RBC Global Asset Management

Global fixed income markets

NEW YEAR 2021

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Bond yields have been inching up for several months, buoyed by the results of clinical trials suggesting that highly effective COVID-19 vaccines may soon receive clearance. Their distribution would start the world on its journey toward "normal" before the end of next year. Even with a widely available vaccine, the economic hangover from the coronavirus pandemic is likely to persist for many years, and so just as a return to "normal" life after COVID-19 is a long way off, so is a return to more "normal" bond yields.

Indeed, yields remain far below their pre-pandemic levels, and we expect this state of affairs to continue over the next year. The coronavirus dealt an unprecedented shock to the global economy, and the recovery is going to be uneven and drawn-out. In this context, central banks will remain concerned with nurturing a labour-market recovery that will likely stretch over several years, and policy support is likely to be removed gradually. A huge loss in consumer demand means that inflation is likely to be muted, and subdued price increases provide another reason for central banks to keep policy accommodative. We do not expect any major central banks to raise interest rates over the next 12 months, and likely well beyond that time frame. Moreover, central banks are likely to find themselves shouldering a rising share of the burden for stimulating economic growth, as fiscal policy may become more restrained. Any decline in fiscal support should extend the period of accommodative central-bank policy, again keeping yields low.

In addition to battling the effects of the pandemic, central banks are changing their policy goals in ways that will keep yields low. Earlier this fall, the U.S. Federal Reserve (Fed) announced that it would begin linking changes in interest rates and bond purchases to an average inflation rate instead of current inflation – an approach known as average inflation targeting. As a result, the Fed will allow inflation to run above 2% to compensate for periods when it trends below that level. Similarly, the European Central Bank (ECB) has signaled that it will be more tolerant of inflation exceeding 2% over time as opposed to targeting inflation "at or below 2%." These changes are significant and acknowledge a goal of higher and more variable inflation.

Should bond investors be concerned about this more enthusiastic embrace of higher inflation by central bankers? Probably not. While central banks are adept at responding to shorter-run fluctuations in the business cycle by easing financial conditions, they are relatively powerless to influence long-run economic trends over which monetary policy has little sway: aging populations, slowing productivity growth and extreme levels of economic inequality. These factors all presage slower economic growth and lower inflation, and thus lower interest rates and bond yields. Inflation has been falling for several decades and has done so in recent years in the face of historically accommodative monetary policy.

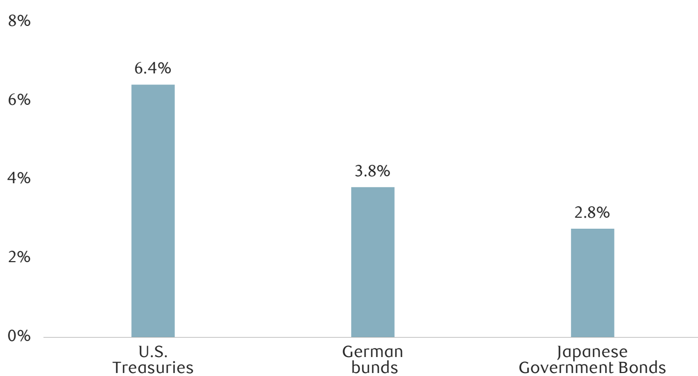
What easier monetary policies have done, and will continue to do, is fundamentally change an important feature of government-bond returns: their effectiveness at offsetting economic and financial risks. Historically, bond yields moved up and down as the outlook for the economy and inflation changed. When the economic outlook improved, usually coincident with higher equity prices, yields also tended to rise. Conversely, when the economic outlook deteriorated and equity prices declined, bonds would rally as interest rates fell. This negative correlation between bond and equity returns is the foundation of balanced portfolios. For the past several decades, bond investors enjoyed the role that government bonds served as insurance against declines in equities and the significant capital gains that bonds generated as yields steadily fell over time.

