, COVID fears spread, the S&P500 fell 30% while Canadian government bonds<sup>1</sup> remained stable and retained their value. While many investors during this time were vacillating between buying or selling, like Bella from the movie *Twilight* deciding whether she should date the handsome vampire or the hot werewolf, we were busy choosing between which bargains to pick up with our cash reserves.

On the flip side, when everyone is optimistic, prices can get bid up to unreasonable extremes (cue the bitcoin ads). With overvalued investments and more downside risk we are happy to sit back in our government bonds enclave and wait for opportunities. Depending on the direction of the economy, inflation, and the yield curve, we will adjust the types and duration of the bonds we own to take advantage of the yield curve.

<sup>1</sup> <https://www.blackrock.com/ca/investors/en/products/239486/ishares-canadian-government-bond-index-etf#chartDialog>

### ***The Rate Hike Cycle***

Bond yields in 2021 were sadder than Eeyore from *Winnie the Pooh*, "...the rates have fallen...again..., I always knew it would...". 10-year US Treasury bonds was yielding less than 1%, as my grandpa says, "that's lower than a snake's belly in a tire rut". After watching rates fall for 40 years with some US Treasury bonds going from 15.3% in 1981 to less than 1% by 2021<sup>2</sup>, investors were looking elsewhere. Unfortunately, as the Johnny Lee song goes, they were often "looking for yield in all the wrong places" and taking on more risk than they should.

Risk was what I was facing as I prepared to race an overpowered corvette around a tight sloped, circular, cement walled track. I suited up with my fire suit and helmet, strapped in, and with a rumble like the space shuttle launching, my car left the safety of the pit. After a few laps on the track my comfort level grew and I was channeling Lewis Hamilton..."I don't aspire to be like other drivers, I aspire to be unique in my own way". I proceeded to push the car harder, each time coming into corners faster, accelerating quicker out of turns, and holding speeds of over 200 kph for longer stretches. My confidence grew but unbeknownst to me, so did the risks.

For investors in late 2021, after 40 years, they were confident that rates would not go up... until they did. Rates rose to 5% in 18 months starting in early 2022, and investors who had been reaching for extra yield in long-term and corporate bonds suddenly found themselves strapped into the financial equivalent of an F1 race car, no longer cruising on a long straightway but approaching a hairpin turn at 200kph. *Drive to Survive* is no longer just a Netflix series but an unpleasant reality. Bonds got crushed. Long-term US Treasury bonds fell by 35%<sup>3</sup> and global bonds dropped over 30% during 2022<sup>4</sup>. The bumpers on the corner of the metaphoric track are not soft water filled barrels, but hard, solid concrete.

For our client's portfolio, we hid from the bloodbath in short-term government bonds and floating rate fixed income which allowed us to ease the impact of the swiftly rising rates. Over 2021 and 2022 these investments squeaked out small positive returns and helped us to weather the storm with a smooth ride.

### ***The Inverted Yield Curve***

In a slowing economy, slack builds up, inflation drops, and future rates fall on expectations of lower growth. At the start of 2023 and 2024 the economy struggled under runaway inflation and the burden of higher rates which rose faster than a scalper's price for Taylor Swift Eras Tour tickets. With lower growth on the horizon, one-year Treasury bonds yielded more than 30-year bonds, a situation about as backwards as pineapple on pizza. *This is known as an inverted yield curve.* When the economy is not healthy, short-term rates rise above long-term rates as investors see lower growth on the horizon.

### ***Finally...A Yield!***

As rates increased during 2023 and 2024, bonds FINALLY provided investors with income. Bond yields rose, which was great for income seekers, but not so great for a struggling economy. Inflation was at 40-year highs and elevated rates threatened to strangle growth if left unchecked. Investors fled to cash and short-term savings, and with a slowdown on the horizon, the yield curve inverted. We continued to own short-term government bonds, but bargains arose in preferred shares, corporate, and high-yield bonds. We started swapping some of our government bonds for these opportunities.

### ***Back to Cutting Rates***

As fall is around the corner and pumpkin spiced lattes return to Starbucks, the Bank of Canada and the Federal Reserve have resumed their rate cuts. Rates in both countries fell by 0.25% in September after central banks had put them on pause. The Federal Funds Rate in the US now sit at 4% from a high of 5.25% while the overnight rate in Canada is at 2.5% after reaching a previous high of 5%. With inflation appearing to fade, increasing job losses, as well as a slowing economy, markets are expecting more rate cuts to come by year-end.

