RBC Global Asset Management

Global fixed income markets

FALL 2023

Soo Boo Cheah, MBA, CFA
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Joanne Lee, MFin, CFA
Senior Portfolio Manager
RBC Global Asset Management Inc.

Taylor Self, MBA, CFA
Portfolio Manager,
RBC Global Asset Management Inc.

The outlook for bond investors appears to be improving, with the highest yields in 15 years forming a positive backdrop for fixed-income returns over the year ahead.

U.S. government bonds returned just over 3.0% over the past 10 months, a period in which 10-year bond yields were essentially unchanged. Over the next 12 months, we expect returns in the mid-to-high single digits as yields are augmented by rising bond prices in an environment where inflation continues to slow and central bankers appear set to begin cutting interest rates.

Our view is that the threat of a recession, whether or not one materializes, will lead central banks to reduce interest rates within the next year. Moreover, inflation is already falling back toward central bankers' 2% target, bolstering the case for lower policy rates. While we have been predicting a recession since late 2022, the call hasn't materialized due to much-better-than-expected U.S. growth, which buoyed equity markets and kept central banks raising interest rates, even after a brief pause during the spring.

Why has growth been so resilient?

The first reason is that we underestimated the full effect of fiscal stimulus and the impact of the pandemic-related savings accumulated in most of the developed world. Fiscal stimulus has been pared, but spending incentives related to the U.S. Inflation Reduction Act and energy subsidies in the eurozone have bolstered growth much more than we anticipated.

Governments were also much slower to curtail pandemic-related expenditures and consumers much more eager to spend their savings stashes. Typically, consumers would raise their savings rates for a period after a serious economic downturn – reflecting a more cautious outlook on the world. Instead, households have spent their savings, and more. Governments, for their part, have made little effort to scale back their own spending and budget deficits remain remarkably high.

Another reason that a recession has so far been avoided is that the economy seems less sensitive to rising interest rates than has historically been the case. In the U.S., corporations took advantage of low yields to lock in borrowing costs for exceptionally long periods (Exhibit 1), and households typically have very long-maturity borrowings related to mortgages. Even terms on car loans are much longer and now stretch as long as 10 years.

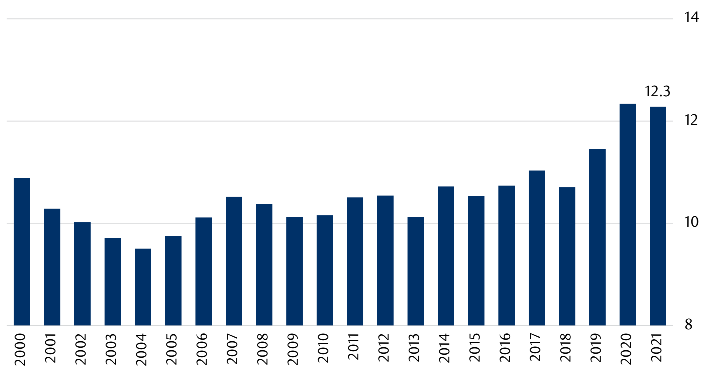
This means that borrowing costs for businesses and households rise much more slowly because a smaller portion of their debt is renewed every year. The impact of interest-rate hikes is therefore spread over a longer period and their effect dulled by earnings growth (for businesses) and income growth (for households). The forbearance of lenders has also been surprising. In Canada, major banks have permitted some mortgage borrowers to extend amortization periods by decades in order to keep payments manageable.

Quantitative easing also reduced the sensitivity of the economy to rate hikes by reducing banks' bond holdings and therefore their exposure to losses linked to rising interest rates. Smaller bond holdings have enabled banks to sustain lending better than if their bond holdings had been more significant. To be sure, the failure of several important U.S. banks indicates that the decline in bond portfolios still had an impact this time around, but absent quantitative easing it would have been much worse.

We still think that the rapid pace and huge scale of interest-rate hikes over the past year and a half will be sufficient to bring inflation back to 2% alongside a cooling of economic activity. As the long lags of policy start to bite, we already see signs that the economy is softening. Inflation has eased substantially, and the risks of overtightening are much higher now.

