



What Rock-Bottom Bond Yields Mean for Investors

Description

In early March, the yield on U.S. 10-year government treasuries dipped below 1% for the first time ever. This marked what has turned out to be a historic move to bonds. The “TINA” trade (There Is No Alternative) has resulted in a run up of equities. Many investors do not believe a <1% return over 10 years makes sense.

Bond investors vs. equity investors

That said, many equity analysts have pointed out that bond markets tend to be “smarter” than equity markets. This could spell trouble for equity investors if one believes what the bond markets are saying right now. Essentially, as long-term bonds near zero, bond investors (who are naturally more risk averse than equity investors), are saying they would rather take a sub-1% yield over 10 years than bet on corporate growth. This implies stagnant growth over the next decade — a sobering thought for growth investors. Indeed, if broad growth expectations do, in fact, resemble what the bond markets are pricing in, many growth stocks today are vastly overpriced. This is especially true as such growth stocks are pricing in double-digit growth for the foreseeable future.

Banking sector

The sector I believe could face the toughest time ahead would be the financials sector. This is due to lower-for-longer bond yields. This time around, I think the Canadian banking sector could get slaughtered for a few reasons. Large Canadian banks like **Royal Bank of Canada** have recently announced cuts to their prime lending rates. This was in response to plummeting bond yields, spurred by Bank of Canada rate cuts of late. These cuts will both reduce interest spreads as well as increase long-term risks. Canadian mortgage holders will inevitably borrow more as money continues to become cheaper.

Housing sector

The Canadian housing sector has rebounded dramatically in recent months. Lower borrowing rates and more favorable stress test rules have lured many Canadians who may not have otherwise been able to take on a mortgage just a few months ago. This impacts the overall credit quality on lenders' books. Lenders like Royal Bank continue to feel the pressure financial markets place on lenders to continuously increase profitability. Therefore, they are likely to take on additional lending activities at higher risk levels in the near term.

Bottom line

I view the position Canadian banks find themselves in today very similar to the situation U.S. banks were in, in 2007. Only worse. Credit spreads are much lower and credit quality is quickly deteriorating. Canadian household indebtedness is currently much worse than American household debts in 2007. For Canadian investors heavily invested in financials, I'd advise diversifying some of the risk away over the next few months.

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