RBC Global Asset Management

Global fixed income markets

FALL 2021

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Bond yields have declined over the past several months on investors' concerns that the coronavirus variant known as delta will undermine the economic recovery. While we cannot rule out the emergence of an even more virulent variant, we believe that bond yields have fallen too far. Much of the globe should experience above-trend economic growth for an extended period, supported by a continued reopening of the economy and supportive monetary and fiscal policies. In our view, government-bond yields are likely to climb over the next 12 months. We forecast that the 10-year U.S. Treasury yield will rise to 1.75% sometime over the next year from about 1.31% currently.

Recent events in New Zealand show us why yields will be sensitive to COVID-related developments over shorter periods. New Zealand had enjoyed relatively robust economic growth and above-target inflation for most of this year, and the country's central bank was expected to be among the first in developed markets to raise interest rates. However, a COVID-19 outbreak and mid-August lockdown on the eve of a monetary-policy meeting derailed the widely expected interest-rate hike.

We don't believe that New Zealand holds many lessons for other markets. The government has relied on travel bans and strict quarantines rather than inoculations, making lockdowns a necessity to combat the spread of the virus. By contrast, countries with extensive vaccination campaigns have seen deaths plummet as significantly fewer people are ending up in hospital with serious cases. In these countries, governments can more readily lift restrictions on economic activity because the likelihood that a surge in COVID cases will overwhelm medical facilities is greatly diminished. It is the central banks of these countries that will probably be the first to raise interest rates, likely accompanied by higher bond yields.

The more relevant case for most bond markets, to our mind, is the U.K. reopening, which was all but completed by July 19. Unlike New Zealand, which has one of the lowest vaccination rates in the developed world, the U.K. has one of the highest. The effectiveness of the vaccine, combined with widespread adoption in the U.K., meant that the economy continued to return to normal without overwhelming the hospital system – even with a surge in delta cases over the summer (Exhibit 1). This experience bodes well for other countries that lifted restrictions later and also have high vaccination rates. The evidence suggests that vaccines are breaking the economically damaging cycle whereby cases fall, business opens up, cases surge, lockdowns resume, cases fall… and so on.

The successful vaccine rollouts mean that the economic recovery has progressed far more quickly than most central bankers and economic forecasters anticipated, even as recently as the first few months of this year. Inflation, running at the fastest pace in a decade in North America, has also exceeded expectations. We believe that the inflation surge is temporary. Most of the rise so far is related to pent-up demand coming into conflict with supply-chain issues such as last month's two-week closure of a Chinese port that is the world's third-busiest, due to a COVID outbreak. Nevertheless, bondholders and central bankers should not fully discount the possibility that higher inflation is here to stay.

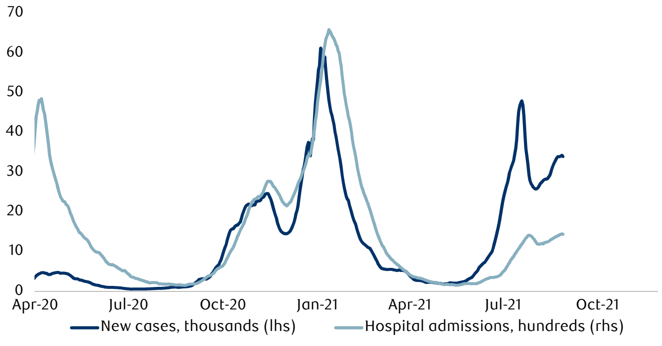
Labour markets in many countries are also on the mend with robust job creation and wage growth. We expect the strong labour market to persist into next year amid strong demand from reopening businesses and the expiry of pandemic-related unemployment benefits.

The sense that the worst of the pandemic's economic effects are in the past has infected the minds of central bankers. Most are actively plotting a retreat from emergency levels of support for their economies. The U.S. Federal Reserve (Fed) is widely expected to begin reducing the pace of asset purchases by early 2022, with an announcement expected before the end of this year. We don't expect any decrease in bond purchases by the Fed to lead to a pronounced rise in yields as happened during the "taper tantrum" in 2013 because the taper is well telegraphed this time, and the expected reductions are likely to be more than offset by a decline in bond issuance next year as Congress spends less on pandemic-related relief and as tax revenues rise.

