RBC Global Asset Management

Global fixed income markets

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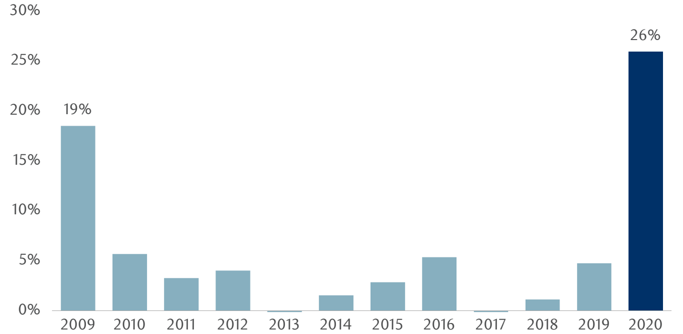
Global bond yields have declined sharply as the coronavirus causes massive disruption to people's lives around the globe. The U.S. 10-year government-bond yield fell from nearly 2.00% at the beginning of the year to an all-time low of just 0.31% in early March, and is currently yielding a paltry 0.60% (Exhibit 1). We expect that the hangover in economic activity due to the virus will continue for some time. As a result, bond yields should stay near their recent lows as unemployment remains high, inflation low and central banks accommodative. For the next 12 months, the focus of the bond market will be on policymakers' responses to the evolving pandemic.

Governments have massively increased spending in recent months, and they will need to tap bond markets aggressively to fund these outlays and make up for lower tax receipts. By the end of this year, global government debt as a share of GDP is expected to rise by a quarter, dwarfing the increase incurred during the global financial crisis in 2009 (Exhibit 2). The result will be the highest government-debt loads relative to the size of the global economy since the Second World War.

Exhibit 1: U.S. 10-year bond yields

Note: As of May 11, 2020. Source: Bloomberg

Exhibit 2: The debt increase is larger than it was in the financial crisis – Annual increase in government debt, as a percentage of GDP



Note: As of March 30, 2020. Source: IMF

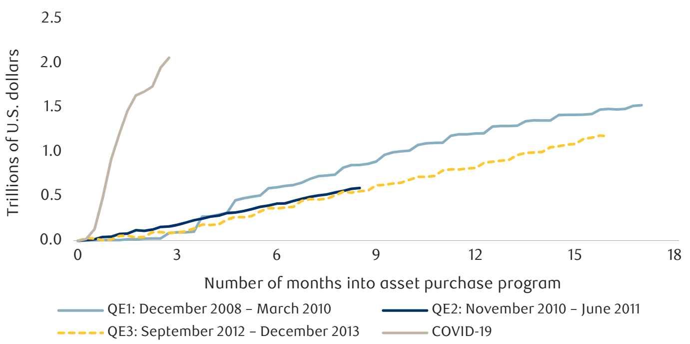
Central banks have also been busy. Those that had managed to raise interest rates over the past several years, such as the U.S. Federal Reserve (Fed) and the Bank of Canada (BOC), have cut rates to effectively zero and started, in the BOC's case, or restarted, as with the Fed, asset purchases. Central banks that were already accommodative, such as those in Europe and Japan, have accelerated the use of other tools as they ease policy. All major central banks have committed to keeping interest rates at low levels for a lengthy period. The Fed has bought nearly US$2 trillion of government bonds since March, a pace and scale greater than at any time in its recent history, and has plans to buy more (Exhibit 3). For the first time, the Fed is purchasing corporate bonds.

For the foreseeable future, concerns about COVID-19 and its lingering effects on the global economy should support bond prices. Uncertainty will reign, and it is in environments such as these that government bonds show their worth. Bond prices will be bolstered by central-bank efforts to keep policy loose via low rates and asset purchases, and without significant progress in the fight against the coronavirus, it is highly unlikely that any central bank will raise rates over the next 12 months. The current environment is a particularly good one for yields to remain low, and we forecast that 10-year yields in most major markets will be essentially unchanged a year from now unless the economic recovery proceeds at a much faster pace than we expect. As the pandemic subsides longer term, it would be reasonable to expect yields to rise and bond prices to fall from current levels. This pandemic, like all others before it, will eventually fade, and a return to something resembling normalcy, not only for individuals but also the bond market, should follow.

The effect of any nascent economic recovery will show up in higher long-bond yields and a steeper yield curve, and the increase in yields will almost certainly happen well before central banks raise interest rates. In the aftermath of the 2008-2009 financial crisis, long-term bond yields started rising as the economy recovered, even though it was seven years before the Fed raised its benchmark rate from the zero setting established during the crisis.