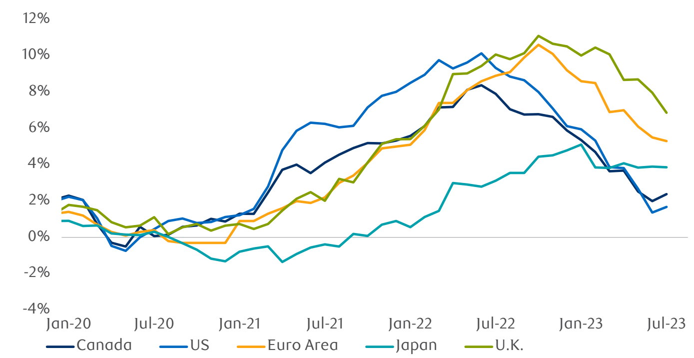
While inflation still exceeds 2%, the pace is down from mid-2022, when prices were rising at the fastest pace since the 1980s (Exhibit 2). Labour-market strength – which central banks have identified as a key contributor to the risk of sustained too-high inflation – has also eased. Consumers and businesses, for their part, are also set to more fully feel the pinch of rate hikes. Payments for Canadian mortgage holders could rise 20% or even more as they renew their loans.

Exhibit 1: Firms issued exceptionally long-maturity debt when yields were low



Note: Data as of December 31, 2021. Bonds, weighted average time to maturity (years). Source: Bloomberg Barclays U.S. Corporate Bond Index

Exhibit 2: Inflation has slowed



Note: Data as of August 30, 2023. Adjusted for country-level differences in inflation calculation methods. Source: National statistical offices

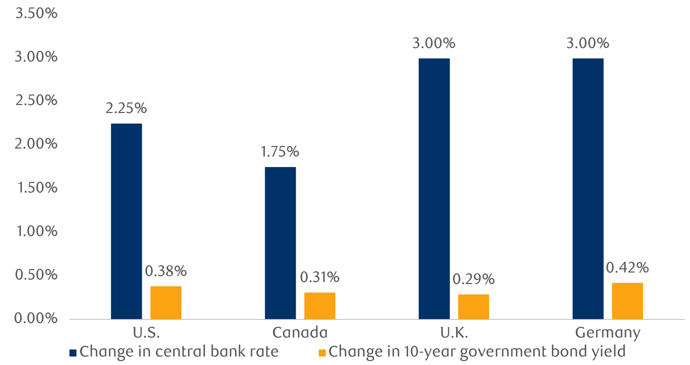
Overall, we believe that the window for continued economic resilience and very high policy rates will close in 2024, and this view is in line with bond-market indicators. The inverted yield curve reflects investors' conviction that an economic downturn is nigh and that high policy rates are unlikely to persist. The extremeness of the inversion is reflected in the fact that, while central banks have raised interest rates hundreds of basis points over the past year, longer-term bond yields are effectively unchanged (Exhibit 3).

Yield-curve inversions, where long-term bond yields are lower than short-term yields, have presaged every U.S. recession since 1945, and it's unlikely that this time will be different. Typically, the yield curve inverts between six months and two years before a recession starts. The yield curve has been inverted since last July, just six months after the first rate hike by the U.S. Federal Reserve (Fed). Based on history, a recession is mostly likely to occur sometime over the next year.

Our view is that we have likely seen the final few rate hikes from most central banks. We think slower price rises and a more balanced labour market will give policymakers the confidence to reduce policy rates from very restrictive levels, bolstering bond returns. Over the next year, the dominant theme in the bond market will likely be peak policy rates and peak bond yields. Bonds are cheap according to most of our valuation metrics, and we expect that returns over the next year will be well supported by coupon income and price gains as central banks start to cut policy rates.

Some investors are legitimately concerned that the long-run impact of poor government finances will be negative for bonds - and that investors will demand higher yields in exchange for higher risk of non-payment. As mentioned above, government deficits remain very large in most countries.