Also differing from 2013 is the economic situation. Today's labour market and economy are strong and inflation is much higher (Exhibit 2). As a result, there is broad agreement that the Fed should start down this path, whereas in 2013 then-Fed Chair Ben Bernanke surprised investors with his intention to scale back bond purchases. Ultimately, the scale of Fed bond purchases on a month-to-month basis is less important than what a shift toward reducing bond purchases says about future interest-rate hikes. Policymakers want to halt asset-purchase programs in advance of hiking interest rates, and the beginning of the tapering process is a key signal that the Fed will eventually follow with rate hikes.

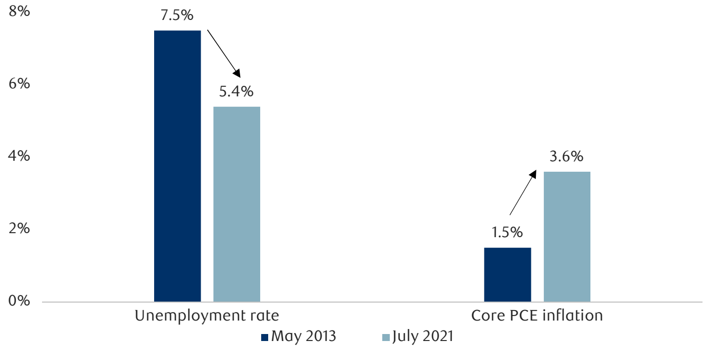
We recognize that it could be some time before central bankers proceed with rate increases. Our view is that the Fed's first rate move will likely come sometime in 2023 after the central bank scales back bond purchases to its satisfaction. That said, investors do not think interest rates will be rising as much as the Fed's forecasts suggest: investors expect just two rate hikes in 2023 – a number that one would expect to be higher if the labour market and inflation were satisfying the Fed's prerequisites. Investors are also less optimistic about how high U.S. interest rates can rise. U.S. interest-rate markets imply that the fed funds rate will rise to 1.70% in five years' time, compared with the 2.50% rate indicated by Fed policymakers as their long-run policy rate (Exhibit 3).

Exhibit 1: U.K. Coronavirus waves
New cases and hospital admissions



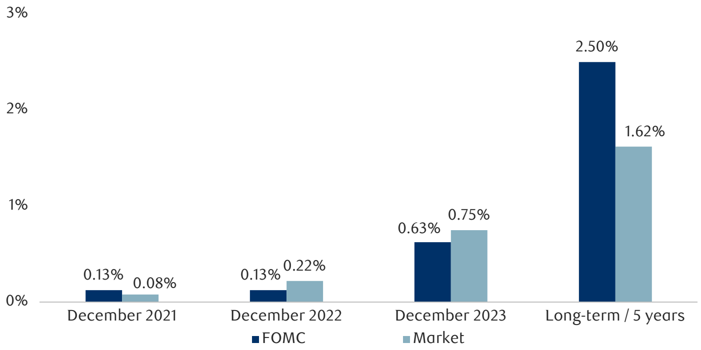
Note: As of August 28, 2021. Source: U.K. Government

Exhibit 2: U.S. economic data ahead of tapering
Unemployment rate and core PCE inflation, percent



Note: As of July 2021. Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis

Exhibit 3: Expectations for the fed funds rate
FOMC forecasts and market-implied interest rates



Note: SEP as of June 2021, market expectations as of September 1 2021.
Source: FOMC Summary of Economic Projections (SEP), Bloomberg

As mentioned above, we are slightly more sanguine than the market, and more aligned with Fed forecasts. Over the next year or so, most economies should continue to record above-trend growth, supporting higher bond yields and suggesting that investors should be preparing for higher rates in most major markets. We are reflecting this scenario in our forecasts.

