RBC Global Asset Management

Global fixed income markets

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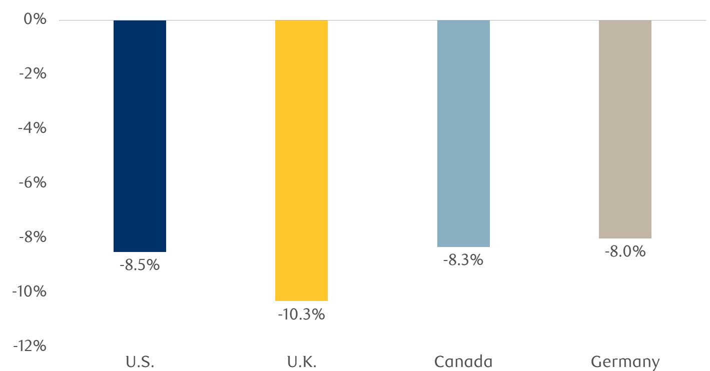
Government bonds posted their worst start to the year since the early 1980s, with major markets declining by at least 8% (Exhibit 1). Worse still, fixed income provided none of the expected ballast to balanced portfolios – prices for both equities and bonds fell. Bond yields rose sharply as inflation surged to its highest level in 40 years and the market priced in aggressive interest-rate hikes to curb price rises.

In this environment, the most important question for investors is whether central banks will tighten policy enough over the next year to stamp out excess inflationary pressures before they become entrenched. Our view is that policymakers will be successful, but at the expense of economic activity and substantial risk of a recession. A cooling economy and slower price rises mean that we are forecasting government bond yields to be largely unchanged 12 months from now, with a forecast that the 10-year U.S. Treasury bond will yield 2.75% sometime in the middle of next year.

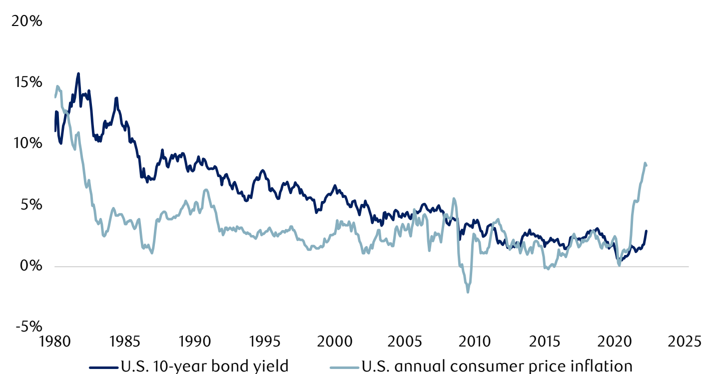
Over the next several months, however, rampant price pressures will be the key focus for bondholders, given that leading central banks have committed to tightening policy aggressively. While bond yields have risen significantly since late last year, they remain low relative to history. Bond yields appear particularly paltry compared with the last time inflation was so problematic. In 1981, the U.S. 10-year government bond yield rose to nearly 16% alongside consumer-price inflation that exceeded 15% (Exhibit 2). We don't think bond yields are at risk of rising to such levels over the next year thanks to the inflation-fighting credibility that central banks have built up since then, but upward pressure on bond yields will remain significant.

Exhibit 1: Government-bond markets have posted particularly poor returns



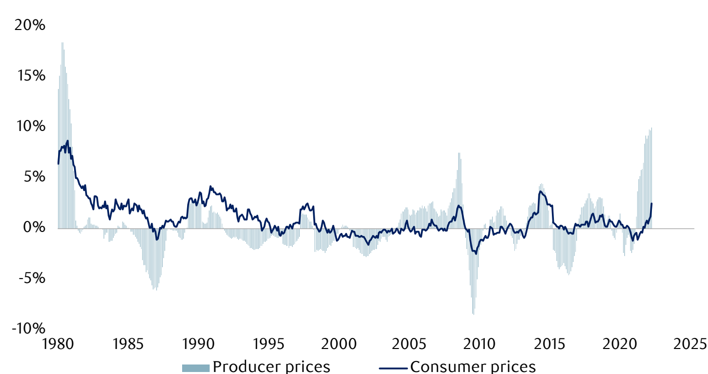
Note: Return period December 31, 2021 to April 29, 2022. Source: Bloomberg Fixed Income Indices