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<sup>2</sup> <https://www.reuters.com/business/finance/us-bond-investors-worry-deep-slide-will-end-40-year-bull-market-2022-04-28/>

<sup>3</sup> <https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf>

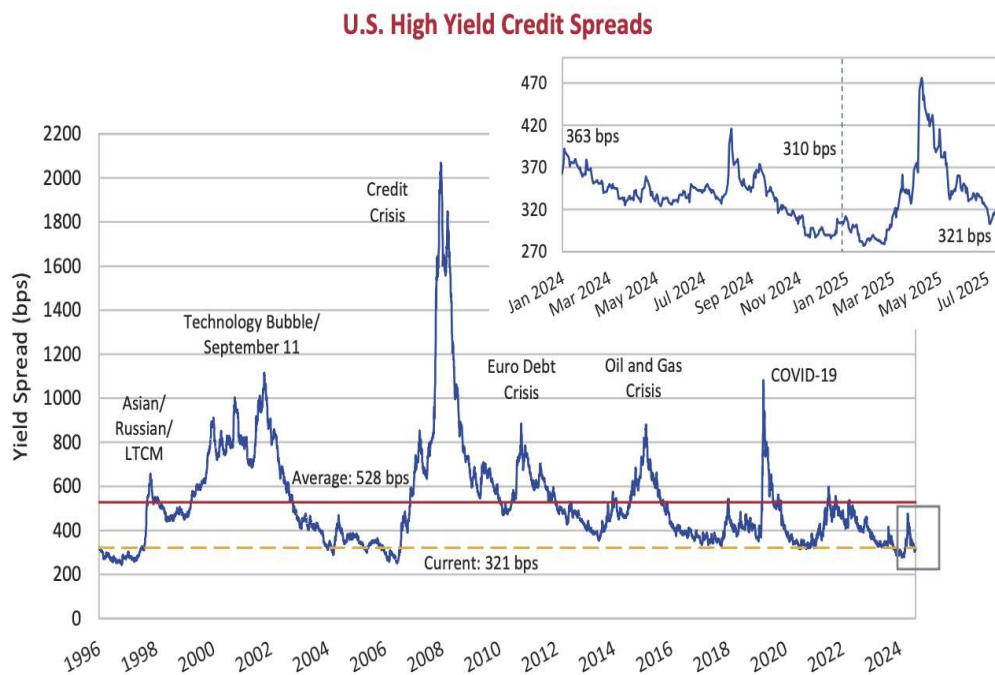
<sup>4</sup> <https://www.ft.com/content/f94c233b-98a5-4f7d-b761-faf15f50ead1>

The changing economy and move in rates have caused the yield curve to undergo a big makeover. Short-term rates are falling, long-term rates are rising and for the first time in almost 20 years, US 30-year Treasury bonds are flirting with 5% yields. It’s a real blast-from-the-past, (I think our Senior Portfolio Manager Dennis Chan has been waiting for floral shirts, bell bottoms and flared pants to come back in style too, so he can wear some of his old clothes, if they still fit.)

**Corporate and Junk Bonds**

Investors receive additional yields for buying corporate or high-yield bonds, but that extra yield has been shrinking. They are now taking on far more risk for far less reward, much like each successful lap I took in the race car. As the car reached higher speeds, each turn was pushing me closer to the edge of bad outcomes, not unlike many parts of the fixed income market today.

The extra yield in investment-grade US bonds has shrunk to the smallest margin since 2005. At the end of June, investors in BBB bonds only received 1.1% in extra yield over governments. Historically, this has been 45% higher, at 1.86% basis points<sup>5</sup>. Investors are now lending to risky borrowers for record-low spreads, kind of like lending your cousin money to open a Blockbuster Video store. In US high yield bonds today, investors receive only 3.21% above governments bonds, almost half of the long-term average of 5.28% since 1996. Credit spreads in bond land are at some of the lowest levels in 20 years. When spreads get tight, bonds get expensive and downside risk increases. In 2007, when spreads hit close to record lows, high-yield bonds lost nearly 30%<sup>6</sup> in the following year. To quote Auric Goldfinger, “No, Mr. Bond, I expect you to die.”



Source: ICE BofA Indices

**Why is the Yield Curve Important?**

In the bond world, different maturities can lead to very different outcomes. Investors owning US Treasuries of 20 years or more over the past five years lost 38%<sup>7</sup>, while short-term holders gained 13%<sup>8</sup>. That’s a 50% swing! Picking the right maturities is essential, and why we carefully choose which bonds and terms to hold.