Exhibit 3: Government bond yields have not risen with policy rates – Respective changes since October 2022



Note: Data as of August 30, 2023. Source: Bloomberg

We have been writing about this risk for some time. The fiscal situation in many places looks particularly poor compared to history. In the U.S., for example, government debt relative to the size of the economy is expected to grow quickly through the middle of this century. This trend might prompt investors to draw comparisons to the European debt crisis of the early 2010s. Our view is that the U.S. situation is quite different. The U.S. tax burden is very low, and unlike European countries that faced huge interest costs and were already highly taxed, the U.S. has substantial room to raise revenues and "right-size" its tax base to reflect an expanded government footprint.

Overall, we think that concerns about government deficits in the developed world are overblown. While government debt and deficits are concerning, bond yields are more likely to be affected over the next year by slower inflation and growth than long-run concerns over fiscal probity.

Direction of rates

We expect the fed funds rate target to be between 4.50% and 4.75% in a year's time and the yield on the 10-year U.S. Treasury to fall to 3.50% from about 4.30% now.

United States

The Fed raised its target range for the fed funds rate to 5.25% to 5.50% in July, after keeping rates on hold in June. This Fed's move was in line with our view based on still too-high inflation and a too-tight labour market. We expect just one more hike from policymakers in the current cycle, likely in November. The fall in inflation, despite a remarkably resilient pace of economic growth, means that the risk of tightening too much is now higher. While falling inflation likely removes the need for much further tightening, resilient growth means that the Fed is likely to keep rates at high levels into the middle of next year before the start of rate cuts. At the time of writing, long-term bond yields in the U.S. were rising quickly, reflecting concerns about the poor fiscal outlook in the U.S.

As mentioned above, while the long-run fiscal outlook is poor, we think that the U.S. government has substantial room to raise revenues through tax hikes. Policymakers could, of course, decide to shrink spending back to a level more consistent with pre-pandemic levels. Whenever these adjustments occur, they are likely to depress growth in the short to medium term, pushing down yields and pushing up bond prices. We expect the fed funds rate target to be between 4.50% and 4.75% in a year's time and the yield on the 10-year U.S. Treasury to fall to 3.50% from about 4.30% now.

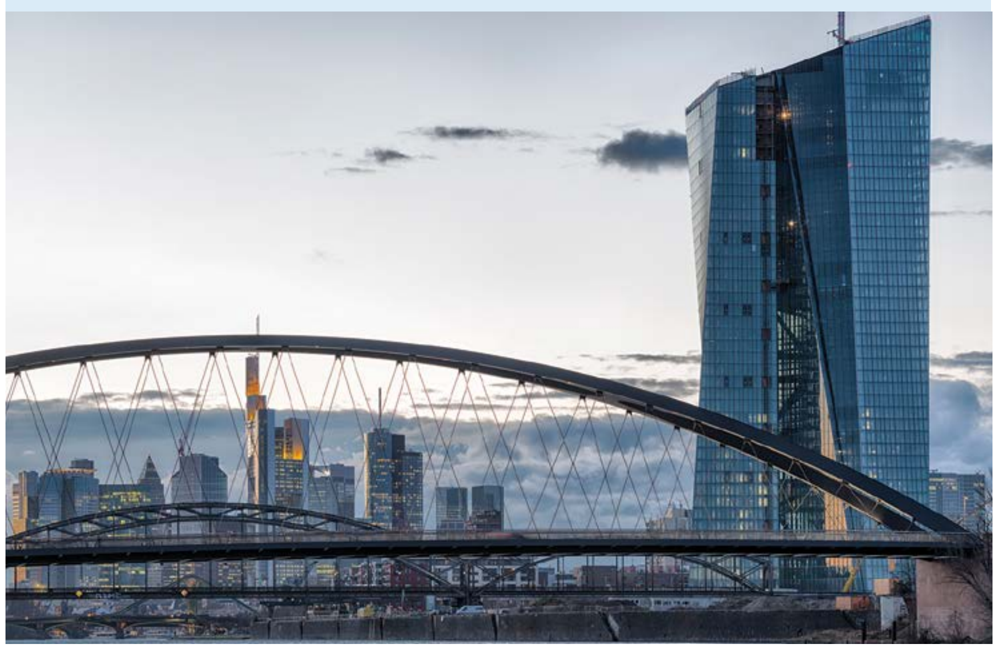
We expect the ECB will hike just once more to 4.00%, before cutting rates around the middle of next year back to 3.25%.

