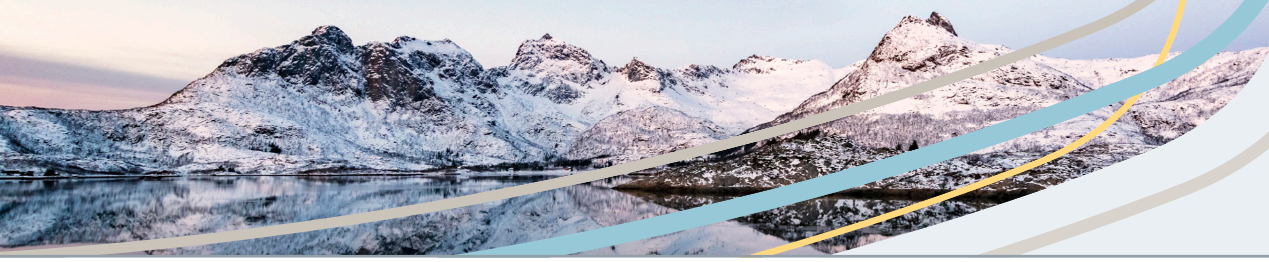

Global fixed income markets

NEW YEAR 2022

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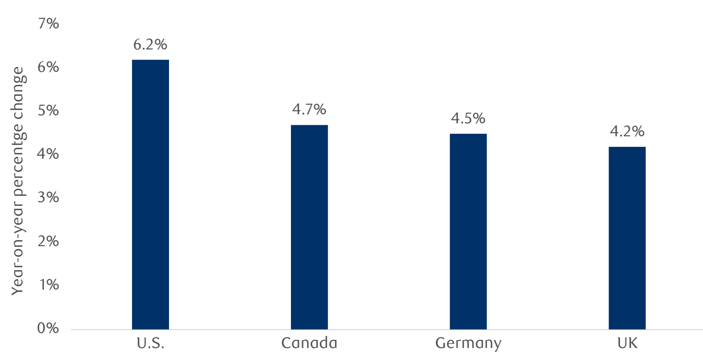
Inflation is at multi-decade highs, economic activity is strong and central banks are expected to raise policy rates substantially over the next year. Yet bonds continue to offer paltry yields. Our own forecast is for the yield on the 10-year U.S. Treasury to rise to 1.80% – still near historically low levels – over the next year from 1.44% at the time of writing. This state of affairs has left us and many other investors seeking an answer to the question: with inflation so high, why are bond yields so low?

Simply put, bond investors believe that inflation will be, as central bankers like to say, "transitory," and unlikely to last. Forecasts of where inflation will be in 2023 are around 2% – even though inflation of at least 4% in most major economies is currently running hotter than at any time since the 1990s (Exhibit 1). Most of the price pressures, however, have been in parts of the economy most affected by the pandemic, which we believe represents a one-off shock. While we expect the current period of higher inflation to pass, it could persist across the globe for most of the next year.

The good news is that the worst of the inflation headache should be behind us. In particular, the surge in headline and core inflation has been driven by particularly strong demand for goods amid shutdowns in services sectors and disruptions to supply chains. We expect that goods-related inflation will cool as demand for physical goods ebbs and supply chains catch up. In the meantime, consumers' increased comfort with in-person interactions is likely to accelerate the shift in spending toward services such as entertainment and travel. Finally, the winding-down of government pandemic-spending programs, which provided a substantial fillip to household budgets, should ease overall demand.

Exhibit 1: Global consumer-price inflation



Note: As of October 2021. Source: National statistical offices, Bloomberg

We are increasingly asked about the parallels between today's markets and the last time surging inflation expectations ran headlong into low and stable bond yields – the 1960s and 1970s. At that time, inflation expectations and bond yields were low and stable due to a combination of central-bank efforts to hold down long-term yields and the U.S. government's commitment to keep the U.S. dollar fixed at US$35 per ounce of gold. However, increasingly expansive fiscal and monetary policies during the Kennedy and Johnson administrations began to stoke inflation, and central bankers held off on rate hikes as long as possible given the then-prominent belief that optimal employment could only occur after inflation had started rising.

