RBC Global Asset Management

Global fixed income markets

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Government-bond yields in developed markets remain historically low, and we expect that they will be broadly unchanged 12 months from now. The dominant factor in our outlook remains the pandemic. A return to normal appears to be a long way off, and so we can expect the pandemic will continue to have an unprecedented impact on people, governments and economies for the foreseeable future. Eventually the pandemic will subside and at that point yields should rise. Investors should be prepared for lackluster government-bond performance.

The effect of current monetary-policy actions on government-bond yields cannot be underestimated. Central-bank policymakers have lowered policy rates dramatically, and have been clear that they do not expect to raise rates for some time, perhaps years. Equally important is the fact that investors appear to believe in the avowal of central banks to keep rates low. The futures market indicates that investors do not expect the U.S. Federal Reserve (Fed) to raise interest rates until the fall of 2024. In Canada, the market is penciling in the first rate hike from the Bank of Canada (BOC) for the fall of 2023.

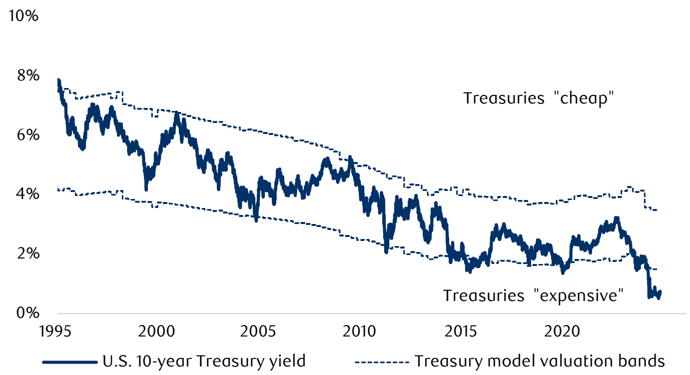
In addition to an extended period of exceptionally low short-term interest rates, central banks have committed to purchasing substantial amounts of financial assets. Through the first half of 2020, major central banks bought more than US$5 trillion of such assets, and the purchases continue, albeit at a slower pace. These transactions include both government bonds and corporate debt, and in the case of Japan, equities. The impact of past purchases, and ongoing commitments to buy both safe and risky assets to ensure orderly markets, has been remarkable.

With central banks directly backstopping the prices of risky assets, global equities and corporate bonds have staged their fastest-ever recovery from bear markets. Meanwhile, government-bond yields have remained near the lows seen in the depths of the pandemic-linked panic in March. Given the continuing impact of COVID-19, policy support for safe and risky assets alike will remain high, muting upward pressure on government-bond yields.

At the same time, government bonds are expensive, based on historical valuation tools, suggesting higher yields will prevail when the economy returns to something resembling normal. Our fair-value estimate (Exhibit 1) for the U.S. 10-year Treasury-bond yield is between 1.5% and 3.5%, implying a fairly substantial rise in yields from the current 0.70%. Our estimate for the yield on the 10-year Canadian government bond is similar. Of course, we do not expect a return to normal yields overnight, but perhaps over several years. As yields rise, capital losses would offset coupon income.

In addition to higher bond yields in the longer term, we think investors should be wary of another development that we believe will have a large effect on the government-bond market: evolving central-bank policy in response to low interest rates and inflation.

Exhibit 1: U.S. 10-year Treasuries are expensive
U.S. 10-year Treasury yield, RBC GAM Treasury model



Note: as of August 31, 2020. Sources: Federal Reserve, RBC GAM

Alongside efforts to cushion the immediate impact of the pandemic, central banks are adapting their tools to longer-term challenges facing their economies. Both the Fed and the European Central Bank (ECB) are undertaking strategic reviews that we anticipate will largely codify actions taken to offset global trends, which have resulted in sluggish economic growth and persistently low inflation. While the pandemic will likely not figure prominently in these reviews, the tools that central banks recently deployed almost certainly will.

The longer-term issues plaguing the global economy include slowing population growth and a larger share of the workforce that is either retired or not working. Absent increases in productivity, these factors will tend to reduce an economy's potential growth, and lower economic-growth rates mean that central bankers must keep policy rates low. Given that most policymakers consider negative interest rates to be ineffective in combatting slow growth, central bankers in the future will likely be forced to use tools other than interest-rate cuts in response to economic downturns.

In addition to facing constraints on the ability to change short-term interest-rates in response to economic fluctuations, policymakers face the problem of too little inflation. At least part of today's subdued price increases can be attributed to the success of central banks in tamping down price pressures via inflation-targeting. Other factors keeping inflation low over the past couple decades probably include technological developments and the globalization of trade, as well as the erosion of workers' bargaining power as reflected in declining union membership. Moreover, low inflation is self-reinforcing, because it generally moderates expectations of future inflation. As the period of high and variable inflation in the 1970s moves further into history, so too have people's memories of that period. While inflation expectations used to be sensitive to changes in current inflation, they do not vary much these days as a greater and growing share of the population has no experience of such episodes.

The decline in inflation and inflation expectations since the 1970s was welcome, but has become a problem for policymakers constrained by low interest rates. When a central bank cuts policy rates to zero, further reductions are limited by inflation. For example, if the policy rate is 0% and people expect 2% inflation, the inflation-adjusted policy rate is -2%. As inflation expectations fall, it becomes harder and harder for central bankers to provide stimulus without descending into negative policy rates – a situation where lenders pay borrowers. Instead of cutting policy rates into negative territory, central bankers can create more policy room by raising expectations for future inflation. Unlike the long-term trends affecting economic growth, central banks can influence inflation expectations via commitments to keep financial conditions loose until a sustained upturn in inflation is generated.