Eurozone

The European Central Bank (ECB) hiked interest rates by 0.25% at both its June and July meetings to bring the deposit rate to 3.75%. Strong demand for European government debt, especially that of fiscally weaker countries such as Italy, has kept policymakers focused on containing inflation. Inflation remains much too high, but disinflation seems to have taken hold in most of the single-currency area. It appears that the current hiking cycle in Europe might come to an end much sooner than most investors were expecting.

As recently as May, investors thought that long-run policy rates in Europe might rise as high as those in the U.S. We did not think this scenario would play out, as Europe's potential for economic growth is likely much lower than the U.S. and the region requires lower central-bank policy rates as a result. The European economy is also more sensitive to rising borrowing costs than America's, leading us to believe that the economic slowdown might happen faster and be more pronounced. Over the past six months, the German economy has been weak, posting two consecutive quarters of contraction. Manufacturing activity is also remarkably weak, partly reflecting the lack of a hoped-for rebound in Chinese growth, and services activity now appears vulnerable to a slowdown as well. Moreover, fears that high unionization rates in Europe would stoke inflation through big wage deals appear to have been unfounded.

We expect the ECB will hike just once more to 4.00%, before cutting rates back to 3.25% starting around the middle of next year. Against this backdrop, we expect yields on 10-year German government bonds to reach 2.60%.



We expect further tightening of monetary policy over the next year, with the overnight rate rising above 0% for the first time since 2016, to 0.10%.

Japan

The Bank of Japan (BOJ) surprised markets by tightening monetary policy at its July meeting, in line with our expectations for an eventual unwinding of the central bank's exceptionally easy policy stance. Unlike its developed-market peers, which have tightened their policy stances at the most aggressive pace in decades, the BOJ, until July, had refrained from making any material tightening. Also unlike its peers, inflation in Japan has not slowed. In response to the highest and longest period of sustained inflation since the 1990s, inflation expectations are climbing quickly, raising the risk that price rises could become entrenched at a higher rate than the BOJ wants.

The changes to the BOJ's yield-curve control policy, which for the past eight years has kept the gap between short- and long-term rates in a tight range, could have large spillover effects on global bond markets. These adjustments have allowed Japanese interest rates to rise, making overseas bonds less attractive to Japanese investors and potentially removing a large and important buyer of global bonds. Truth be told, Japanese investors had been large sellers of foreign bonds for some time due to punitive currency-hedging costs and a realization that Japanese interest rates couldn't stay near zero forever. We expect further tightening of monetary policy over the next year, with the overnight rate rising above 0% for the first time since 2016, to 0.10%. The yield on the 10-year Japanese government bond should also rise, to about 0.75%, from 0.60% at the time of writing.

We forecast that the policy rate will remain at 5.0% for the rest of 2023. In 2024, we expect the BOC will cut the policy rate to 4.25% by the fall. We expect the Canadian 10-year government bond will yield 3.00% sometime over the next 12 months.

Canada

After pausing rate hikes for five months, the Bank of Canada (BOC) resumed benchmark increases in June and July, lifting the policy rate to 5% for the first time since 2001. Strong demand and sticky inflation, due in large part to strong population growth, prompted the decision. The BOC does not expect inflation to return to its 2% target until mid-2025, about two quarters later than the bank forecast in April. Immigration, strong labour markets and household savings accumulated during the pandemic continue to underpin strong demand and are helping to offset higher inflation and mortgage rates. That said, consumer spending is drifting lower as debt-servicing costs climb and that trend will continue and even accelerate. Tight credit conditions and prospects for slower economic growth are starting to dent business investment. We forecast that the policy rate will remain at 5.0% for the rest of 2023. In 2024, we expect the BOC will cut the policy rate to 4.25% by the fall. We expect the Canadian 10-year government bond will yield 3.00% sometime over the next 12 months.

