RBC Global Asset Management

Global fixed income markets

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Soo Boo Cheah, MBA, CFA
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Joanne Lee, MFin, CFA
Senior Portfolio Manager
RBC Global Asset Management Inc.

Taylor Self, MBA, CFA
Portfolio Manager,
RBC Global Asset Management Inc.

The bond market is challenging investors in ways it hasn't for at least a decade.

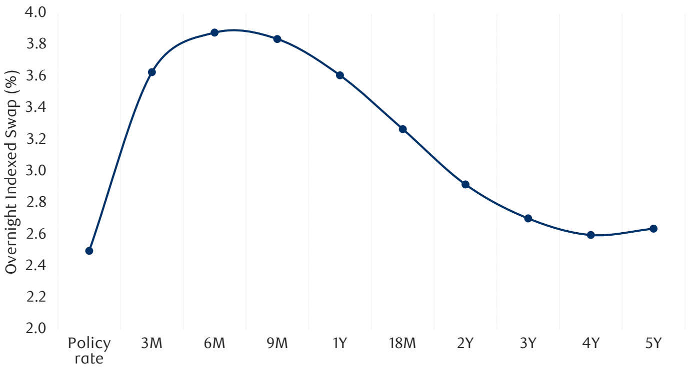
The 10-year Treasury yield rose to 3.50% in June, the highest level since 2011, amid efforts by the U.S. Federal Reserve (Fed) to counter the most severe inflation in 40 years. In this context, one of the big questions on bond investors' minds becomes: Is 3.50% the top yield for the current cycle? It will take a while before we know the answer. The adverse effect of higher interest rates typically takes about a year to move through the economy. In the meantime, the U.S. 10-year yield is likely to trade in a wide range on both sides of 3%, with inflation data as the key driver.

The broad range in bond yields that we foresee is the product of competing views on how the inflation story will unfold. One camp believes that inflation is close to peaking and that a few more Fed hikes and falling inflation mean that, by mid-2023, interest rates will be restricting economic growth. A short but shallow recession could ensue. The opposition counters that inflation will not be coming down so fast, and that central banks should stay on an aggressive tightening course until policy rates are decisively above the inflation rate. This group argues that a fed funds rate of at least 4.5% or higher will be necessary to wring inflation from the system.

A look at central-bank policy this year gives an idea why this debate is so important. The Fed is in the process of raising policy rates at the fastest pace since the 1970s, with rate hikes totaling 2.25 percentage points since March. The U.S. central bank has also started to roll back extensive bond purchases for the first time since 2020. Leading economic indicators, following in the wake of the rapid surge in borrowing costs, are deteriorating at a pace that could presage a rapid slowdown in consumption over the months ahead. Rising borrowing costs are clearly a burden on the economy and will at some point weigh on the jobs market and growth.

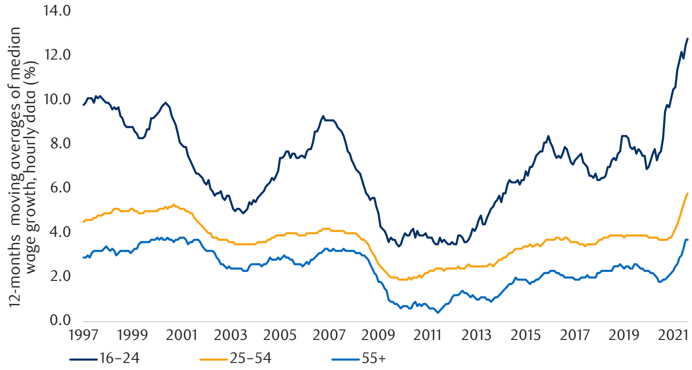
According to market indicators, the Fed will complete its tightening cycle by the summer of 2023 and start easing a few months later (Exhibit 1). The U.S. yield curve – a measure of the relationship between short- and long-term interest rates – appears to confirm that the current tightening cycle is in its last stages. Inverted yield curves – periods in which short-term yields exceed longer-term yields - have been a generally dependable predictor of bad economic news an average of 18 months into the future.

Exhibit 1: Policy-rate expectation
Investors are expecting the Fed to finish its aggressive tightening in six months



Note: As of August 30, 2022. Source: Bloomberg

Exhibit 2: Tight labour market led to higher wage growth for everybody – U.S. wage growth tracker by age



Note: As of July 31 , 2022. Source: BLS and Federal Reserve Bank of Atlanta

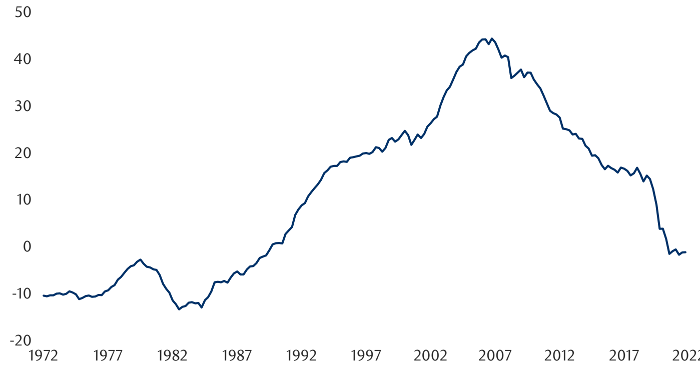
The Fed's decision to embark on quantitative tightening could be helping to force down bond yields as withdrawing liquidity in a slowing economy will tend to crimp economic growth, leading investors to seek safety in government bonds. This development runs counter to the notion that halting rollovers in maturing bonds should send bond yields higher since it reduces demand for fixed-income assets.