At the same time, developed-market economies were experiencing a surge in demand as the generation born in the 20 years after World War II (the Baby Boomers) and women began joining the workforce in droves. Union membership was widespread and labour's bargaining power was largely backed by public policy. The shock of leaving the gold standard in the early 1970s, followed by the rapid rise in oil prices, sent inflation, and inflation expectations, soaring. As result, the yield on the 10-year Treasury rose as high as 15.8% in 1981, inflicting substantial losses on investors (Exhibit 2).

One could draw parallels between the Fed's reluctance to act in the 1970s with its current policy framework of average inflation targeting (AIT), which aims to let inflation exceed its target for a time with the goal of boosting employment. In both cases, the cost of higher inflation was expected to be outweighed by the benefits of job creation.

This premise was eventually proven to be false in the 1970s, and there is a chance, albeit small in our view, that the pandemic could end up being a shock to the global economy similar in scope to the one that prompted inflation to shoot higher in the 1970s. This time around, it is possible that government largesse financed by debt might create a sufficiently large increase in demand that the impact will be similar to the expansion of the labour force 50 years ago.

But there is another very important distinction between the pre-inflationary period of the 1960s and the time leading up to the pandemic: the macroeconomic backdrop. Fifty years ago, expansive fiscal spending and loose monetary policy were pursued during a period of very strong underlying drivers of economic growth. In 1970, the labour force was growing at nearly 3%. In contrast, current projections for the labour force are running at just 0.5% to 1.0% a year (Exhibit 3), with similar levels of economic growth.

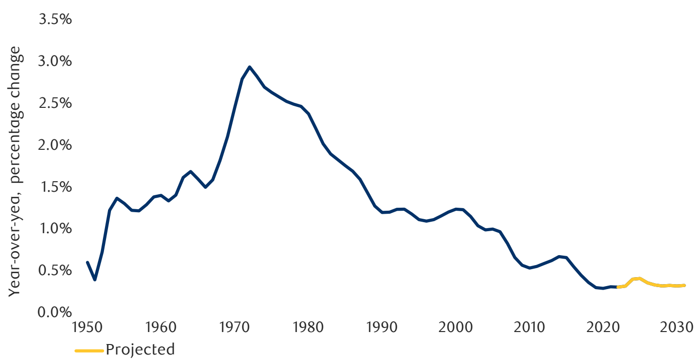
Moreover, the commitment today of most central banks to keep inflation close to 2% did not exist in the 1970s and continues to be a hugely important reason why bond yields remain low in an environment of rising inflation.

However, should price pressures begin to expand beyond the relatively narrow set of industries that they are currently affecting, the odds will increase that much higher bond yields lie ahead. Indeed, investors worried

Exhibit 2: History of the U.S. 10-year Treasury yield

Note: As of November 22, 2021. Source: Bloomberg

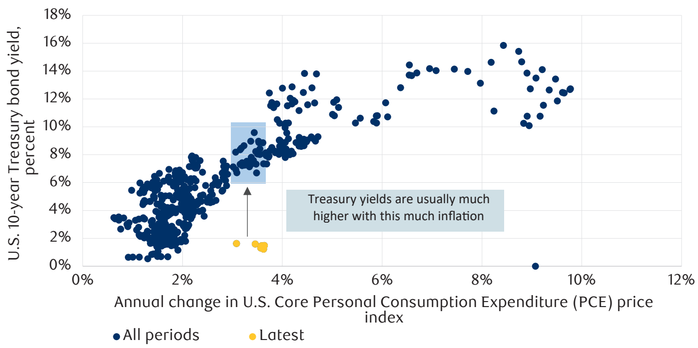
Exhibit 3: U.S. potential labor-force growth



Note: As of October 30, 2021. Source: U.S. Congressional Budget Office about an extended period of yields exceeding 2% could start to demand extra compensation – in the form of higher government-bond yields. In fact, Exhibit 4 shows that current rates of core inflation have historically been associated with 10-year bond yields of 6% to 10%.

At this point, we don't see glaring signs of persistently high inflation. We also note that low yields have been shaped by long-running, structural forces that preceded the pandemic and are likely to survive it. These forces include population aging; technological change and globalization; increased income and wealth inequality; rising government debt loads; and large-scale bond purchases by central banks. In some cases, the pandemic may have even reinforced some of these trends. Moreover, a growing number of bond investors are holding bonds for liquidity, or regulatory or policy reasons, which means they are not likely to demand full compensation for inflation. Over time, we expect inflation to remain close to 2% and bond yields further underpinned by structural reasons to be low.