Exhibit 2: U.S. bond yields and inflation



Note: As of May 26, 2022. Source: Bloomberg, U.S. Bureau of Labor Statistics

Exhibit 3: Japanese producer prices suggest more inflation



Note: As of April 2022. Source: Bloomberg, U.S. Bureau of Labor Statistics

Inflation has accelerated and spread beyond areas of the economy most affected by supply-chain disruptions. Moreover, inflation expectations have risen markedly and workers are now starting to demand larger pay increases to offset the rising cost of living. A shortage of workers is another factor pushing up wages. In the U.S. and the U.K., businesses have more open job positions than there are people looking for work, suggesting that workers will continue to hold the upper hand in salary negotiations. As long as labour markets remain so competitive, central banks will likely seek to deliver substantially tighter policy. Investors expect the U.S. Federal Reserve (Fed) to hike its benchmark interest rate by 0.50% at the next three meetings in June, July and September, and the Bank of Canada (BOC) is likely to be just as aggressive.

Even Europe and Japan, which had managed to avoid damaging inflation, now face surging price pressures that have forced the hands of central banks that had stood pat on interest rates for at least a decade. Investors are betting that the European Central Bank (ECB) will soon raise interest rates for the first time since 2010. The Bank of Japan (BOJ)'s commitment to extra-loose policy is also being questioned by investors. Japanese inflation, at just above 2%, (Exhibit 3) is much lower than its developed peers but still at the highest level in several years, and leading indicators suggest even higher inflation is on the horizon. Actions by the ECB and BOJ are important because Japanese and euro-area government bonds together account for just shy of 50% of the global government-bond market, an even larger share than the U.S. A shift to more hawkish policy stances by the ECB or BOJ, or both, will only add to the pressures pushing up yields on government bonds around the globe.

In addition to rate hikes, shrinking central-bank balance sheets could add to the upward pressure on government-bond yields over the coming year. The Fed has said it will begin reducing the size of its balance sheet in June, with the BOC and Bank of England (BOE) following suit. We don't expect the ECB to pare its balance sheet in the next year, but it has said it will significantly curtail asset purchases as it begins to hike rates.

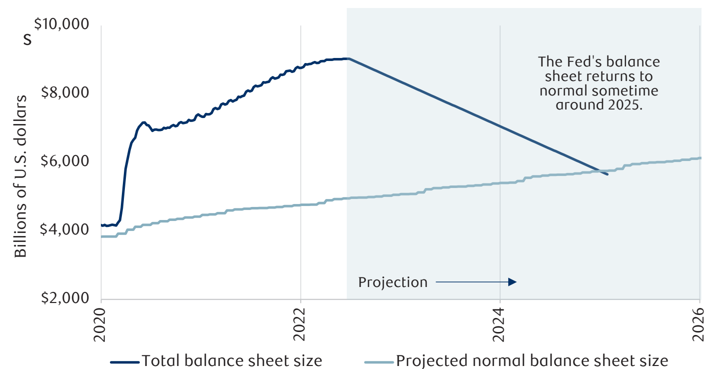
Why should shrinking balance sheets matter? For years, substantial and persistent purchases of government bonds by central banks have helped push down global bond yields. A rough rule of thumb indicates that Fed bond purchases equal to 1% of GDP lower the yield on the 10-year bond by roughly 0.05%. Since March 2020, the Fed has purchased bonds equal to 14% of U.S. GDP. In other words, absent the Fed's bond purchases, 10-year bond yields might be 0.70% higher than they are today. So bondholders who have benefited from central-bank bond purchases must now consider what will happen when the footprint of these participants shrinks. There is a strong possibility that the retreat of central banks poses a multi-year headwind for

bond prices, as the unwinding of bloated balance sheets will take several years if the process is completed (Exhibit 4).

