RBC Global Asset Management

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The bond market is telling investors that the worst of the pandemic may well be over.

Yields are rising in almost all major bond markets, with the yield on the 10-year U.S. Treasury bond more than doubling to about 1.50% recently from the lows recorded in the early months of the health crisis. The steady pace of inoculations against COVID-19 continues apace, boosting optimism that the broad economy will start to recover.

The rewards of efforts to combat the disease are being reflected in declining transmission and mortality rates, and we can clearly see their impact on investors' evolving views of the pandemic. In the depths of the first COVID-19 wave last summer, the yield on the 10-year Treasury was just 0.50%, and investors expected the first Federal Reserve (Fed) rate hike in the next cycle to occur in late 2025. Just three months ago, as the initial set of vaccine approvals came through, the 10-year yield had risen to 0.90% and market indicators suggested that the next rate hike would arrive in mid-2024. Expectations are now that the Fed will begin hiking rates in the first half of 2023, and the 10-year yield is well north of 1.00%

The Democratic takeover of the U.S. Senate raised the probability of another large fiscal stimulus package. President Joe Biden and Janet Yellen, the former Fed chief and now Biden's Treasury Secretary, have both stressed that the big risk is doing too little to support the economy rather than too much. Additional government spending would likely accelerate the U.S. labour-market recovery and, by extension, the date of the Fed's first hike.

Yet government bond yields remain very low, even by the standards of the past few years. Over the medium to longer term, we believe yields are likely to rise further as investors shift their focus from the short-run shock of the pandemic to longer-term fundamentals. According to our estimates, the U.S. 10-year bond yield should range between 1.50% and 3.50% during "normal" macroeconomic scenarios.

While long-run projections based on fundamentals can be useful, they often fall short during periods of extreme economic distress and disruption – such as during a pandemic. Economic improvement is occurring, but the health emergency continues to weigh on economic activity and, by extension, bond yields. Put differently, while the start of vaccinations was an important milestone for getting the world on the road back to "normal," the pandemic continues to act as a millstone restraining yields.

A key focus for the bond market is the expected date of the Fed's first interest-rate hike since the crises erupted. From the middle of last summer, nearly all of the changes in the 10-year yield could be explained by evolving expectations of the

timing of the first rate hike (Exhibit 1). In our view, the first hike should coincide with the moment when policymakers judge that the entire shock of the COVID-19 pandemic has passed. Based on previous cycles, we think the very earliest the Fed would want to start hiking is early 2023. Whenever the first rate hike does occur, further hikes are almost certain to proceed at a gradual pace.

Expectations of accelerating economic growth have translated into signs that investors are more concerned about inflation than at any time since the post-financial crisis recovery spanning 2008-2011. It was during this period that quantitative easing and unprecedented levels of fiscal stimulus emerged as seemingly permanent features of the macroeconomic landscape. Investors are again questioning the continued expansion of government spending even as the most disruptive phase of the pandemic is likely behind us. Inflation is widely expected to accelerate through the middle of this year due to large year-over-year increases in gasoline and food prices, and we expect U.S. inflation could top 3% for a few months sometime this year. But the bond market's concern appears to extend beyond this widely expected blip in food and gasoline prices. There are worries that the expanding scope of government spending and exceptionally easy central-bank policy in response to the pandemic are stoking longer-term inflation pressures.

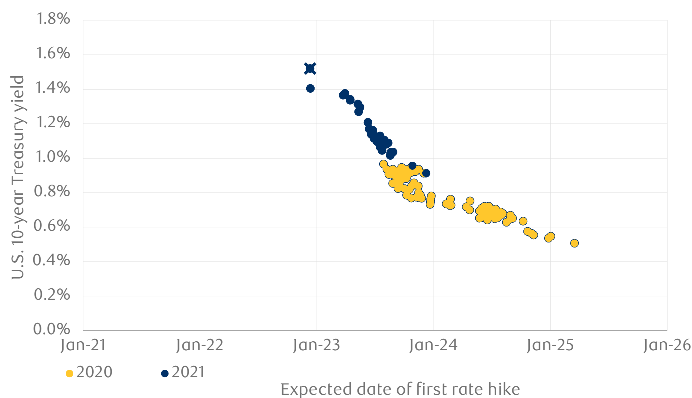
While our thinking is that bond yields should be higher in the long run, we are skeptical that policymakers have truly upset the period of persistently low inflation that is now entering its third decade (Exhibit 2). In fact, the current concerns that budget-busting fiscal spending and gigantic central-bank balance sheets will spur inflation feels eerily similar to the market narrative that dominated the years following the financial crisis.