Exhibit 4: Core inflation and Treasury yields



Note: Data period January 1980 to October 2021. Source: Bloomberg

Direction of interest rates

Our forecast for the 10-year Treasury yield is unchanged from last quarter: we expect the yield to be around 1.80% over the next year.

U.S. – The U.S. Federal Reserve Board (Fed), spurred by a faster-than-expected labour-market recovery and worries about the persistence of inflation, started to reduce the pace of asset purchases in November. In turn, the scaling-back of bond purchases by the Fed means that policymakers are preparing to hike interest rates. Many investors believe that the first rate hike will likely occur in the second half of 2022 after the Fed completely halts buying bonds. Investors expect at least two rate hikes by the end of 2022 and as many as three, based on interest-rate futures. We are penciling in just one because we are somewhat more concerned about the lasting negative impact of the pandemic on the economy.

Both labour-market and inflation considerations should give the Fed pause before it embarks on an interest-rate hiking cycle. We do not expect the slowdown and eventual stop of Treasury purchases by the Fed to affect yields much, as the reductions are likely going to be offset by a decline in bond issuance next year (Exhibit 5) amid a phasing-out of pandemic-related spending programs and improved growth.

The elevation of Lael Brainard to Vice Chair of the Fed most likely will have little impact on the path of monetary policy but suggests a greater focus on bank regulation. A new group of rotating voting members is due in January to join the Federal Open Market Committee, the Fed's policymaking body, making the Fed marginally more hawkish, in our view.

We are raising our forecast for the 10-year Treasury yield to 1.80% over the next year from 1.75% last quarter.

Exhibit 5: Fed bond buying vs Treasury-bond issuance
Projected changes for 2022, compared to 2021

Note: As of October 30, 2021. Source: Deutschebank, Federal Reserve, U.S. Department of Treasury

We expect the BOC to hike interest rates twice by the end of 2022, raising the policy rate to 75 basis points and the 10-year yield to rise to 2.00% from about 1.60%.

Canada – The Bank of Canada (BOC) stopped quantitative easing in November, which was earlier than the year-end expectations of investors. The unexpected end of the asset-purchase program was bad for bonds as yields rose in anticipation of earlier rate hikes. Updated economic forecasts suggest that the BOC believes that economic slack is likely to be absorbed in the first half of 2022, alongside continued above-target inflation. This scenario suggests that the BOC could begin hiking interest rates as soon as next April.

The market expects five BOC rate hikes before the end of 2022 in an outcome that we view as unlikely given that the BOC almost never gets so far ahead of the Fed, which is expected to hike three times in the same period. We expect the BOC to hike interest rates twice by the end of 2022, raising the policy rate to 75 basis points and the 10-year yield to rise to 2.00% from about 1.60%. As in the U.S., the likely cooling of inflation pressures and an anticipated reduction in bond supply as fiscal spending is reined in are likely to ease upward pressure on Canadian government bond yields.

We forecast the yield on the U.K. 10-year gilt will rise to 1.25% over the next year from approximately 0.90% currently.

U.K. – The Bank of England (BOE) unexpectedly held interest rates steady at its November meeting but has telegraphed interest-rate hikes for next year. We expect at least two rate increases that would lift the BOE's bank rate to 0.50% from 0.10% currently. The first hike is likely to be a relatively small 0.15%, moving the policy rate away from emergency levels, while the second would be 0.25%, more in line with the scope of past rate hikes. We had expected the BOE to leave rates unchanged next year, but the central bank has mounted one of the most vigorous public responses to the global surge in inflation. The BOE has also forecast that it plans to conclude quantitative easing by the end of the year. We forecast the yield on the U.K. 10-year gilt will rise to 1.25% over the next year from approximately 0.90% currently.

We expect the 10-year bund yield to reach -0.05% before the end of 2022 from -0.20% currently. We forecast no rate hikes in that time.