There is some good news that comes with falling bond prices: the long-term outlook for fixed-income returns is as good as it has been since the onset of the pandemic. Bond returns have been particularly poor due to a retreat from exceptionally low levels of expected policy rates and inflation. Long-run expectations for policy rates are now much higher and consistent with interest rates that we believe should prevail in normal conditions. Inflation expectations have also risen sharply, but are consistent with the 2%-or-so inflation period that prevailed from the late 1990s until 2015 (Exhibit 5). The normalization of long-run expectations for inflation and policy rates, combined with a Fed that is on track to hike rates aggressively over the next year, have pulled U.S. 10-year bond yields into the upper end of our fair-value range of 1.5% to 3.5%. For yields to continue rising at the breakneck pace of the past year, there would need to be a much larger surge in inflation coupled with an ineffective policy response.

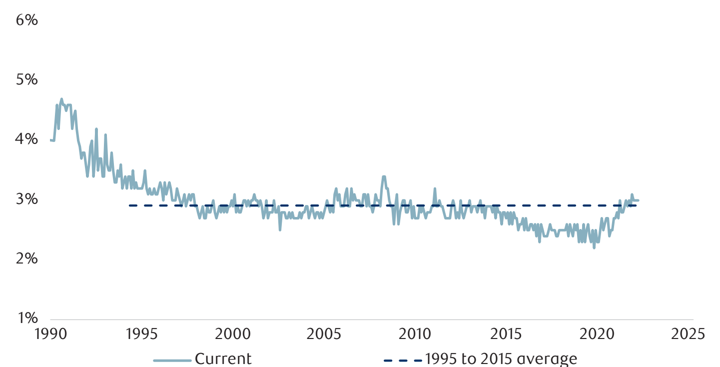
This is not our outlook. We expect tighter monetary policy to slow global economic activity and inflation before the end of the year, relieving some pressure for bond yields to keep rising. High inflation should also prove to be its own cure, as rampant price increases are destroying the purchasing power of households. As the economy slows and demand for labour eases, the ability of workers to offset inflation via wage demands will be curtailed, and as the macroeconomic backdrop becomes more challenging, expectations for aggressive central-bank hiking should moderate. In turn, the upward pressure on bond yields should ebb. If yields are unchanged a year from now, as we expect, bond investors should expect single-digit returns.

Exhibit 4: Balance-sheet shrinkage is a multi-year process – Federal Reserve balance-sheet projection

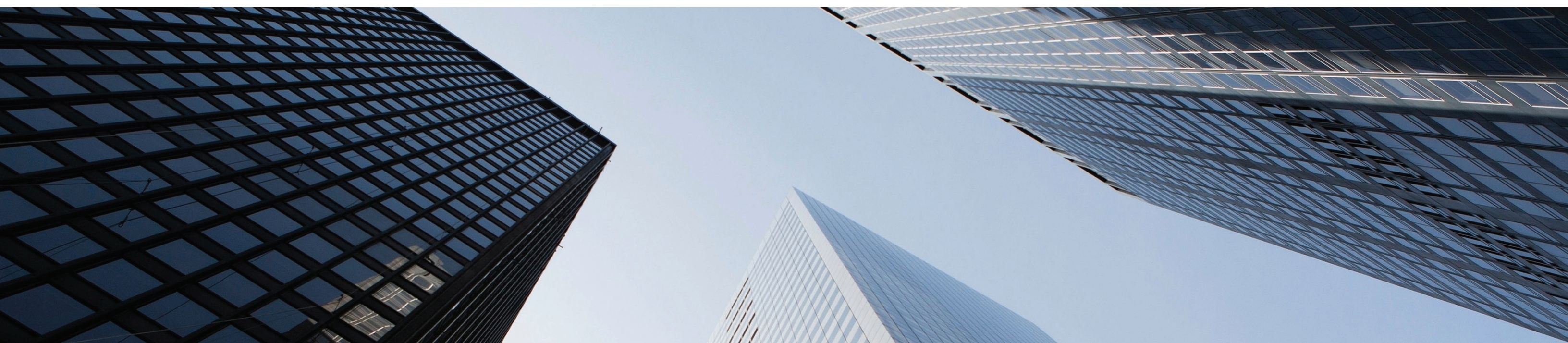


Note: As of May 26, 2022. Source: Bloomberg, U.S. Bureau of Labor Statistics

Exhibit 5: Inflation expectations have risen to the prior period average – Consumers' median long-run inflation expectations



Note: As of March 2022. Source: Bloomberg, U.S. Bureau of Labor Statistics



Direction of interest rates

We expect the Fed to hike the fed funds rate to 2.75% by the middle of next year. We expect the U.S. 10-year Treasury yield to rise to 2.75% over the next 12 months, an increase of 50 basis points over our prior one-year forecast.