<sup>5</sup> <https://www.lysanderfunds.com/canso-july-2025-corporate-bond-newsletter/>

<sup>6</sup> Bank of America US High Yield Index - <https://www.thebalancemoney.com/high-yield-bonds-historical-performance-data-417116>

<sup>7</sup> <https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf> (at the end of June 2025)

<sup>8</sup> <https://www.ishares.com/us/products/239466/ishares-short-treasury-bond-etf>

**What Are We Doing Now?**

Short-term bonds have served us well, but our relationship with them is coming to an end, it's not their fault, it's us. With higher and attractive yields now back in long-term fixed income, we have started trading some of our short-term and floating-rate bonds for long-term government bonds. We have also been adding US Treasury Inflation Protected Securities (TIPS) throughout the year. TIPS provide us with long-term inflation protection as we receive a yield plus an inflation adjustment and our TIPS holdings this year has outperformed other US Treasury bonds<sup>9</sup>.

We continue adjusting our holdings in corporate bonds, high-yield bonds, and preferred shares as prices climb and risks mount. When investors were shunning these investments in 2022 and 2023, we added to them. Now that money is pouring in and risks are being ignored, we're turning cautious, trimming positions, taking profits and increasing our government holdings.

**Exhibit 2****US small-cap valuations are relatively low**

Small-cap Russell 2000 price to trailing last-twelve-month earnings (excluding negatives) versus the broad S&P 500



Data as at 13 January 2025. Sources: FactSet, BNP Paribas Asset Management.

**Ready, Steady, Go!**

We have written a lot about what is happening in bonds but what about the stock market? Last quarter we highlighted how equity markets perform when rates fall. Spoiler alert: Very well! The S&P500 has produced almost double the long-term average return during the past 16 rate cut cycles, delivering an average annualized 20%<sup>10</sup>. Meanwhile, there is a record \$7.6 trillion in cash sitting on the sidelines. Rates continue to fall, and investors are starting feel nausea at returns on cash. That money will need a new home, and equities look like an attractive place to move into.

We remain optimistic on our equities from small and mid-cap stocks to international companies. Small and mid-cap stocks have historically outperformed in rate cut cycles<sup>11</sup> and are trading at the lowest valuations relative to US large caps since 2000.

We continue to see some of the cheapest valuations ever for international companies compared to US stocks and maintain our overweight exposure<sup>12</sup>. If stocks were the Ryder Cup, we would be rooting for Team Europe over Team USA. This year we have seen gold prices surge. They started the year at \$3700/oz and have reached over \$5000/oz (in \$CAD). We took some profits in our gold equities that have already doubled this year and rebalanced portfolios last quarter back to their target gold weights while using the proceeds to add to our US small and mid-cap holdings.

<sup>9</sup> <https://www.mackenzieinvestments.com/en/products/etfs/mackenzie-us-tips-index-etf-cad-hedged-qtip>

<sup>10</sup> <https://ca.rbcwealthmanagement.com/documents/3565317/3617925/2025+-+Q2+-+The+Vanishing.pdf/cc25eee0-a6f6-4c76-b5d6-79c39f680e0c>

<sup>11</sup> <https://blogs.cfainstitute.org/investor/2025/04/24/small-caps-vs-large-caps-the-cycle-thats-about-to-turn>

<sup>12</sup> [https://www.brandes.com/docs/default-source/links/chart-of-the-week/international-vs-us-equity-valuations-and-returns-06302023.pdf?sfvrsn=19473593\\_31](https://www.brandes.com/docs/default-source/links/chart-of-the-week/international-vs-us-equity-valuations-and-returns-06302023.pdf?sfvrsn=19473593_31)

**Back on the Track**

At lower speeds I had no problem navigating the tricky sections of the track, the problem was I was no longer driving at lower speeds. I approached the last corner at 150km/h. I came in too fast but managed the first three corners. I flew around the last corner and suddenly heard tires screeching as I reflexively slammed on the brakes and felt the car rocket off the track....

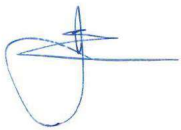
\*Unfortunately, I must blank out this section describing what happens next as my mother reads this newsletter and I don't want her to have a heart attack, and I would have to live with the guilt\*

...seconds felt like hours, but I finally regained power over the car as the back tires found something to grab onto other than air and pulled me back safely onto the course. I crawled through the last lap with a car that sounded as it was on life support. Gravel had lodged into the rims and were making unpleasant noises like I had tossed handful of pennies or loose teeth into the engine as I slid into the safety of the pit that I thought I might never see again.

When I pushed harder during my track run, I was taking unnecessary risks. Some sections allow you to gain time safely, while others offer little reward for significant danger. Coming out of the corner onto straightaways have much less risk and you can pick up valuable seconds while other sections reward Lewis Hamilton like driving with a gain of only a few fractions of a second. The risk-return trade-off just isn't worth it much like many sections of the bond market today.

I learned my lesson about unnecessary risks, and I'll be more careful with the next movie I watch. It will not be *Mission Impossible*. I think *Emily in Paris* might be a safe bet. Maybe I will invite my mom.

-Kind regards,



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