We expect the UK benchmark interest rate to fall to 5.25% sometime over the next 12 months and the yield on the 10-year gilt to drop to 4.25%.

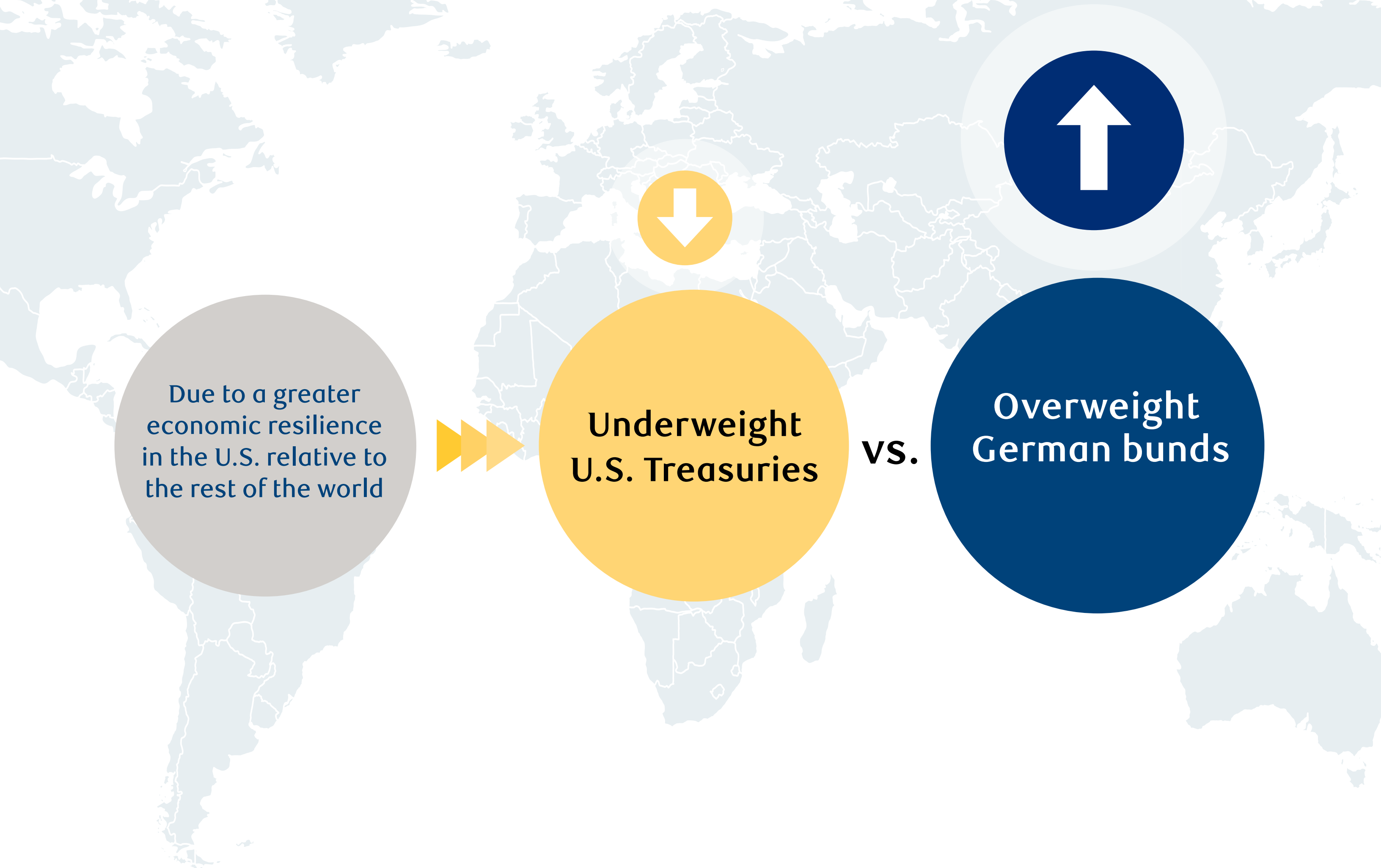
U.K.