U.S.

As is the case in most other markets, inflation in the U.S. is at multi-decade highs. Unlike other markets, however, a substantial portion of the inflation seems to be related to excess demand stemming from extremely generous government programs related to the pandemic. Moreover, a very tight labour market suggests that the prospect of inflation expectations becoming more entrenched is much higher for the U.S. than elsewhere. Wage growth is running at nearly 6%, much faster than the 3%-4% that is typical even for a tight labour market. The strong demand side of the economy could mean the Fed has room to tighten policy without weighing too heavily on the economy.

In addition to rate hikes, which we expect to proceed at a pace of 50 basis points per meeting until the fall, the Fed will begin shrinking its balance sheet in June. The amount of balance-sheet reduction expected is equivalent to about 70 basis points of hikes. Overall, market expectations as they stand today would mark the most aggressive policy-tightening cycle since the early 1980s.

Yet growth and inflation are already showing signs of flagging, which we believe means the Fed is unlikely to tighten as much as investors expect. Surveys of consumer confidence are consistent with an extremely poor outlook for economic growth, and insofar as workers have been demanding more generous pay rises, they have still failed to fully offset the rise in prices – leading to declines in real incomes. The yield curve is also presaging an economic slowdown: the brief inversion of the 2-year and 10-year yield signals that a recession might be a year or two away. While we are not forecasting a recession, policymakers seem resigned to the risk of a significant slowdown through their efforts to curb inflation. It is likely that a firm commitment by central bankers in response to roughly a year's worth of above-target inflation will reduce the need for more tightening later.

We expect the Fed to hike the fed funds rate to 2.75% by the middle of next year. We expect the U.S. 10-year Treasury yield to rise to 2.75% over the next 12 months, an increase of 50 basis points over our prior one-year forecast.

Over the next 12 months, we expect 10-year yields to rise to 2.60% and the BOC to raise the benchmark overnight interest rate to 2.50%.

Canada

With persistently elevated inflation, the BOC raised its policy interest rate in April by 50 basis points to 1.00%, the biggest hike in more than two decades. The BOC also ended its policy of reinvesting proceeds from maturing bonds and began quantitative tightening. As a result, the BOC's balance sheet will shrink as maturing Government of Canada bonds are no longer replaced. The BOC's view is that the resulting increase in the supply of bonds not held by the central bank will work in tandem with rising benchmark interest rates to cool the economy. The current backdrop of high inflation is expected to ease as high energy prices and global supply-chain disruptions start to abate, putting a lid on higher yields going forward.

Over the next 12 months, we expect 10-year yields to rise to 2.60% and the BOC to raise the benchmark overnight interest rate to 2.50%.

Our forecast is for bank rate to peak at 2.00%, an upward revision of 50 basis points from the previous quarter. Our 10-year gilt yield forecast is also higher, at 2.25%

U.K.

The U.K.'s annual inflation rate is expected to reach double digits before the end of the year, and the country's inflation problem appears more pernicious than in its developed-market peers. Unlike the U.S., where high inflation has been tied to particularly generous pandemic-spending programs, the U.K.'s problems appear linked to its 2020 exit from the European Union, compounding the impact of surging food and energy prices. There is little that the BOE can do to combat these issues.

Nevertheless, the BOE is doing what it can to ward off the possibility of inflation becoming entrenched. The central bank started hiking interest rates both earlier and more aggressively than other developed-market central banks, and policymakers have laid out aggressive plans for winding down the balance sheet, particularly through sales of the BOE's substantial holdings of corporate bonds.

The assuredness of the BOE's fast start has faded considerably. While inflation and economic activity in late 2021 suggested that a new rate-hiking cycle was prudent, surging energy costs and rising prices for food already seem to be hurting demand. In response, gilt yields have failed to match the rise in developed-market peers and expectations for future hikes in the policy rate have been reduced. Our forecast is for the bank rate to peak at 2.00%, an upward revision of 50 basis points from the previous quarter. Our 10-year gilt yield forecast is also higher, at 2.25%.