Fair-value estimates for bonds suggest that the yield on the benchmark 10-year U.S. Treasury should rise over time to between 1.5% and 3.5%. The range comes from our fair-value model, which is based on inflation, equilibrium interest rates and a term premium, the last of which estimates the return that investors will demand to compensate for the risk that yields could change substantially.

Exhibit 3: Asset-purchase programs of the Federal Reserve



Note: As of May 6, 2020. Source: U.S. Federal Reserve Banks

We expect the massive increase in government debt will raise questions regarding budgetary sustainability given that the fiscal picture for many countries was not encouraging even before the pandemic. For Italy and the U.S., in particular, the fiscal response to the impact of the coronavirus has made a bad situation much worse. Discussions that were already difficult will become more so. None of this sounds encouraging for long-term bondholders, whose holdings are based on promises of fixed cash flows stretching long into an uncertain future. In time, investors may demand higher compensation given the risks.

It is hardly inevitable, however, that higher debt loads will lead investors to demand higher yields. Take Japan: despite a debt-to-GDP ratio of over 200%, the Japanese government can borrow for up to 10 years at negative interest rates. Part of the reason that investors are so comfortable with such low yields is due both to the particular preferences of Japanese investors and the Bank of Japan (BOJ), which effectively sets nearly all government borrowing rates through its yield-curve control program. Other central banks are starting to follow in the BOJ's footsteps as they too emerge as the largest purchasers of government debt to facilitate the massive increase in deficits. The expanded central-bank purchases mean that the amount of newly issued debt that investors will need to absorb is relatively modest.

Central-bank asset purchases, while originally a temporary means to facilitate a faster return to economic growth, might be permanently necessary to prevent government borrowing costs from rising. After the Second World War, the Fed worked to keep U.S. government borrowing costs low by intervening in the Treasury market. The European Central Bank's (ECB) purchases of government bonds in recent years have been portrayed as an essential tool of monetary policy, when they are in fact largely aimed at containing borrowing costs for the Italian government.

A concern for bondholders is the dwindling inventory of tools that central banks have left to stimulate the economy with rates at or below zero and already large balance sheets full of government and, increasingly, corporate bonds.

For central banks with policy rates at or above zero, one possible tool that has been discussed is negative interest rates, which are already in place in Japan and Europe. We understand the appeal of cutting interest rates below zero. In prior recessions, the Fed would have typically cut interest rates by several percentage points without even considering the possibility of running into 0%. In the past three major recessions, the Fed cut rates by 400 to 600 basis points (Exhibit 4). In the current cycle, however, the Fed has been able to cut by only 225 basis points. Opening the door to negative interest rates would create an additional avenue to looser monetary policy for central banks that have not already gone down this path.

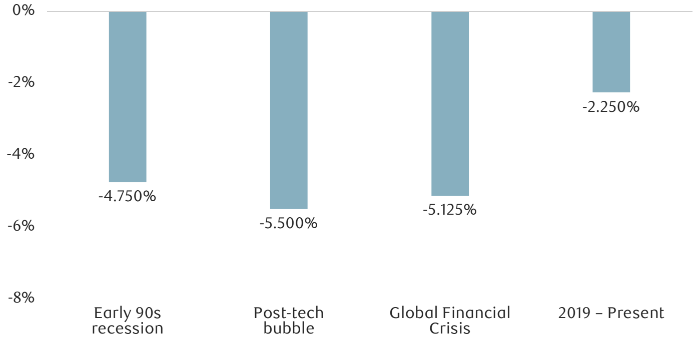
We believe, however, that the Fed and BOC will hesitate to employ negative interest rates because the evidence is mixed on whether they work. Moreover, negative interest rates seem to come at a huge cost to the earnings and operations of banks, which policymakers rely on to convert monetary-policy changes into borrowing that boosts economic growth. Sweden has abandoned an experiment with negative rates, citing its ineffectiveness in jump-starting the economy. While the new governor of the BOC, Tiff Macklem, has publicly raised the possibility of negative rates, the appetite for a policy rate below zero appears to be tepid in Canada's closest trading partner, the U.S. We would be surprised to see the BOC pursue negative rates independently of the Fed.

The more likely course, if required, is that more central banks will pursue a policy known as yield-curve control. Japan has had such a policy in place for several years, and a common view in North America is that yield-curve control represents a much more natural evolution of current policy than negative rates. Yield-curve control is simply a more explicit form of forward guidance – a tool familiar to most central bankers. In this case, the commitment to a certain path or level of policy rates is replaced with a path or level for bond yields across the yield curve.