If the first group is right about inflation and the trajectory of economic growth, then U.S. 10-year Treasury yields have peaked, and the Fed will stand ready to cut rates on signs that interest rates are too high for the economy to handle. The assumption here is that inflation is coming down quickly toward the 3% level currently anticipated by inflation derivatives.

Those in the second camp will not be satisfied with the Fed taking its foot off the monetary pedal. They argue that that central bankers should extend rate hikes until inflation, excluding food and energy, falls back to about 2%. Their case rests on a belief that the Fed has been too willing to maintain a loose monetary policy after economic recoveries take hold, and that investors must be relieved of their reliance on very low interest rates that inflate demand for credit.

For now, consumer demand continues to run hot even in the face of higher interest rates and persistent inflation, leaving economists with the difficult job of figuring out when demand will adjust sufficiently lower that prices for basic items such as food and rent can start to turn down. The unemployment rate is very low, with demand for labour outstripping supply and contributing to inflation. This labour-market tightness has translated into wage growth for all age groups, but especially for young people (Exhibit 2), and household balance sheets are by some measures in their best shape in 30 years (Exhibit 3). As a result, households can often borrow to make up for purchasing power lost to inflation, adding to inflationary pressures.

Exhibit 3: Private-sector balance sheet has never been this good over the past 30 years
Household net debt as a % of GDP



Note: As of June 30, 2022. Source: Bloomberg, Household total debt minus Household & Non-profit Organization currency & deposits

The labour-market strength will likely persist unless the U.S. economy goes into a deep recession over the next year. Unfilled positions are widespread across industries, and unemployment rates may stay sticky because of a tendency for employers to hoard existing workers during periods of high employee turnover. The adjustment is likely to start from a sharp reduction in job postings driven by uncertainty about the pace of growth. For now, an employment-market scenario characterized by an insufficient workforce, low productivity and rising wages is a recipe for inflationary pressures and could restrain economic activity in the coming year, forcing the Fed to keep policy tighter than it would like.

The bond market is at this stage pricing in a scenario in which the Fed continues hiking rates until they reach restrictive territory and then nudging them lower - all over the next 12 months. As the tug of war between the inflation-peak-is-behind crowd and fight-is-not-won crowd takes place, we expect yields to trade between 2.5% and 3.5% over the next 12 months. In such an environment, it will be essential for bond portfolio managers to follow a nimble pragmatism in trading portfolios rather than aligning with either of the views outlined above.

Direction of interest rates

Our forecast is for the yield curve to stay inverted with the 10-year yield at 3%, expecting economic weakness brought on by Fed rate hikes.

United States

Since the Fed delivered its first hike in March, U.S. 10-year Treasury yield has vacillated between a low of 2.35% in April and the June high of 3.5%. We are expecting this type of extreme swing to continue over our forecast horizon, based on the preceding arguments.

Our forecast for the fed funds rate is that it will rise to 3.5% by the end of this year, but the possibility exists that it will get to as high as 3.75% to 4.00% by mid-2023. Whether we get that high and for how long will depend on how fast inflation declines. In our opinion, inflation may linger considering the economy needs time to adjust to Fed's tightening measures. As such, we are expecting the Fed to stay at the restrictive level longer than what we saw at the end of 2017-2019 tightening cycle. Our forecast is for the yield curve to stay inverted with the 10-year yield at 3%, expecting economic weakness brought on by Fed rate hikes.

We are raising our outlook for the 10-year bund yield to 1.5% from 0.50%.

Eurozone

The Russia-Ukraine war continues with no end in sight. Sanctions imposed on Russian commodity exports have sent energy and crop prices much higher, and summer drought across much of Europe has added to economic woes and fueled further price increases. Economic indicators point toward a deeper slowdown come the winter, and we should expect high energy prices and frequent disruptions. Governments are likely to continue implementing measures to give consumers a degree of relief from surging energy costs. The impact on businesses has and will continue to be severe as cost increases related to energy have been unprecedented.

For the European Central Bank (ECB), the war presents a predicament in the conduct of monetary affairs. The central bank simultaneously faces a more precarious economic environment than North America but with the prospect of worse inflation. As a result, the ECB will have to balance the need to manage inflation with the possibility that the continent's energy shortage will trigger social unrest in parts of Europe over the next year. Investment indicators suggest the ECB will hike its policy rate as high as 2.3% within the next 12 months and 1.65% by the end of this year, but we think this view may be too aggressive. Come winter, the absence of a ceasefire in Ukraine and energy shortages may well trigger the feared unrest, business disruptions, worsening fiscal positions and weaker-than-expected economic growth in parts of Europe. The window for rate hikes is shrinking fast for the ECB.