Central-bank asset purchases and balance-sheet management are likely to be a permanent feature of bond markets, with possible implications for the relationship between assets that have generally been designated as "safe" and "risky." Central-bank support for risky assets might already be changing the relationships between government-bond markets, which have historically performed the task of buffering balanced portfolios, and risky assets. The performance of two key markets during the March bond rally illustrates a shift in how investors' ability to depend on government fixed-income markets may be shifting. As pandemic-related panic spread, Japanese equities fell by about a third, while Japanese government bonds rose just 2% at a time when short-term rates were already near zero. In contrast, U.S. government bonds returned 12% given that the Fed was then still able to cut rates significantly.

After years of battling persistently low inflation and sluggish economic growth, the Bank of Japan (BOJ) owns more than 50% of the country's government-bond market and controls bond yields through a program of yield-curve control, which ensures that the gap between short- and long-term interest rates stays small. While a mix of asset purchases and the targeting of long-term yields is intended to stimulate economic growth, it has somewhat undermined the case for holding government bonds as safe assets in a balanced portfolio. Japan's experience raises the possibility that the U.S. could be headed in the same direction.

In summary, checks on policymakers' ability to use short-term interest rates to stimulate economic growth means commitments to keep rates low for longer and longer periods will become the norm. Asset purchases will become everyday policy tools, keeping government bond yields from rising substantially. Finally, central banks will likely become more tolerant of higher inflation. In most of our scenarios, what strikes us is the relatively poor outlook for both nominal and inflation-adjusted government-bond returns.

Direction of rates

U.S. – The Fed cut its target range for the fed funds rate to between 0.00% and 0.25% in mid-March. To quote Chair Jerome Powell, the central bank is "not even thinking about thinking about raising interest rates." In addition to the commitment to not raise rates, the Fed will make monthly purchases of US$80 billion in Treasury bonds and US$40 billion of mortgage-backed securities at least through the end of this year.

The Fed will most likely announce the results of its strategic policy review in September. We do not expect a revolutionary outcome. In July, Powell said the review would largely codify what the Fed has already been doing, and we expect that the Fed will pursue a monetary policy focused on generating more inflation when its target is not met. We expect no change to the policy rate in the U.S. over the next 12 months. Our one-year ahead forecast for the 10-year Treasury yield is 0.75%.

Germany – In July, the ECB board of governors left its policy interest-rate unchanged at -0.50% and slowed emergency asset purchases linked to the pandemic, reflecting better market conditions. We do, however, expect asset purchases to continue for the foreseeable future as economic activity remains muted. An agreement struck earlier in the summer will result in substantial EU-backed debt issues in the years ahead to fund pandemic and economic reform. The debt issues will make the EU one of the largest issuers of euro-denominated sovereign debt, representing an enormous transformation for European government-bond markets. We expect that such large EU bond issuance will reduce the difference in borrowing costs between more creditworthy and less creditworthy European governments. As with all other major central banks, we do not expect a change in the ECB's policy rate over the next 12 months, and forecast the 10-year German bund yield to be -0.30% in a year.

Japan – There was no change to the BOJ's 0% policy rate over the past quarter. The BOJ's yield-curve control policy was also unchanged, with the 10-year government-bond yield managed in a range of -0.20% to 0.20%. The BOJ has also increased purchases of Japanese government bonds (JGB). We do not expect a change in interest-rate policy from the BOJ over the next year. Our 12-month forecast for the 10-year JGB is 0.00%, in the middle of the BOJ's yield-curve control band.

U.K. – After cutting the benchmark interest rate to 0.10%, the Bank of England (BOE) left rates unchanged at its August meeting and ruled out the use of negative policy rates. Instead, BOE policymakers said they will tie any eventual change in policy rates to a sustained rise in inflation above the central bank's 2% target and the removal of some of the current high level of economic slack. Policymakers emphasized that risks to the outlook remain skewed to the downside. In addition to the pandemic, the U.K. is entering the final phase of exiting from the EU. With interest rates already near zero and the BOE explicitly ruling out negative rates, we do not expect any change in the policy rate over the next 12 months. Our 12-month forecast for the 10-year gilt yield is 0.40%.

Canada – Over the summer, a surge in COVID-19 infections in the U.S. and globally (but not so much within Canada) cast doubt on the strength of the global economic recovery, resulting in longer-term bond yields hitting post-pandemic lows and Canada's 10-year bond trading at a yield below 45 basis points. Investors now expect that accommodative monetary policies will last longer and perhaps become even more stimulative. Bank of Canada (BOC) Governor Tiff Macklem said in July that he expects the BOC to keep its policy rate near zero until economic slack is absorbed and the central bank's 2 percent inflation target is "sustainably achieved."

The BOC has wound down some of the market-support programs that were introduced in the spring as the pandemic spread. We expect that BOC purchases of Government of Canada bonds through quantitative easing will be even more necessary as supply rises. The government announced changes to its bond-issuance program for this year, shifting the focus to longer-term maturities as well as increasing the frequency and size of issuance. Over the next 12 months, we expect no change to the BOC's 25-basis-point overnight rate, and we expect a 10-year yield of about 70 basis points.

Regional recommendations

We expect the significant new EU issuance to lead to higher interest rates in "core" markets. As such, we are underweighting Germany and channeling the proceeds into Japanese government bonds, which offer higher yields on a currency-hedged basis.

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