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New Year insights: is it time to get on the bond-wagon?

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Over the past two years, rapidly rising interest rates have led to disappointing returns for bonds. We believe that the pain of this repricing is now mostly behind us. The backdrop for bonds is now the most attractive it has been in decades. The reasons for our positive outlook?

1. An intense tightening of monetary policy, including sharply rising short-term interest rates, is now behind us.
2. Bond yields and valuations are attractive.
3. The risk/reward for bonds is compelling.

We've already started to see a shift in the bond market in the last two months of 2023. U.S. 10-year bond yields have fallen over 1% since their October highs. Despite this rally, we still believe the case for bonds remains favourable in the quarters ahead. Overall, for investors who left risk assets or those carrying large cash balances, the current environment provides an attractive opportunity to invest some of that money in bonds.

Peak rates present an opportunity for fixed income investors

Since March 2022, developed market (DM) central banks have been raising short-term rates to tackle high inflation. However, this trend has shifted over the last few months. Many DM central banks have paused their rate hiking, while leaving the door open for future increases, if required. Others have suggested their next move may be to cut rates rather than hike. It is reasonable to assume that short-term interest rates are at or close to their peak for the current cycle.

We examined prior times the Bank of Canada reached peak overnight rates to see what this could mean for fixed income investors. We looked at two elements:

1. What happened to fixed income returns in the 12-month period following the last rate hike?
2. How did bond returns compare to short-term investments like GICs (Guaranteed Investment Certificates), which have become increasingly popular over the last two years?

As Exhibit 1 shows, returns, both relative and absolute, have historically been very attractive for fixed income investors during the first year following the final hike in short-term interest rates.

1. On average, bonds have returned 8.4% in the year following the last rate hike, while GICs have returned 3.3%.
2. Bonds outperformed in all instances, by an average of 5%.
3. When short-term cash savings rates were as high as they are today, bonds outperformed, though occasionally by a smaller margin.
4. Interestingly, these fixed income returns are not front-loaded. They are spread rather evenly over the next 12 months.

Looking back through history, the period following the last rate hike has been a favourable environment for bonds.

Valuations look attractive

RBC GAM developed a valuation framework to analyze where bonds yields are trading relative to where they should be based on inflation and real rates. Exhibit 2 looks at this for the Canadian bond market. By this measure, bond yields have been overvalued for much of the last two decades. However, this shifted as rates have risen recently. The model now shows that Canadian bond yields are the most attractive they've been from a valuation perspective in many years. This valuation story is also true for most global bond markets, including the U.S. and Europe.

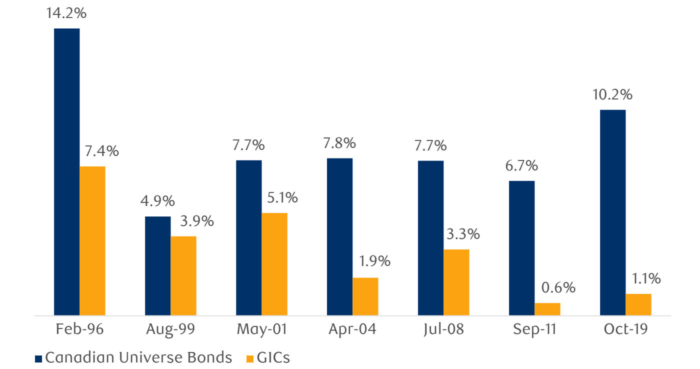
The risk/reward story looks compelling

Over the coming year, our base case expectation is for interest rates to fall as inflation continues to cool and economic growth slows. However, there is still a risk that inflation doesn't return to central bank targets, which could push bond yields higher. Yet even if yields were to continue to rise from here, the downside risk looks lower than in the recent past.

An example of this is shown in Exhibit 3. This chart illustrates the one-year return that a 10-year U.S. Treasury bond would provide if yields fall (yellow line) or rise (blue line) by 1% going back to 1960. Two time periods stand out:

- **2020**: bond yields reached their all-time lows in the summer. At that time a drop in yields of 1% would lead to a potential return of 9.3%. If they rose by the same amount, the expected loss was 8.7%. In other words, the upside or downside from bonds was about the same.

