RBC Global Asset Management

Global fixed income markets

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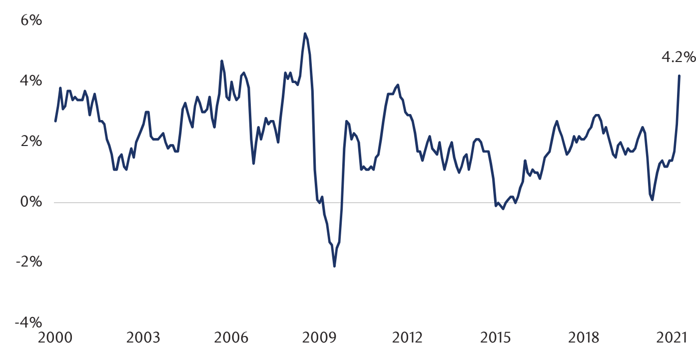
Government-bond yields were largely unchanged over the past three months, and, while still on the low side, are within our fair-value range. Over the next 12 months we expect yields to rise, but at a much slower pace than they did in early 2021. Economic growth and inflation are likely to peak sometime during the summer, relieving much of the pressure on bond prices. Our 12-month forecast for the U.S. 10-year Treasury yield is 1.75%.

As the darkest days of the pandemic recede, inflation readings at their highest in a decade are emerging as a major worry for bondholders. U.S. consumer prices rose 4.2% in April from a year earlier, the fastest pace since 2008 (Exhibit 1), while the increase in Canada was 3.4%, the most since 2011. We believe inflation was higher still in May, and that this period of more significant inflation could persist through the middle of the year. Asset prices are also climbing, with housing prices gaining nearly 25% in most developed markets. We believe, however, that a lasting return to much stronger inflation is unlikely and this view is reflected in our forecasts for bond yields. A more aggressive pickup in inflation would likely send yields much higher than we expect.

Is higher inflation a harbinger of persistently stronger price pressures to come? While inflation will in all probability remain above 2% for most of 2021, price increases are likely to subside after we get past the next few months. Eventually, we expect inflation to fall back to central bankers' targets near 2%, and perhaps even below that. Central bankers have struggled for years to generate meaningful inflation, and while the pandemic was a historic shock to industrial supply chains and workers, it has failed to unseat any of the long-run structural forces pushing down on prices. These forces include aging populations, technological innovation, rising wealth and income inequality, and the increased power of corporations to set wages.

Exhibit 1: U.S. inflation highest since 2008
U.S. Consumer Price Index, year-over-year change



Note: As of May 26, 2021. Source: U.S. Bureau of Labor Statistics

We also believe that the initial burst of inflation caused by the pandemic is likely to be followed by deflationary pressures. These include a higher labour-participation rate, as the option to work from home gives more people access to jobs, an accelerated transition to online shopping, where

prices tend to be lower than in physical stores, and a higher savings rate as the psychological impact of the pandemic increases the desire of households to hold larger rainy-day funds.

That said, we are not totally out of the woods on inflation. The economy is opening up unevenly, as consumers spend relatively freely on goods while activity in service industries remains constrained because these businesses often require close contact. As a result, money normally earmarked for spending at restaurants and hair salons and on vacations has been funneled into electronics and home improvements. At the same time, corporate supply chains are struggling to keep up with demand, and much of the current inflation revolves around goods makers passing on the rising costs via higher prices.

Meanwhile, consumer demand has been supported by a massive ramping-up of pandemic-related government spending financed by bond sales. Government deficits around the world are the highest they have ever been outside of wartime and show few signs of being curtailed. The extension of explosive government spending and historically low interest rates just as the worst economic effects of the pandemic fade is generating fear that governments are using the pandemic to add permanent fiscal programs rather than simply offset COVID-related losses.

The final ingredient in this fear-of-inflation recipe is the current cadre of central bankers, all of whom came of age during the past several decades of falling inflation and who appear to be more permissive of inflation than any group since the 1960s. There is a well-founded concern that this set of policymakers would prefer to let inflation run hot rather than tap the brakes on an economic recovery.

Post-recession fears about inflation, especially after large government-stimulus programs, have ample precedent. Inflation surged to 4% as the economy began to recover from the 2008-2009 financial crisis, and then cooled as the cyclical effects of the economic rebound faded and long-term structural factors re-asserted themselves. This is likely to be the case this time around. As demand for goods eases and services return in force, the inflationary impact of consumers' unbalanced spending will likely pass.

Most central bankers view the current rise in inflation as likely to be transitory. As a result, they will focus on the damage caused by the pandemic to labour markets, particularly lower-income households whose members are typically employed in service industries. Central banks will therefore be unlikely to start raising interest rates until the labour-market recovery is advanced. Emergency government programs have helped alleviate the worst of the economic effects of the crisis but they must eventually end. The recovery from the pandemic for these households, unlike the recovery in the stock market, is likely to be slow. We note that it took the labour market the better part of a decade to recover the jobs lost during the financial crisis.

Bond yields are likely to push higher only when the labour-market recovery is more firmly established and investors anticipate that central banks are getting closer to rate hikes. But these conditions are a long way off in our view. Fixed-income markets are pricing in a return to pre-pandemic policy rates that overstate the case for persistently high inflation and overlook just how much lingering damage COVID-19 is likely to have inflicted on labour markets.

Direction of interest rates

U.S. – Inflation moved to its highest point in over a decade in April at 4.2%, and is likely to remain high for the next few months as pandemic-related effects work their way through the year-on-year numbers and supply bottlenecks remain tight. For now, we don't expect inflation to become so high that it concerns the U.S. Federal Reserve (Fed). The labour-market recovery in the U.S. is still in the early stages and the Fed is likely to consider any high inflation as transitory. Market indicators suggest that the first rate hike will occur in late 2022 or early 2023.