We expect the Bank of England (the BOE) to halt policy tightening before the end of this year, with rates peaking at 5.75%. In the coming months, policymakers will shift their attention beyond the peak in rates, and we expect the BOE to cut rates in 2024 as household finances deteriorate due to higher interest costs and slowing economic activity. As the renewal pace of fixed-rate mortgages picks up, household consumption is likely to slow. The impact of higher mortgage rates on borrowers will be dramatic, and some Britons renewing a 25-year mortgage could face a 50% increase in monthly payments. As weak as we expect economic activity to be, inflation remains above the BOE's target, and this fact will tend to underpin rates and keep the BOE from supporting real activity as much as it would like.

The path toward lower yields faces a large hurdle given investors' concern over the credibility of the U.K. Treasury. The government's deteriorating finances and the probability of rising issuance in the coming months may lead investors to demand higher yield premiums. Debt-servicing costs currently stand at 4% of GDP, double the level in 2020 and the highest in 20 years. The surge is particularly large due to inflation compensation paid on government debt whose payments are linked to changes in prices. This issue is particular to the U.K., as a large percentage of the country's government debt is tied to such changes. We expect the U.K. benchmark interest rate to fall to 5.25% sometime over the next 12 months and the yield on the 10-year gilt to drop to 4.25%.

Regional outlook

Reflecting greater economic resilience in the U.S. relative to the rest of the world, we recommend being underweight Treasuries and overweight German bunds.



Interest-rate forecast: 12-month horizon

Total-return calculation: August 31, 2023 – August 31, 2024

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.50%	4.10%	3.75%	3.50%	3.90%	6.67%
Change to prev. quarter	-0.25%	0.60%	0.45%	0.25%	0.20%	
High	6.25%	6.00%	5.25%	4.75%	4.90%	0.23%
Low	2.50%	2.60%	2.60%	2.75%	3.50%	10.91%
Expected Total Return US$ hedged: 6.9%						

Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.25%	3.00%	2.75%	2.60%	2.50%	2.45%
Change to prev. quarter	(0.25%)	0.50%	0.35%	0.35%	0.25%	
High	4.50%	4.00%	3.75%	3.50%	3.00%	(2.54%)
Low	2.00%	1.75%	1.75%	1.75%	2.00%	11.90%
Expected Total Return US$ hedged: 6.2%						

Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.10%	0.20%	0.40%	0.75%	1.70%	1.32%
Change to prev. quarter	0.10%	0.00%	0.00%	0.00%	0.15%	
High	0.50%	0.75%	0.90%	1.25%	2.30%	(6.80%)
Low	(0.10%)	0.00%	0.20%	0.35%	1.20%	8.80%
Expected Total Return US$ hedged: 6.7%						

Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.25%	3.75%	3.25%	3.00%	3.10%	6.44%
Change to prev. quarter	0.50%	0.25%	0.25%	0.25%	0.20%	
High	5.75%	5.50%	4.75%	4.25%	4.00%	(0.33%)
Low	2.25%	2.25%	2.25%	2.25%	2.40%	12.21%
Expected Total Return US$ hedged: 6.7%						

U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	5.25%	4.75%	4.50%	4.25%	4.50%	5.78%
Change to prev. quarter	0.50%	1.50%	1.10%	0.50%	0.50%	
High	6.50%	6.00%	5.50%	5.00%	4.80%	0.95%
Low	3.50%	3.00%	3.00%	3.00%	3.75%	15.37%
Expected Total Return US$ hedged: 7.8%						

Source: RBC GAM

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to investors in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, and RBC Global Asset Management (Asia) Limited, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate and permissible, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

Publication date: September 15, 2023