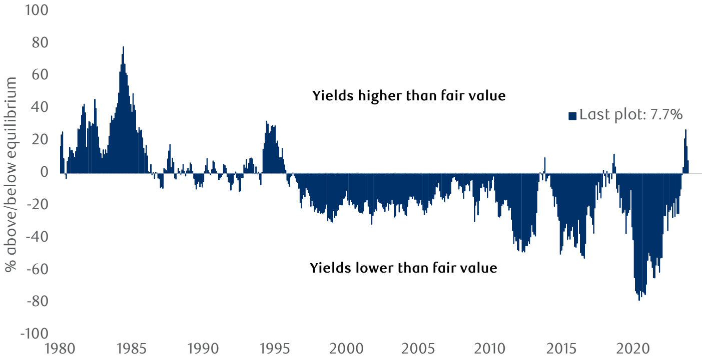
Exhibit 1: One-year returns show bonds outperform following the last hike by Bank of Canada



Note: Dates represent one year after peak Bank of Canada rate. "Canadian Universe Bonds" : FTSE Canada Universe Bond Index. "GICs" : the rate for a 1-year GIC when the Bank of Canada reaches peak rates. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results. An investment cannot be made directly into an index. Source: Morningstar Direct, Bank of Canada.

Exhibit 2: Canada bond market valuation

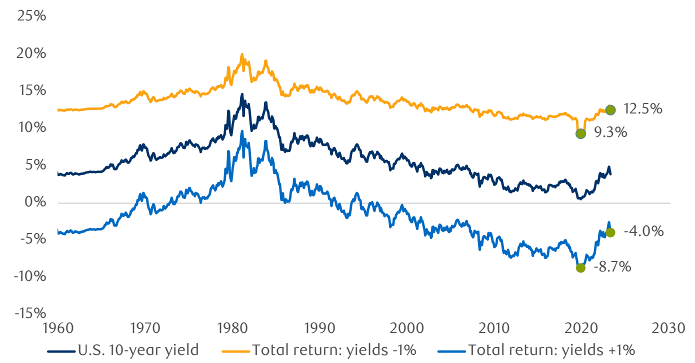
10-year government bond yield relative to equilibrium



Note: As of December 31, 2023. Source: RBC GAM

Exhibit 3: U.S. 10-year Treasury Bond

Total returns given +/- 1% shift in yields over 1-year



Note: Chart reflects hypothetical computation of total returns in the event that yields were either to rise or fall 100 basis points over the subsequent 12-month period. Source: Bloomberg, RBC GAM. Deutsche Bank as of December 31, 2023

- **Today**: fast forward to today, this story looks a lot different. Based on current levels, if bond yields were to fall by 1% over the next year, the expected total return would be 12.5%. If bond yields rose by the same amount, the expected loss would be 4.0%, a much milder loss than the 2020 results.

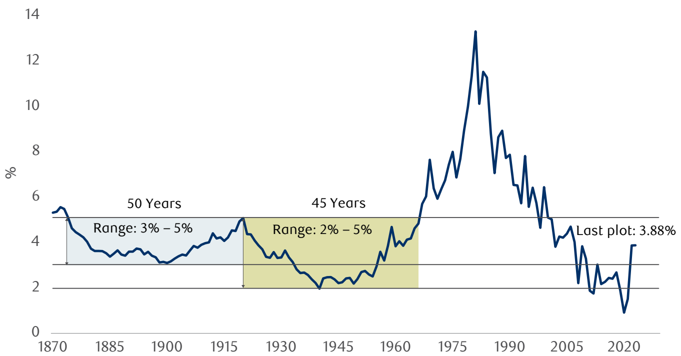
This suggests that the risk is heavily skewed towards positive outcomes. The downside risk is significantly lower now than it was back in 2020, while the upside risk for bonds also looks more attractive. This, combined with our view that we're more likely to see yields fall over the coming year, provides an attractive risk/reward set-up for bonds.