To be sure, our 1.75% forecast on a U.S. 10-year Treasury is paltry. After accounting for expected inflation of 2%, the yield is negative in real terms. Our yield forecast reflects not only continued uncertainty about the near-term and long-run effects of the coronavirus, but also some of the same macroeconomic trends that have pushed down on yields for the past four decades. These trends include demographic and technological changes, rising wealth and income inequality, slowing productivity growth, rising debt loads and, not least, credible inflation targeting by central banks. Most of these trends are likely to continue to hold down bond yields. Some of them, such as rising debt levels and inequality, have been exacerbated by the pandemic. Governments are exiting the pandemic with much higher debt-to-GDP loads and deficits, as some pandemic-era programs become permanent outlays. Over the long term, higher debt loads lower the expected growth and dynamism of an economy – weighing on bond yields.

Another factor keeping bond yields low is relatively poor economic outlooks in Europe and Japan, whose central banks are aggressively purchasing government bonds.

The European Central Bank (ECB) and the Bank of Japan (BOJ) are both purchasing vast amounts of government debt to bolster economic activity that is flagging because of structurally lower growth and inflation, and high government-debt levels. As a result, European and Japanese investors are investing more in foreign government-bond markets, such as the U.S. and Canada, depressing yields in places that would in isolation warrant higher yields.

Given our forecasts for higher bond yields, the outlook for government fixed income over the next 12 months is poor. We expect returns to be in the low single digits or even negative. Over the long term, we also expect bond yields will likely remain low. Nevertheless, low expected returns should not preclude holding government bonds as a safe asset in one's portfolio. Even with low yields, government bonds can still act as an important asset class offering ballast to a portfolio in case of a sell-off in equities and/or deterioration in the premium yields offered by corporate bonds.

While our forecasts are for higher yields a year from now, it is also true that yields are likely to remain much lower than historically was the case. Without a steady decline in bond yields (bond prices move inversely to yields), investors are unlikely to realize price appreciation from bonds and must be more careful about how they construct fixed-income portfolios.

To make up for projected declines in bond returns, investors have had to find new opportunities, one of which is in Chinese fixed income. These bonds offer higher yields and lower volatility than bonds in most developed markets and some emerging markets. Long closed off from foreign investors, the Chinese bond market is now the world's second-largest behind the U.S. and ahead of Japan. Chinese government bonds are slated for inclusion in the FTSE Russell World Government Bond Index (WGBI) over the next few years. Eventually, we expect China will be the sixth-largest member of the index, just behind Germany and ahead of the U.K. We have included Chinese bonds in several of our global fixed-income portfolios for several years in a bet that they will become more widely held. The fact that Chinese yields are relatively high makes them both a source of relatively attractive coupon income and an area of potential capital appreciation if their yields fall to levels more in line with other comparable markets.

Direction of interest rates

We expect no change to the fed funds rate over the next year, and see 10-year Treasury yields rising to 1.75%.

U.S. – The U.S. economy is so far powering through the negative impact that the delta variant is having on growth. Moreover, we expect growth to remain above trend for some time, likely accompanied for a time by inflation that exceeds the Fed's 2% target. Reflecting the progress made toward an economic recovery, we expect the Fed to begin slowing bond purchases early next year and completely stop before the end of 2022. Rate hikes, however, will likely not occur until 2023. Key to any eventual rate hike will be the performance of the labour market, which has some ways to go before satisfying the Federal Open Market Committee's (FOMC) goal of maximum employment.

As a reminder, the basis for Fed action has changed with the adoption of a policy that inflation must be sustainably above 2%, instead of being at that level at the time policy decisions are made. This approach is known as "average inflation targeting" and joins the policy that the unemployment rate be consistent with maximum employment. While the Fed has not defined what it means by maximum employment, it is fair to say it is well below July's unemployment rate of 5.4%.