Today, the apparent determination of central bankers to indefinitely hold short-term policy rates near zero should erode confidence that bonds can fulfill this insurance role. What's more, government-bond yields are paltry. In Europe and Japan, where policy rates have been kept low for years, government bonds provided a much smaller buffer against declines in risky assets compared with the U.S. and other countries where yields were relatively high (Exhibit 1). We can see this even more dramatically by segmenting government bond markets into maturity buckets. For shorter-term bonds, such as those with fewer than five years to maturity, the response to equity declines is essentially nil for German bunds and Japanese government bonds (JGBs) (Exhibit 2).

For investors in government-bond indexes, the sapping of the insurance feature from shorter-maturity bonds is not trivial. Between 30% and 50% of government bonds in major indexes have less than five years to maturity. Index investors should realize that a substantial portion of their fixed-income allocations are providing little, if any, buffer against equity sell-offs. In these cases, short-term government bonds essentially become cash, earning a slight amount of interest, but of little use in a traditional balanced portfolio. Worse still, short-term government bonds, unlike cash, carry the risk of capital losses if yields rise.

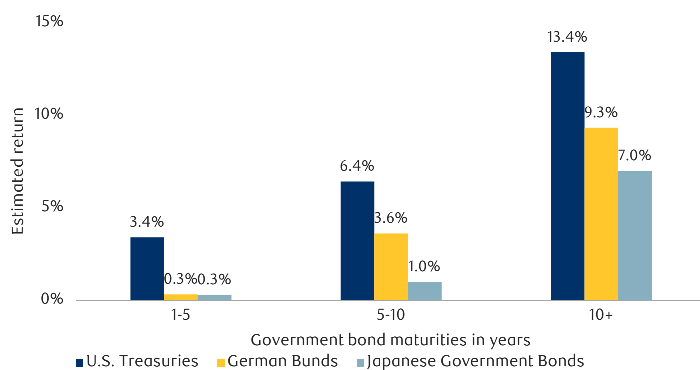
Luckily, there is a significant area of the government-bond market that can still perform the insurance function in a balanced portfolio: long-maturity government bonds. This portion of the government-bond yield curve is more sensitive to changes in macroeconomic expectations, and has remained so even as central banks expanded their hold over larger shares of the front end of the yield curve. We managed this transition for years in Japan, where the problem of bonds' declining usefulness in periods of macroeconomic risks is most acute thanks to yield-curve control. For nearly a decade, we have owned no JGBs with a maturity of 10 years or fewer in our Global Bond Fund as they served no portfolio purpose that we couldn't achieve by holding cash. We instead owned a combination of longer-maturity JGBs, which continued to be sensitive to changing economic conditions in Japan, as well as currency-hedged non-Japanese bonds that would respond to changes in global risk appetite. Unfortunately, a problem that was previously restricted to Japan and increasingly to Europe is spreading around the globe thanks to the evolution of central-bank policy.

Exhibit 1: Risk diversification from government bonds – Estimated returns to government bonds when risk assets decline by 20%



Note: As of Oct. 30, 2020. Source: Bloomberg, Bank of America Merrill Lynch Indices, RBC GAM calculations

Exhibit 2: Risk diversification from different maturity buckets – Estimated returns to government bonds when risk assets decline by 20%



Note: As of Oct. 30, 2020. Source: Bloomberg, Bank of America Merrill Lynch Indices, RBC GAM calculations

Central-bank policies are likely to continue to impair the ability of larger and larger swathes of the government-bond market to respond to changes in risky assets, and investors therefore need to be clear what purpose government bonds are serving in their portfolios. We expect that longer-maturity government bonds will continue to provide a degree of protection against equity-market declines. Shorter-term government bonds, on the other hand, will lose this ability, and investors should consider high-quality, short-term investment-grade bonds as an alternative in this area of their portfolios. In sum, bond holdings must reflect how much central-bank intervention has affected fixed income's relationship with other assets, especially risk-sensitive ones like equities.