Yield-curve control would relieve some of the pressure on central-bank asset purchases, which can interfere with the normal functioning of the bond market. Japan's experience is that being more explicit in where it wants yields has permitted the BOJ to keep yields low while dramatically scaling back the size of its government-bond purchases (Exhibit 5). In doing so, the BOJ has improved the outlook for market liquidity and maintained its intended easing bias by keeping the 10-year JGB yield around its target of zero.

For now, concerns about fiscal sustainability will be put aside by investors and policymakers as uncertainty regarding the short- and long-term impacts of the pandemic on national economies remains high. Over the longer term, however, strong fiscal and monetary responses mean that bond yields should rise. We expect that returns for government bonds will be modest, as low starting yields are eaten away by capital losses.

Exhibit 4: Central banks typically cut rates by much more – Fed policy-rate changes during the last four rate-cut cycles



Note: As of April 30, 2020. Source: U.S. Federal Reserve Banks

Exhibit 5: Yield-curve control and the Bank of Japan's annual government bond purchases

Note: As of April 1, 2020. Source: Bank of Japan

As we continue to adapt and evaluate our portfolios in the face of stunning changes to our markets, we need to prepare for the eventuality that large swaths of global fixed-income markets may be eventually owned by central banks. The presence of large non-profit-oriented market participants could change some of the fundamental relationships we expect in fixed income.

Direction of rates

U.S. – 10-year government bond yields have fallen to near-record lows of 0.60%. With the fed funds rate target already set between 0.00% and 0.25%, yields are unlikely to fall much further unless the Fed decides to adopt negative interest rates - something we consider unlikely at this time. Asset purchases are also likely to support bond prices over the next year. The Fed`s balance sheet has doubled in size from a year ago, and will continue to grow to eventually include substantial holdings of not only government debt, but corporate bonds and their associated ETFs as well. We forecast the 10-year Treasury yield to be little changed a year from now, at 0.75%.

Germany – We do not expect a change in the ECB's policy rate over the next year. However, policy easing in response to the pandemic will continue in the form of asset purchases. With the policy rate on hold at -0.50%, we expect bund yields to be just -0.30% in a year`s time. ECB policy is much more important for the bonds of European countries with large government debt loads such as Italy and Spain. Central-bank asset purchases are underpinning investor confidence and keeping borrowing costs low even as government debt climbs from already high levels.

Japan – The Bank of Japan (BOJ) continues to provide strong support for government-bond prices via asset purchases and explicit yield targets. We do not expect the BOJ to adjust its policy rate over the next 12 months. Any sustained appreciation in the yen could prompt some additional easing measures, but we think that these will be restricted to asset purchases and not a change in the policy rate, currently at -0.10%. Fiscal policy is highly stimulative as the government works to offset some of the economic damage from the pandemic. The resulting increase in bond supply should be easily absorbed by the market, which remains anchored by the BOJ`s yield-curve control policy. Japan is a good example of a country where high government-debt loads have resisted the clarion call of higher yields. We expect 10-year bonds yields to be little changed in a year, and within the current policy-defined range of -0.20% to +0.20%.

U.K. – Our 12-month forecast for 10-year gilt yields is 0.40%, essentially unchanged from its level at the time of writing. The Bank of England (BOE) faces a similar policy outlook as many of its central-bank peers: already low policy rates, expansive asset-purchase programs, and a prolonged period of poor economic growth and below-target inflation. We forecast no changes to the policy rate over the next year and expect the BOE`s efforts to keep policy accommodative should keep bond yields low.

Canada – Bond markets over the past three months were as volatile as they've ever been. The global spread of COVID-19 and subsequent closure of huge portions of the economy led to massive financial-market intervention by the Bank of Canada (BOC). Since January, the BOC has cut its benchmark interest rate by 150 basis points to 0.25% and embarked on Canada's first foray into central-bank debt purchases. The purchases have expanded the BOC's balance sheet to almost half a trillion dollars. The quantitative-easing programs ensured that financial markets functioned properly by alleviating short-term funding strains and providing support for businesses. The BOC's asset purchases will include as much as $50 billion of provincial bonds and as much as $10 billon of Canadian corporate debt.

It has become clear that the crisis will culminate in a deep recession and that short-term interest rates will likely stay at current levels well into 2021. It is also possible that the BOC will expand its debt purchases, and perhaps introduce negative interest rates if the economy worsens more than expected. We look for longer-term bond yields to remain within recent ranges until compelling evidence of a recovery is underway. Investors have so far been willing to accept extraordinarily low yields on debt sales that have led to exploding budget deficits, but their willingness to continue doing so without demanding higher yields will depend on whether they feel comfortable that the deficits will at some point be brought under control. Absent that assurance, yields could head higher. We expect no change to the BOC's overnight rate of 25 basis points, and have left our forecast for the 10-year bond yield at 75 basis points.

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