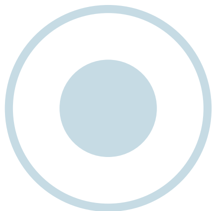
Our expectations for the 10-year bund yield is to see it falling towards 0.50%, from around 0.90% at the time of writing.

Eurozone

Investors expect the ECB to start hiking interest rates in July, and anticipate at least three 25-basis-point increases by year-end, bringing the central bank's seven-year-long experiment with negative interest rates to an end. Market attention has centered on surging inflation, but we believe the drag of much higher energy costs on economic activity will be a bigger concern for the ECB. To be sure, the ECB is still likely to hike interest rates, but not as much as many investors believe.

The hiking of policy rates will also coincide with the reduction or end of important policy supports for European bond markets. Weaker sovereign issuers, such as Italy and Spain, have benefitted from lower borrowing costs due to large-scale ECB asset purchases. As these programs are wound down, borrowing costs should rise. The extra compensation that investors demand for purchasing Italian bonds has already risen from remarkably low levels, and we expect this to continue for some time.

Overall, our forecast for Europe is for the ECB to exit negative interest rates over the next year, from a current level of -0.50%. Our expectations for the rise in the policy rate are more conservative than those being priced in by the market, and this has a large impact on our expectations for the 10-year bund yield, which we see falling towards 0.50% from around 0.90% at the time of writing.



Our forecast for the 10-year government bond yield is 0.25%, an increase of 10 basis points from last quarter. We expect no change to the policy rate.

Japan

The most important factor for any Japanese bond forecast is whether the BOJ will continue with its policy of yield-curve control, which keeps the policy rate below zero and the yield on the 10-year government bond in a range of +/- 25 basis points around a target of 0%.

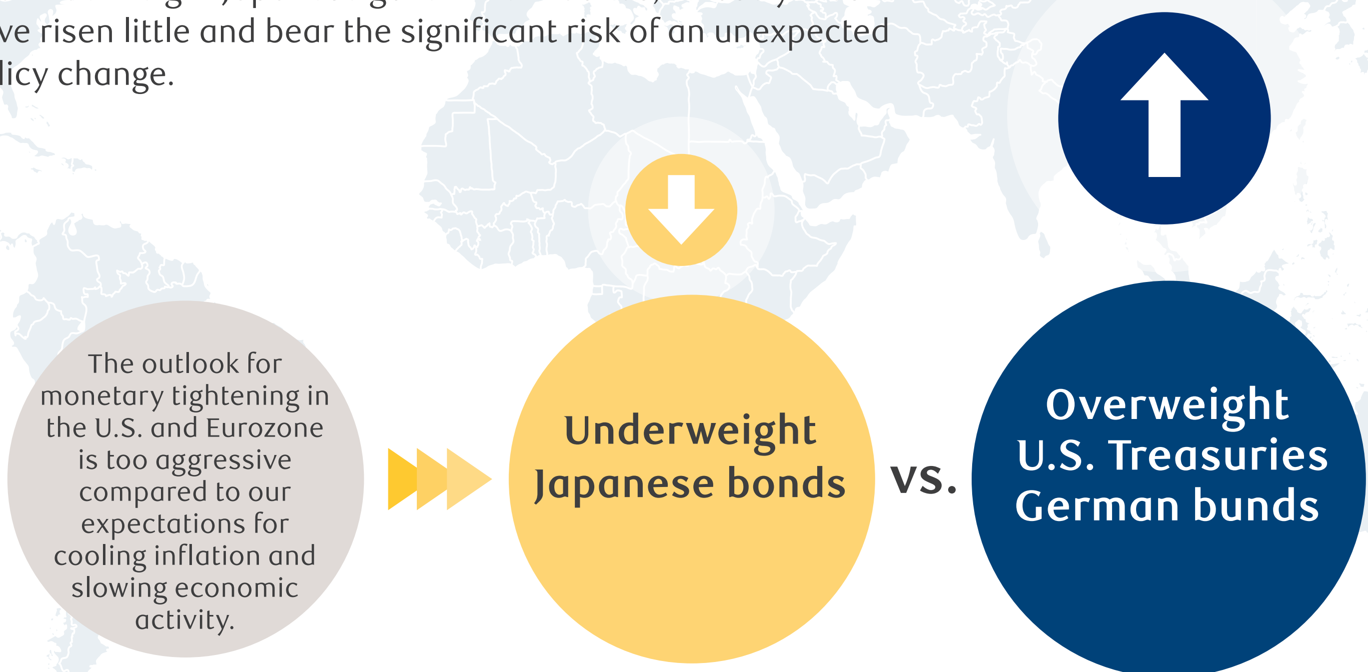
A likely surge in inflation over the next 12 months would present the largest challenge that Japanese policymakers have faced since launching their yield-curve-control monetary framework in September 2016. Inflation is running at a multi-year high, and leading indicators such as producer prices and yen weakness signal that even greater price pressures may be in store. Domestic inflation and the remarkable re-evaluation of expected policy rates in other developed markets suggest that investors will start to question whether a similar policy shift might be in the cards for the BOJ.