Eurozone – As in most regions, we expect the eurozone to adopt a more restrictive monetary-policy stance over the next year. The surge in COVID cases over the past month has dented Europe's economic recovery somewhat, but in our view probably won't sidetrack the European Central Bank's (ECB) quest to move the eurozone away from emergency support measures. Supporting such action is inflation at multi-year highs in many members of the single-currency area, suggesting a gradual tightening of policy should be in the cards for next year.

Unlike most other central banks, however, the ECB's support for the economy will in our view be limited to reducing asset purchases rather than boosting benchmark interest rates. As an example, we expect that a 1.5 trillion-euro program instituted when the pandemic hit in early 2020 to be wound down sometime in 2022.

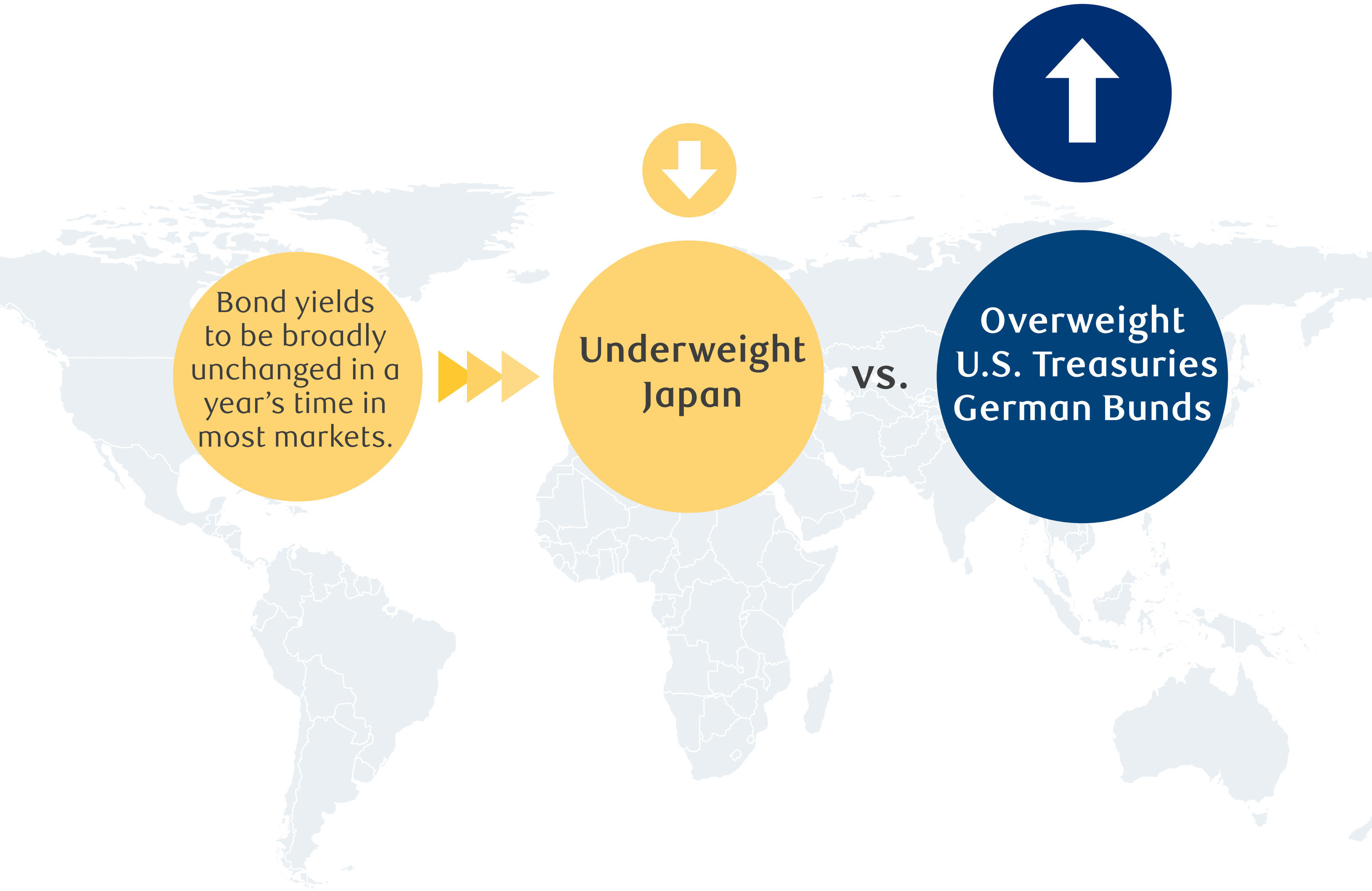
This development is important for the eurozone because 2022 will likely be the first year since 2018 that the value of bonds purchased by the ECB lags the amount issued by eurozone governments. The resulting increase in the supply of bonds will tend to raise yields, especially in Italy, whose government is among the five largest sovereign borrowers. While German bond issuance is likely to remain modest, we expect yields to rise given an increase in new bonds issued in common by eurozone members, which will reduce demand for German bunds. We expect the 10-year bund yield to reach -0.05% before the end of 2022 from -0.20% currently. We forecast no rate hikes in that time.

