DON'T FEAR A BEAR IN BONDS

Income's Bull Market

Introduction

Interest rates have been on the decline over the past several decades, resulting in what many refer to as "the 35-year bond bull market." It appears this paradigm has finally shifted into what many are now anticipating as the beginning of the "bond bear market." The negativities associated with rising interest rates and a "bond bear market" may actually be misunderstood. While it is true that bond prices decline as a result of rising interest rates – it's not the whole story. Investors must take into account the higher income built over the life of a bond rather than focus on the temporary price declines. Interest rates may be rising, but this type of environment actually presents a bull market for income – the main driver of a bond's total return.

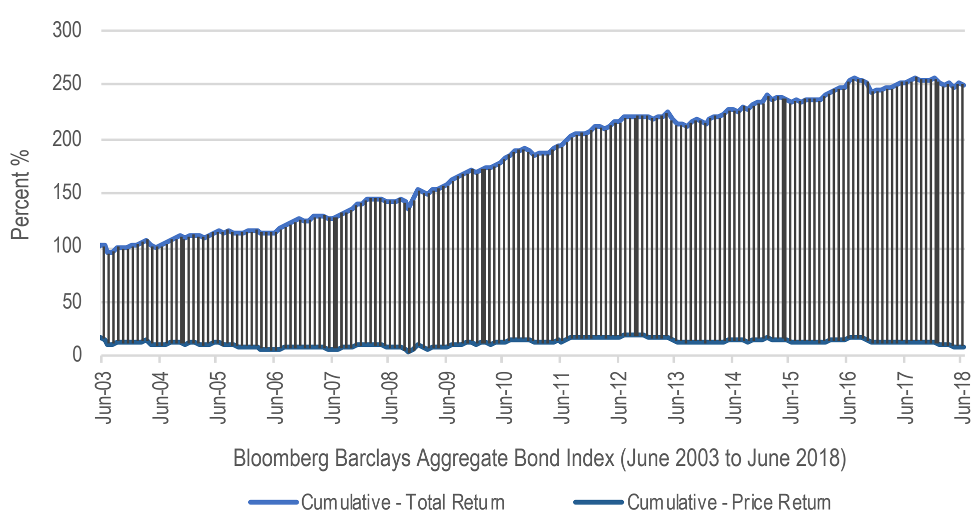
Income Drives Total Return

As investors are taught in Bond 101, there is an inverse relationship between price and yield. When interest rates rise, bond prices fall – which, intuitively, is a bad thing! So why should investors embrace a rising rate environment? As interest rates rise, bond investors are able to reinvest at higher yields. Over a longer-term horizon, the periodic reinvestment of coupon interest and principal repayments capture the higher prevailing market yields. This reinvestment at higher yields can have a meaningful positive impact for an investor with a long-term horizon.

The main components of a bond's total return are the price return and coupon return. The price of the bond fluctuates with market rate movements, but it is the income component that drives the majority of the total return. In addition, not only is income more stable month after month, but over the long term, the reinvestment at higher rates should offset the decline in bond prices. Underlying this dynamic is the time effect, mitigating price changes as bonds march daily towards their maturity's par price. Remember that price declines caused by rate increases are not permanent: all else equal, at maturity bonds pay off at par. This shows how important it is for investors to avoid timing the direction and path of interest rate changes. The series of charts below displays the Bloomberg Barclays Aggregate Bond Index and shows how the income component drives the index's total return over time.

Exhibit 1 shows the cumulative total return of the Bloomberg Barclays Aggregate Bond Index with the middle section representing the cumulative income gained over the time period.