Another concern for investors are impending changes to the FOMC's composition, which will make the body as a whole more likely to tighten monetary policy. The January changes involving the scheduled rotation of FOMCs voting members, coupled with the expected phasing-out of bond purchases, will tend to push up yields. Investors should also keep an eye on Fed Chair Jerome Powell, whose four-year term is up for renewal in February. President Biden is expected to rename Powell to the post, but could change his mind. We expect no change to the fed funds rate over the next year, and see 10-year Treasury yields rising to 1.75%.

We anticipate that the 10-year bond yield will rise to 1.50% sometime within the next year from about 1.20% currently.

Canada – In July, the Bank of Canada (BOC) fulfilled its intention to further reduce bond purchases, to $2 billion weekly from $3 billion, in light of the economic recovery. The BOC's decision to trim the pace of purchases was also influenced by a reduction in the government's financing needs. The BOC reiterated its commitment to hold the policy rate as low as possible until demand recovers and on the condition that inflation remain around 2 percent over time. Canadian inflation rose to its highest annual pace in two decades in July, reaching 3.7%. Like the Fed, the BOC continues to view the current jump in inflation as largely temporary. We expect to BOC to lower bond purchases to $1 billion a week in October, assuming the economy continues performing well, and to completely phase out quantitative easing early next year. Our earliest expectations for policy rates to rise is late 2022.

The yield on the Canadian 10-year bond fell over the past quarter as rising concerns about the delta variant and the global economic slowdown re-emerged. As a result, we believe that policymakers are more likely to hold off on raising rates until the near-term impact of these developments becomes clearer. Persistently higher inflation and a return to more consistent economic performance should lead to a modest upward trend in rates over the next year.

The BOC is scheduled to announce any changes to the way it makes policy decisions by the end of the year. The current policy mix targets inflation, and the outcome of recent reviews by the Fed and the European Central Bank (ECB) suggest that the BOC could add targets for the unemployment rate similar to the Fed. Other concerns that could be considered are financial stability, climate change, and income and wealth inequality.

Over the next 12 months we expect no change to the BOC's overnight rate, currently at 0.25%, and anticipate that the 10-year bond yield will rise to 1.50% sometime within the next year from about 1.20% currently.

We forecast the 10-year bond yield to be 0.10%, compared with about zero now.

Japan – We do not expect the Bank of Japan (BOJ) to undertake a major shift in policy over the next year. The policy rate remains -0.10% and the BOJ's target range for the 10-year Japanese Government Bond (JGB) yield is still centered on 0.00%. Japan's low vaccination rate has left the country struggling to contain the delta variant, weighing on economic activity. With the policy rate and long-term bond yields already near zero, the BOJ is unlikely to increase policy accommodation over the next year. Over the long term, Japanese yields should remain low thanks to persistently weak inflation and an aging and shrinking population that is weighing on potential growth. We expect the policy rate to be unchanged at -0.10% in a year's time and forecast the 10-year bond yield to be 0.10%, compared with about zero now.

We expect the 10-year gilt yield to rise to 0.80% over the next year from 0.50% currently.