We forecast the 10-year JGB yield to be broadly unchanged at 0.10% over the next year from 0.07% currently.

Japan – Japan's economic recovery from the pandemic is lagging most of its global peers given the country's relatively lackluster vaccine rollout, and this situation will in our view keep the Bank of Japan (BOJ) committed to buying unlimited quantities of government bonds in order to maintain the 10-year yield between -0.20% and +0.20%. While the BOJ's "yield-curve control" policy is, thus far, another failed attempt in Japan's long-running efforts to bolster price growth, a more pronounced jump in economic growth bolstered by fiscal stimulus will likely keep yields in the upper part of the BOJ's target range over the coming months. We forecast that the yield on the 10-year Japanese government bond (JGB) will be broadly unchanged at 0.10% over the next year from 0.07% currently.

Regional outlook

Our forecasts are for bond yields to be broadly unchanged in a year's time in most markets. As a result, countries and regions offering higher yields on a currency-hedged basis and with relatively steep yield curves should be attractive over the coming months. We are retaining our overweight positions in U.S. Treasuries and German bunds, and our underweight in Japan.



Interest rate forecast: 12-month horizon

Total Return calculation: November 30, 2021 – November 30, 2022

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.38%	0.75%	1.50%	1.80%	2.20%	(0.96%)
Change to prev. quarter	0.25%	0.10%	0.25%	0.05%	(0.15%)	
High	0.63%	1.40%	2.15%	2.50%	2.85%	(5.07%)
Low	0.13%	0.13%	0.50%	0.90%	1.30%	5.50%
Expected Total Return US$ hedged: (0.7%)						

Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.50%)	(0.30%)	(0.25%)	(0.05%)	0.25%	(3.94%)
Change to prev. quarter	0.00%	0.10%	0.15%	0.20%	0.10%	
High	(0.50%)	(0.25%)	(0.00%)	0.20%	0.45%	(6.24%)
Low	(0.50%)	(0.60%)	(0.60%)	(0.50%)	(0.35%)	2.73%
Expected Total Return US$ hedged: (2.6%)						

Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.10%)	(0.10%)	(0.05%)	0.10%	0.75%	(0.43%)
Change to prev. quarter	0.00%	0.00%	0.45%	0.00%	0.00%	
High	(0.10%)	(0.05%)	0.00%	0.25%	0.85%	(2.08%)
Low	(0.10%)	(0.10%)	(0.10%)	(0.10%)	0.40%	4.94%
Expected Total Return US$ hedged: 0.3%						

Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.50%	1.80%	2.00%	2.30%	(1.83%)
Change to prev. quarter	0.50%	0.80%	0.55%	0.50%	0.30%	
High	1.00%	1.60%	2.00%	2.25%	2.60%	(3.99%)
Low	0.25%	0.50%	0.75%	1.00%	1.40%	6.77%
Expected Total Return US$ hedged: (1.5%)						

U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.50%	0.60%	1.00%	1.25%	1.50%	(8.80%)
Change to prev. quarter	0.40%	0.40%	0.60%	0.45%	0.20%	
High	0.60%	1.30%	1.60%	1.75%	1.90%	(14.74%)
Low	0.10%	0.20%	0.50%	0.75%	1.10%	(2.41%)
Expected Total Return US$ hedged: (9.0%)						

Source: RBC GAM

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