Exhibit 1: Income Gained Over Time

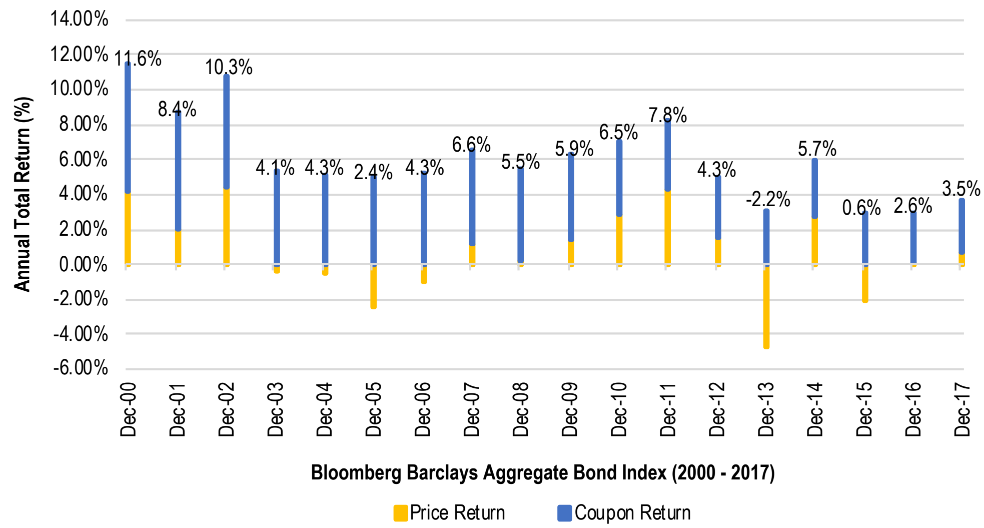


Source: Bloomberg, as of 6.30.18

Exhibit 2 shows the annual total return of the Bloomberg Barclays Aggregate Bond Index broken out by the income and price components. In most years, income is the dominant driver and typically offsets the price returns.

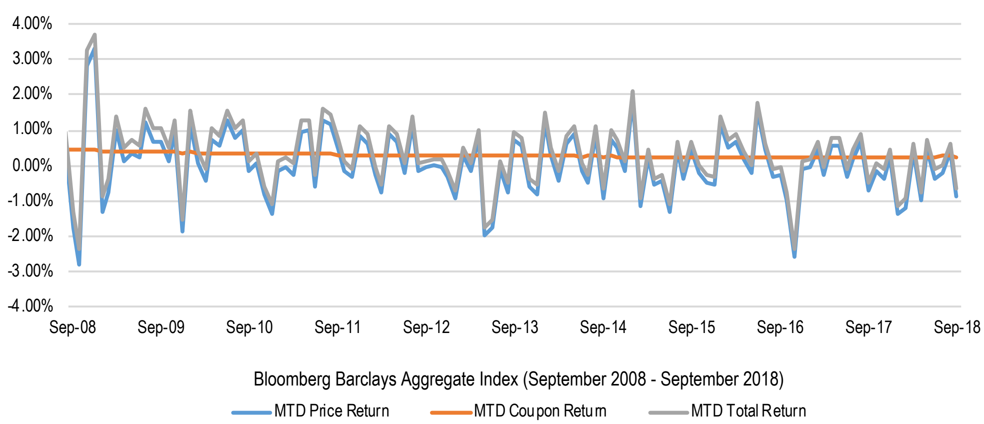
Exhibit 3 shows the monthly total return of the Bloomberg Barclays Aggregate Bond Index over the last several years. Coupons produce stable income month over month, while the price fluctuates and is more unpredictable.

Exhibit 2: Income Drives Annual Total Returns



Source: Barclays Live, Bloomberg Barclays Aggregate Bond Index, as of 12.31.17

Exhibit 3: Income is Consistent



Source: Barclays Live, Bloomberg Barclays Aggregate Bond Index, as of 9.30.18

Income Outweighs Price Return

In the face of a rising rate environment, it is important to emphasize the increasing significance of income return and how that component is a main driver of overall total return. The chart below displays RBC Global Asset Management's projected total returns over the next 12 months for a number of fixed income indices. Not only is each index projected to produce a positive absolute return, notice the projected income component more than offsets the projected price component.

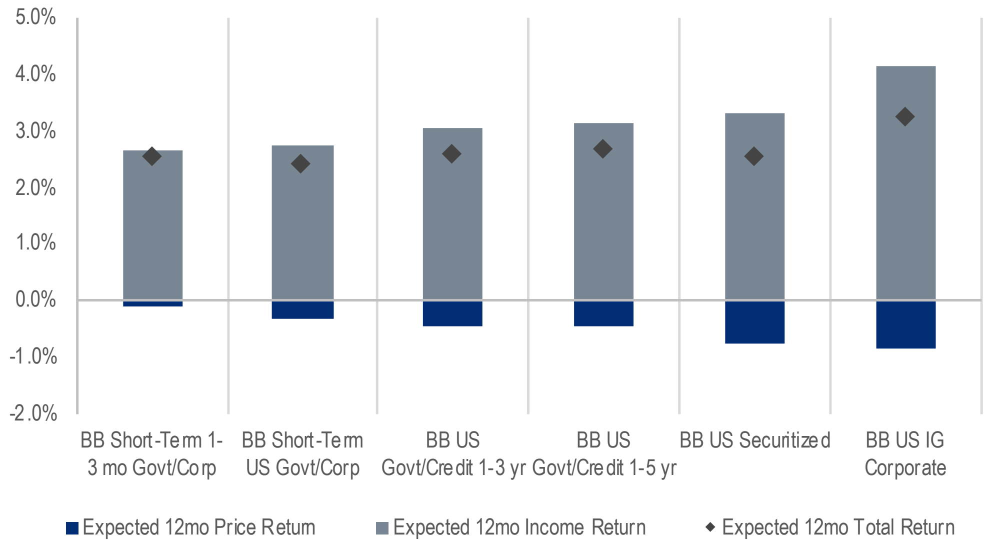
Another way to express the benefits and consistency of income is through a simulated projection of total returns over a longer time horizon, represented by the BofA ML 1-10 Year AAA-A Government Credit Index. Again, income (as represented in the dark blue bars in the chart below) not only drives the cumulative total return, but it more than offsets any negative impacts from the changes in price, while adding nearly 30 basis points to annual total return.