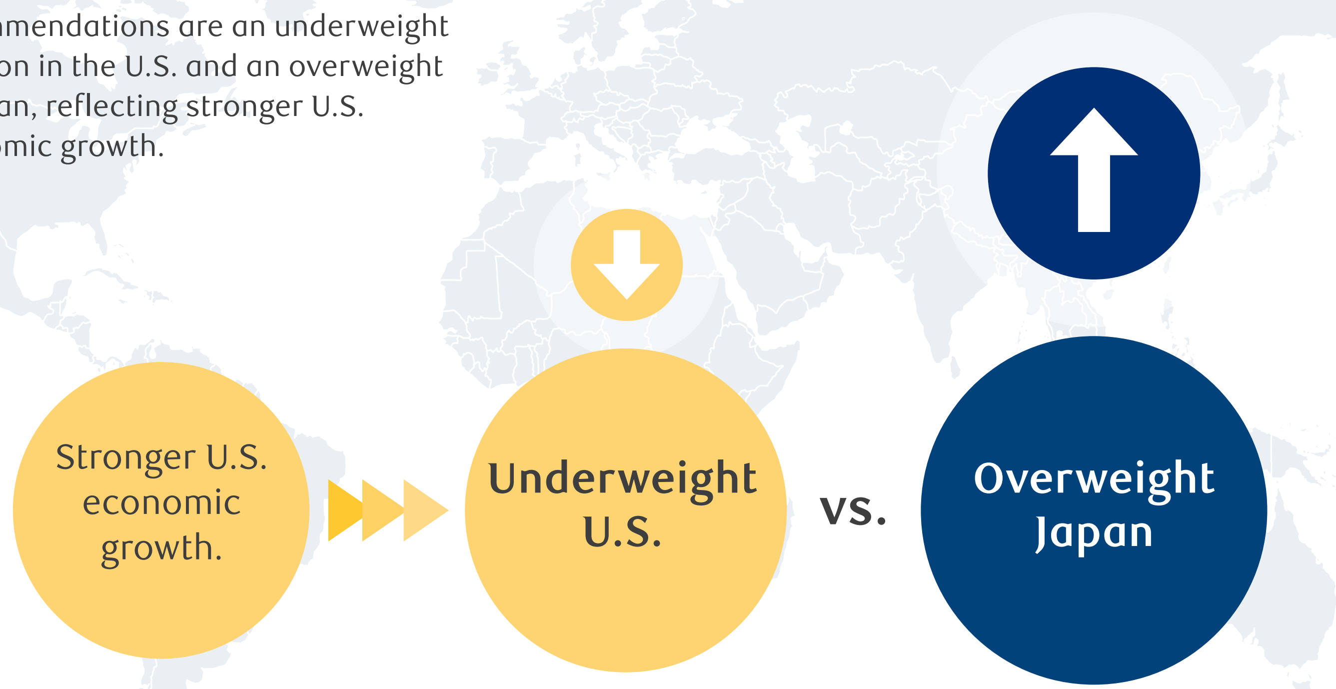
U.K. – We do not expect the Bank of England (BOE) to raise its policy rate over the next year. Nevertheless, confidence in the outlook for the U.K. economy through the medium term is running high enough that the BOE's Monetary Policy Committee (MPC) was recently emboldened to detail plans for reducing the pace of asset purchases and, eventually, embarking on a program to shrink its balance sheet. The MPC indicated that it would halt reinvestments of maturing securities once the policy rate reached 0.50% and actively sell assets once it reached 1.00%. We are skeptical that the BOE will follow through anytime soon with such an approach as it would put it at odds with most of its peers. Many investors share our skepticism: market indicators suggest that the policy rate will reach no higher than 0.70% over the next five years, falling short of the 1.00% that the BOE has set as the minimum rate for selling assets. Nevertheless, the U.K.'s recovery from the pandemic continues apace against a backdrop of higher-than-target inflation, paving the way for bond yields to rise over the year ahead. We expect no change to the policy rate. However, we expect the 10-year gilt yield to rise to 0.80% over the next year from 0.50% currently.

We expect to see the German 10-year bund yield rising to -0.25% in the year ahead from about -0.50% currently.

Eurozone – Apart from the BOJ, the ECB is likely to remain the central bank least likely to tighten monetary policy over the next few years. The ECB, having kept its policy rate in negative territory for more than five years, has been unwilling to cut the rate even further in response to the pandemic. Instead, policymakers have relied on asset purchases to keep borrowing costs low for governments and corporations, while vowing to keep rates on hold for ever-longer periods. Inflation in the Eurozone has risen much less markedly than in the U.S. or Canada, which we believe is due in part to the fact that COVID-related fiscal measures were less targeted at consumption. We expect no change to the ECB's overnight policy rate in the next 12 months and see the German 10-year bund yield rising to -0.25% in the year ahead from about -0.50% currently.

Regional recommendation

We expect bond yields to rise in most markets over the next 12 months. Our recommendations are an underweight position in the U.S. and an overweight in Japan, reflecting stronger U.S. economic growth.



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Publication date: September 15, 2021