U.S. – The U.S. 10-year bond yield has climbed steadily over the past quarter, primarily in response to rising optimism about potential vaccines for COVID-19. We caution investors not to take this increase as a start of a trend: the road back to normal is still long and the Fed will need to continue providing substantial policy support to the economy by keeping yields low. We expect no change in the fed funds rate over the next year and asset purchases are likely to continue, along with the possibility of an increase in the pace of purchases and a greater emphasis on longer-maturity bonds. With this in mind, we expect the U.S. 10-year bond yield to be around 1.00% in a year's time, near its current level. While the Democrats won the presidency and retained control of the House of Representatives, they appear to have fallen short of taking control of the Senate. Given this outcome, a large increase in fiscal spending is much less likely than would have been in the event of a Democratic sweep.

Canada – The Bank of Canada (BOC) said late last month that it does not anticipate raising its short-term benchmark interest rate before 2023, based on the bank's current economic forecast. In the near term, the rise in coronavirus cases and related business restrictions are slowing the economic recovery and holding down bond yields. Looking into 2021, the prospects for a COVID-19 vaccine are improving, and any resulting uptick in economic growth would likely lead to higher yields. A vaccine within Canada may be available on a limited basis in a few months but probably won't be widely available until the latter part of next year.

During the past quarter, the BOC shelved many of the extraordinary market-calming measures put in place in the wake of spring lockdowns, as macroeconomic stability continued to improve. The BOC announced most recently that it would begin scaling back bond purchases to $4 billion a week from $5 billion, and that it would start to refocus its purchases on longer-term bonds, which are more tied to borrowing costs for households and businesses. This should not be considered a tightening of policy, but rather as tailoring the program better to the needs of the market to ensure its maximum efficacy. The BOC's rationale for shifting its emphasis to longer-term securities was the already low benchmark interest rate and the bank's success so far in persuading investors that rates will stay low. We expect that longer rates could drift to the higher end of the recent range.

Over the next 12 months we expect no change to the BOC's 25-basis-point overnight rate. The 10-year yield is forecast at 85 basis points.

Japan – Monetary policy in Japan has been on hold at extremely accommodative levels for many years, with little to show for it by way of increased inflation, and as the economic recovery is likely to drag on, we don't expect the Bank of Japan (BOJ) to tinker much with policy. There was no change to the BOJ's policy over the past quarter. Our 12-month forecast for the 10-year JGB yield is little changed at 0.05%, anchored by yield-curve control policy that keeps the yield between -0.20% and +0.20%.

U.K. – The Bank of England (BOE) announced further support for the economy in November, saying it would boost purchases of government bonds. Moreover, two members of the BOE's monetary-policy committee are on the record as saying they would support negative interest rates if necessary to prop up the economy. Absent a deeper downturn in the economy, however, we do not expect the BOE to cut rates into negative territory over the next year. Huge uncertainty does exist surrounding the future of the U.K.'s relationship with its largest trading partner, the EU, and this uncertainty hangs over sterling-denominated assets. We continue to expect that some sort of agreement will be reached - likely one that does not dramatically change the status quo. We expect the 10-year gilt yield to be 0.30% in a year's time and that the policy rate should remain unchanged at 10 basis points.

Eurozone – The Eurozone's decision this year to begin issuing EU-backed bonds represents a milestone in European integration. The program accomplishes two things. First, it reduces the risk of a break-up of the Eurozone, many of whose member governments are highly indebted. Second, the safety promised by jointly issued bonds would allow yields to rise in countries such as France and Belgium, with the net effect being to tighten spreads between more and

less creditworthy governments in the Eurozone. As with other major central banks, the panoply of support programs announced by the ECB in response to the coronavirus is likely to continue through the end of next year. As Europe recovers from the pandemic, we expect ECB policy may ease more over the next year. We do not expect the ECB to change its overnight deposit rate from the current -0.5% over the next 12 months. However, the central bank may ease policy through increases in the size and scope of asset purchases.

We forecast the 10-year German bund yield at -0.40% 12 months from now.

Regional views

We have no regional bias at this time given that monetary policies in all major regions are unlikely to change from today's extremely accommodative levels.

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