Rising Rates: Wanted

In the highly anticipated rising rate environment, bondholders can benefit from the reinvestment of income at higher yields. The 2-year Treasury hit its lowest point of 0.16% in September 2011, while the 10-year Treasury hit its lowest point of 1.38% in July 2016. Nearing the end of 2018, yields on the 2-year and 10-year Treasury are hovering around 2.80% and 3.20%, respectively. Moving away from those undesirable low yields into higher yields will help bondholders when it's time for reinvestment.

Investors with a long-term horizon should not fear rising rates, as the income generated from their bonds should offset price declines in the event interest rates rise faster than the market anticipates. Especially for patient investors, the benefits over time should outweigh the near-term concerns during the next "bond bear market."

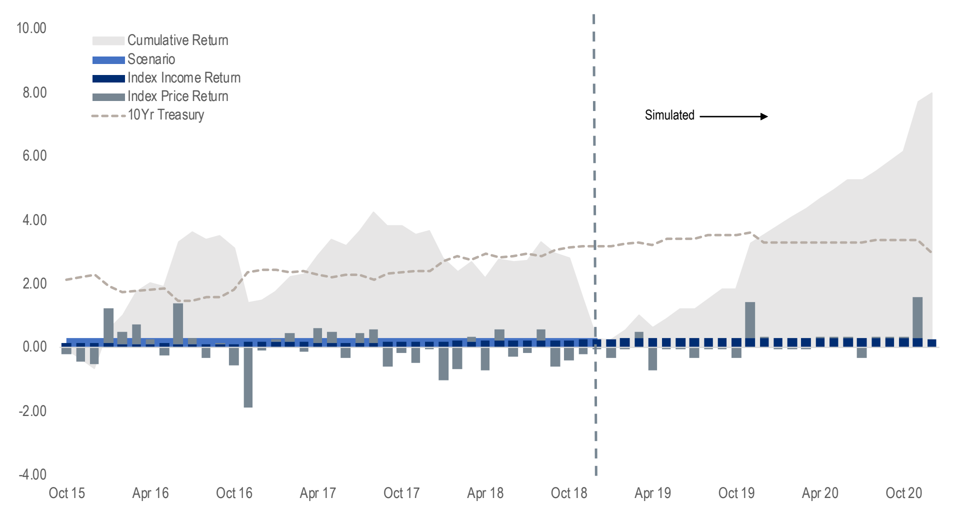
Exhibit 4: Projected 12-Month Returns



As of 9.30.18

Source: RBC GAM-US, Bloomberg. RBC GAM-US Model and Forecast Rates are based on projected economic, geo-political and market conditions. Views of RBC Global Asset Management are as of the date of publication and are subject to change without notice. RBC GAM-US Expected Returns are based in each index and the modeled and forecasted rates above. The information is not a guarantee of future rates and actual results may differ materially from those described as a result of various factors.

Exhibit 5: Bank of America 1-10 Year AAA-A US Corporate & Government Index



As of 10.31.18 (model updates with real-time data)

Source: Bloomberg (yield/rates data), Bank of America (index data), RBC GAM-US calculation of price return based on yield and total return. Simulated yields based on scenario indicated and projected economic and market conditions. Simulated price, income and cumulative returns based on scenario indicated, forecasted yield changes and no spread changes. Views of RBC Global Asset Management are subject to change without notice. The information is not a guarantee of future performance and actual results may differ materially from those described as a result of various factors.

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