In contrast to the temporary impulses likely to bolster inflation through the middle of 2021, several long-run forces are tamping down price pressures and bond yields, and are likely to do so for the foreseeable future. These include aging populations, technological progress, rising wealth inequality, the increased concentration of corporate interests and labour's weakening bargaining power. Finally, and not least, major central banks have built up a reservoir of credibility since moving to inflation-targeting frameworks in the mid-1990s.

Our assumptions of slow economic growth and mild inflation against a backdrop of lingering pandemic effects lead us to conclude that the optimal policy path for the Fed will be to avoid raising interest rates unless inflation becomes problematic, and a situation in which central banks move gradually in raising rates should help keep bond yields low.

If we are wrong about inflation, it will probably be because we are underestimating the negative impact that the pandemic will have on global supply chains and the growing reluctance of nations to cooperate with each other. A more nationalistic approach to industrial development and economic self-sufficiency could reverse many of the disinflationary effects of globalization over the past 30 years, pushing up prices to uncomfortable levels and perhaps building a case for higher bond yields than we expect.

Exhibit 1: U.S. 10-year Treasury yield and Expectations for the Federal Reserve
August 2020 to February 2021



Note: As of February 25, 2021. Source: Morgan Stanley, Bloomberg, RBC GAM

Exhibit 2: Persistently low inflation
U.S. Core PCE Inflation, year-over-year change

Note: As of January 31, 2021. Source: U.S. Bureau of Economic Analysis, Bloomberg, RBC GAM

U.S.

The U.S. 10-year bond yield has climbed to its highest level in over a year in response to an improving outlook regarding COVID-19 as well as rising inflation fears. Based on current market pricing, investors expect the Fed to begin hiking interest rates sometime in the first half of 2023. We believe that expectations for an aggressive hiking cycle are misplaced: upticks in inflation are likely to be transitory and the economy's recovery from COVID-19 will likely stretch over several years, leading to a cautious hiking cycle from policymakers when it does occur. We expect no change in the policy rate over the next 12 months and forecast the 10-year bond yield at 1.30% a year from now.

Canada

The Bank of Canada (BOC) reiterated in January that policy interest rates will remain unchanged until at least 2023, when the central bank expects its 2% inflation target to be sustainably achieved. The BOC plans to continue with its first ever quantitative-easing program, and will adjust the program as confidence in the economic recovery increases. One positive development is lower federal borrowing requirements, which will fall almost 30% to $260 billion in fiscal 2021-2022 from the previous period.

A budding global economic recovery has enabled the BOC to begin scaling back the emergency measures implemented at the height of the pandemic-related financial-market panic last spring. We expect the BOC, which owns about 40% of Government of Canada bonds, to continue with its $4 billion in current weekly bond purchases concentrated in the mid- to long-term range, but to reduce that amount come April if financial markets remain calm.

Over the next 12 months, we expect no change to the BOC's policy rate and 10-year yield to trade around 1.10%.

Japan

There was no change to the Bank of Japan's (BOJ) policy over the past quarter, and we do not believe that any fundamental changes are likely over the next 12 months. In addition, we expect no change to the policy rate, currently at negative 0.10%. Japanese inflation remains stubbornly low even after the most aggressive policy response in the developed world over the past several years, including a BOJ balance sheet that now dwarfs the Japanese economy. Our 12-month forecast for the yield on the 10-year Japanese government bond (JGB) is unchanged at 0.05%. The 10-year yield should remain within the BOJ's target range of negative 0.20% and positive 0.20%.

U.K.

After struggling with its pandemic response for much of 2020, the U.K. government's relatively successful vaccine rollout has offered a rare bright spot for the economic outlook. However, the U.K. economy still faces several headwinds over the next year, not least of which is the final contours of its new relationship with the EU. The EU will remain the U.K.'s largest trade partner, and the sides have yet to reach a final agreement on regulating financial services. We forecast no change to the policy rate over the next year and expect the 10-year government-bond yield to be broadly unchanged at 0.50%.

Eurozone

Monetary policy in the eurozone continues to be exceptionally accommodative. The European Central Bank's (ECB) pandemic-response programs are expected to extend for the next couple of years, backstopping prices of both sovereign and corporate bonds. The formation in February of a credible Italian government by Mario Draghi, former head of the ECB, has lowered the risk-related premium paid for Italian bonds versus German bonds to levels not seen since before the European sovereign-debt crisis of the early 2010s. We expect the ECB to leave its overnight policy rate at negative 0.50% over the next 12 months, and we forecast the 10-year German bund yield to be essentially unchanged a year from now at negative 0.35%.

Regional recommendations

We judge that the European yield curve is overly flat in comparison with Japan's. We recommend a 5% overweight in JGBs and a similarly sized underweight in German bunds. For the U.S., we prefer to stay on the sidelines as we foresee volatility in the near term.

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