We forecast no change in the fed funds rate over the next 12 months. It is more likely, in our opinion, that the next rate hike will come sometime in 2023 rather than in 2022. Well before the first rate hike, the Fed will move to slow its asset-purchase program, a multi-step process that will take some time. We are forecasting the 10-year Treasury to be around 1.75% within the next 12 months. Treasury yields are likely to be range-bound for the rest of the year as the post-pandemic bump in growth and inflation is expected to cool.

Canada – Bank of Canada (BOC) policymakers struck a tone that made investors think they might scale back monetary stimulus sooner than expected, even as they have committed to holding their benchmark interest rate as low as they reasonably can. In the BOC's view, the 2% inflation target will be sustainably achieved by the second half of 2022 instead of sometime in 2023. As expected, the central bank also reduced the pace of bond buying to $3 billion per week from $4 billion, and we expect that figure to decline to $2 billion within the next six months. The BOC's decision to rein in asset purchases contrasts with the Fed, which deems it too early to even discuss the possibility of reduced bond purchases. The reduction in asset purchases was driven by

concerns that Canada's central bank owns too much of the country's bond market.

April marked the release of the first federal fiscal budget since 2019, and bond-issuance forecasts were in line with investor expectations of $286 billion for the current fiscal year, a decrease from the previous year's $374 billion. The government plans to devote a larger share of its issuance to longer-maturity bonds, which we believe could limit their performance. According to the budget's forecasts, bonds with maturities of 10 years or longer will comprise 42% of issuance in the current fiscal year, up from 29% last year and 19% two years ago.

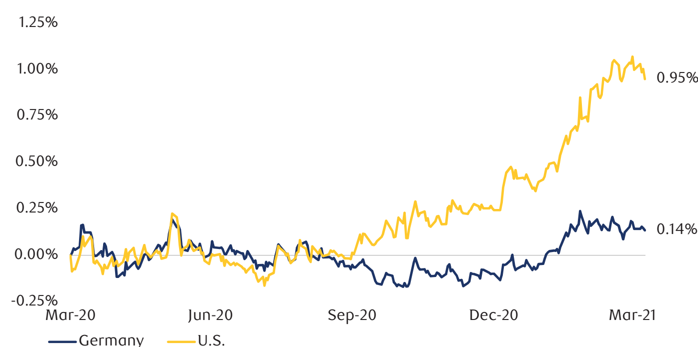
Canadian bond yields have stabilized after doubling in the first quarter of 2021, and we expect bond yields to trade in a range that prices in strong economic growth, higher inflation and increased government-bond issuance. Investors have priced in roughly 40 to 50 basis points of tightening by the end of 2022, in line with current BOC guidance and our expectations. Over the next 12 months we expect no change to the BOC's overnight rate, currently at 25 basis points, and forecast that the yield on the 10-year government bond will reach 1.60%.

Japan — The Bank of Japan (BOJ) made no policy changes over the past quarter, and we expect that to be the case over the next 12 months. The policy rate, at -0.10%, is unlikely to be changed without a more fundamental re-evaluation of the central bank's policy framework, and the BOJ just completed a thorough policy review. Based on the outcome of the review, we have marginally increased the odds of a more negative policy rate. At this point in the cycle, however, it is unlikely absent another meaningful downturn in activity. Meanwhile, this summer's Tokyo Olympics should provide a nice fillip for the economy, and we expect some steepening of the Japanese yield curve. Over the long term, the likelihood of higher bond yields is low given persistently weak inflation and an aging and shrinking population. Our 12-month forecast for the yield on 10-year Japanese government bonds is 0.10%, an increase of 5 basis points from our forecast last quarter.

U.K. – The U.K. has emerged as a leader in getting its people vaccinated, and its economy is opening up at the same time that the ruling Conservative government, long a preacher of fiscal probity and austerity, has chosen to instead turn on the fiscal taps. The fiscal expansion and the pandemic are masking some of the disruptions lurking after the country officially left the European Union at the end of 2020. Nevertheless, the U.K. economy is doing reasonably well given the circumstances, and gilt yields have been heading higher. We expect the Bank of England to be on hold for at least 12 months, by which time it should be clear whether the global economy has turned the corner. We forecast the yield on the 10-year government bond at 0.70% within the next 12 months.

Eurozone – The vaccination rollout in most of the eurozone has lagged that in other developed markets, with the effect being to dampen economic activity as the euro-area economy unexpectedly contracted over the first three months of the year. Inflation pressures in the eurozone are relatively muted compared with the U.S., leading investors to the conclusion that rate hikes will be later in arriving and be more modest when they do. The European Central Bank's (ECB) asset-purchase programs remain particularly important for holding down yields on euro-denominated sovereign and corporate bonds. We expect that these programs will continue until at least the end of this year. Perhaps reflecting the relative weakness of its economic recovery, the ECB has been much more aggressive than its U.S. counterpart in keeping a lid on borrowing costs. As an example, the ECB has raised its asset-purchase pace in response to higher real yields, and this step partly explains why German yields have risen less than U.S. Treasury yields over the past year (Exhibit 2). We expect the ECB to leave its overnight policy rate unchanged over the next 12 months and for the German 10-year bund yield to be -0.25% in a year's time.

Exhibit 2: U.S. yields have risen much more than German yields – Change in U.S. and German government-bond yields since March 2020



Note: As of May 26, 2021. Source: Bloomberg, RBC GAM

Regional recommendations

We are overweight European sovereign bonds versus Japanese government bonds, reflecting the former's better potential for capital appreciation on a currency-hedged basis.

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