A final word

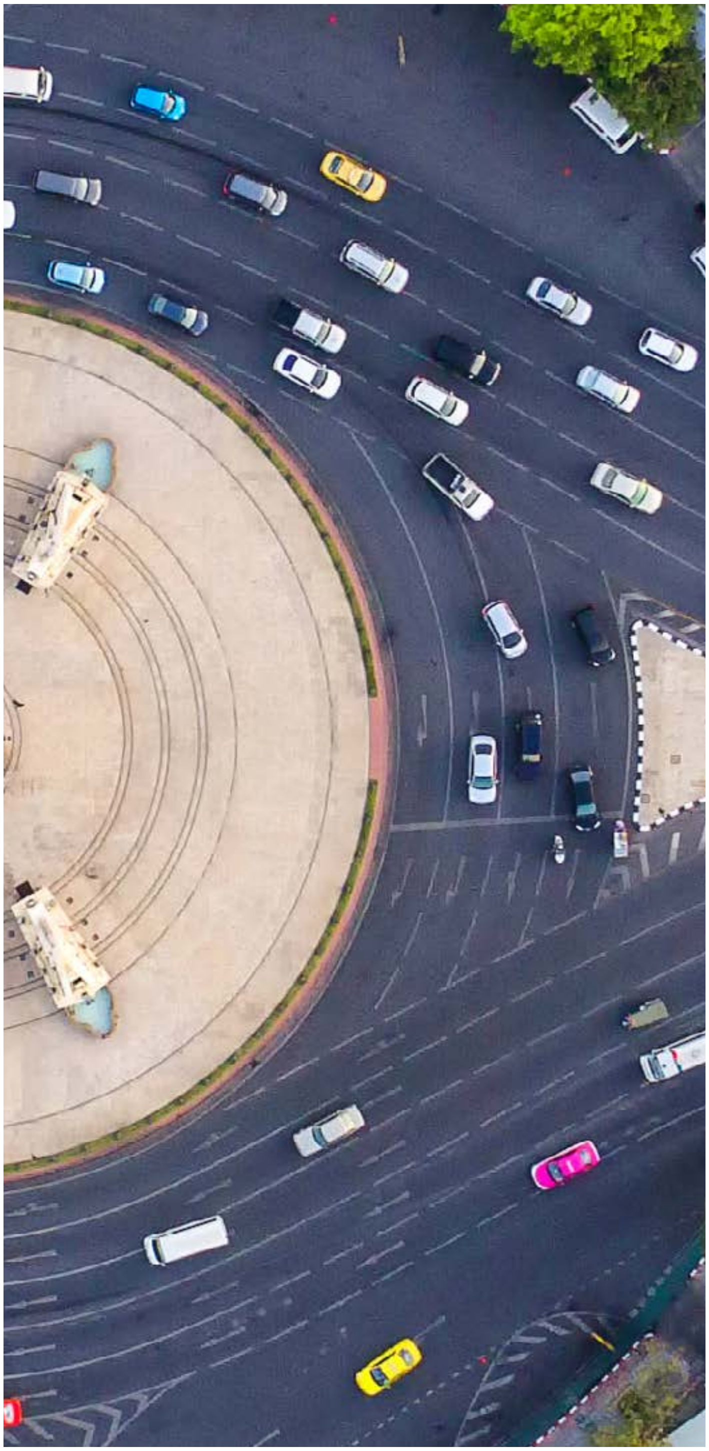
As we've discussed above, at RBC GAM we believe that the major valuation risk for bonds is now mostly behind us. Even with the recent rally, bonds are the most attractive they've been in decades and the backdrop is skewed to the upside. For example, a move in the U.S. 10-year yield towards 3.5% over the next 12 months could still generate total returns in the high single digits.

After years of below-average bond yields, they are now well within their normal range of the past 150 years. At these higher yield levels, bonds can once again be a good source of income and offer the potential for capital gains should yields fall from today's levels. The importance of bonds within portfolio construction is once again evident.

Exhibit 4: U.S. 10-year bond yield



Note: As of December 31, 2023. Source: RBC GAM



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