Investors are betting on a possible re-run of the scenario that faced Australia's government bond market, when the country's central bank unexpectedly decided to abandon its own yield-curve-control policy in November 2021, several years ahead of previous guidance, and sent bond yields surging higher.

Our view is that that the BOJ is unlikely to abandon yield-curve control over our forecast horizon. Economic growth in Japan has remained downbeat, even during the COVID recovery. What's more, while inflation has risen, the vast majority stems from rising energy and food prices, which are unlikely to persist. Policymakers have also been consistent in their defense of the current policy framework, going so far as to offer to buy unlimited amounts of Japanese government bonds every day in order to protect the top of the 0.25% target yield range. Our forecast for the 10-year government bond yield is 0.25%, an increase of 10 basis points from last quarter. We expect no change to the policy rate.

Regional outlook

We believe that the outlook for monetary tightening in the U.S. and Eurozone is too aggressive compared to our expectations for cooling inflation and slowing economic activity. We are overweight U.S. Treasuries and German bunds and underweight Japanese government bonds, whose yields have risen little and bear the significant risk of an unexpected policy change.



Interest rate forecast: 12-month horizon

Total Return calculation: May 31, 2022 – May 31, 2023

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.8%	3.0%	3.0%	2.8%	2.7%	3.9%
Change to prev. quarter	1.5%	1.3%	1.0%	0.5%	0.2%	
High	3.3%	3.5%	3.8%	3.8%	3.5%	(1.0%)
Low	1.3%	1.5%	1.6%	1.8%	2.0%	10.6%
Expected Total Return US$ hedged: 0.2%						

Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.0%	0.3%	0.5%	0.5%	0.6%	11.0%
Change to prev. quarter	0.5%	0.6%	0.6%	0.4%	0.3%	
High	0.8%	1.0%	1.0%	1.0%	0.9%	5.0%
Low	(0.5%)	(0.4%)	(0.1%)	(0.1%)	0.1%	16.3%
Expected Total Return US$ hedged: 2.0%						

Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.1%)	0.1%	0.2%	0.3%	1.0%	1.3%
Change to prev. quarter	0.0%	0.0%	0.1%	0.1%	0.2%	
High	(0.0%)	0.2%	0.4%	0.5%	1.1%	(0.6%)
Low	(0.1%)	(0.1%)	(0.1%)	0.0%	0.5%	9.1%
Expected Total Return US$ hedged: 2.6%						

Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.5%	2.5%	2.5%	2.6%	2.6%	5.0%
Change to prev. quarter	1.0%	1.0%	0.7%	0.6%	0.4%	
High	3.0%	3.5%	3.5%	3.5%	3.4%	(1.4%)
Low	1.3%	1.5%	1.6%	1.8%	1.9%	11.6%
Expected Total Return US$ hedged: 5.0%						

U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.0%	2.1%	2.3%	2.3%	2.1%	5.4%
Change to prev. quarter	0.5%	0.8%	0.9%	0.7%	0.5%	
High	2.8%	2.6%	2.6%	2.5%	2.3%	2.5%
Low	1.3%	1.3%	1.4%	1.5%	1.8%	11.2%
Expected Total Return US$ hedged: 5.8%						

Source: RBC GAM

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