The ECB's decision in July to end just over eight years of benchmark interest rates below zero and introduce a modified bond-purchase program aimed at defending Italy and other weak Eurozone members, showcased the political sensitivity required to manage the currency's bloc monetary affairs. The new policy tool, known as the Transmission Protection Instrument (TPI), is designed to provide a safeguard for the euro. While the measure stipulates that it can be used to stabilize only countries following prudent macroeconomic policies, to us it seems destined to be invoked in support of the very weakest. We expect that the TPI will be utilized within our forecast horizon, and that the criteria for its invocation will be defined leniently.

The TPI may, in fact, be part of the reason that investors are not more concerned about Italy's September 25 national elections, which according to polls would be won by a right-wing bloc were they held today. Italian bonds benefited over the summer from the ECB's relentless support: the real test could come after Europeans return from their extended summer vacations.

Our base case scenario is that the ECB will deliver a total of 0.75 percentage point of rate hikes over the next year, taking its policy rate to 1.50%. We are also raising our outlook for the 10-year bund yield to 1.50% from 0.50%.

Our forecast for the 10-year government bond yield remains unchanged at 0.25%.

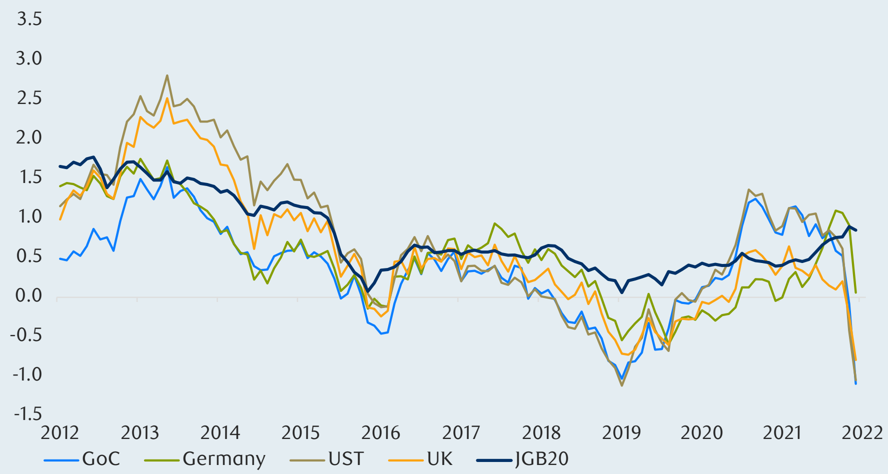
Japan

Sales by Japanese life insurers of foreign bonds reached a new monthly record of 1.6 trillion yen (US$11.7 billion) in July as the yield advantage associated with investing abroad diminished on a currency-hedged basis (Exhibit 4). We expect these financial repatriations to continue in the coming months, and that they will tend to depress government bond yields as some of the proceeds end up in the domestic fixed-income market.

Japanese inflation is running at a multi-year high, and rising producer prices and a weak yen suggest that even greater price pressures are in store. Most of the inflation is being driven by higher costs for energy and food, and aside from these two categories, inflation is well below the Bank of Japan's (BOJ) 2% target. However, there are signs that Japan's deflationary attitude is lifting as households expect an extension in short -term inflation and businesses expect higher prices over the intermediate term. For the time being, the BOJ can take comfort in the fact that neither investors nor consumers expect inflation to remain a significant issue in the longer term.

Over the forecast horizon, we expect the BOJ to retain the policy that holds the range between short- and long-term yields steady (yield control), and foresee no change to the policy rate. Our forecast for the 10-year government bond yield remains unchanged at 0.25%.

Exhibit 4: Japanese Government Bonds provide the best yield on a currency-hedged basis – Global 10-year bond yield % (hedged into JPY)



Note: As of July 31, 2022. Source: Bloomberg

We expect the 10-year yield to trade at 2.75% and the BOC to raise the benchmark overnight interest rate to 3.50%.

Canada

The Bank of Canada (BOC) surprised investors by raising its policy interest rate in July by 1 percentage point to 2.5%, the biggest move since 1998 and the largest increase by any G7 central bank during the current tightening cycle. The rate increase brings the policy rate into the middle of the range that the BOC estimates is neither conducive nor destructive to economic growth (the neutral rate). We expect the BOC to extend rate hikes given the breadth of inflation and expectation among consumers and businesses that high inflation will persist. Over the next 12 months, we expect the 10-year yield to trade at 2.75% and the BOC to raise the benchmark overnight interest rate to 3.50%.

Our yield forecast for the 10-year gilt climbs by 0.50% to 2.75%.

United Kingdom

U.K. inflation continues to ratchet higher and there are bold forecasts that it could reach 20% by early next year. The country's inflation problem appears more pernicious than in its developed-market peers.

While high U.S. 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 Bank of England (BOE) can do to combat these issues.

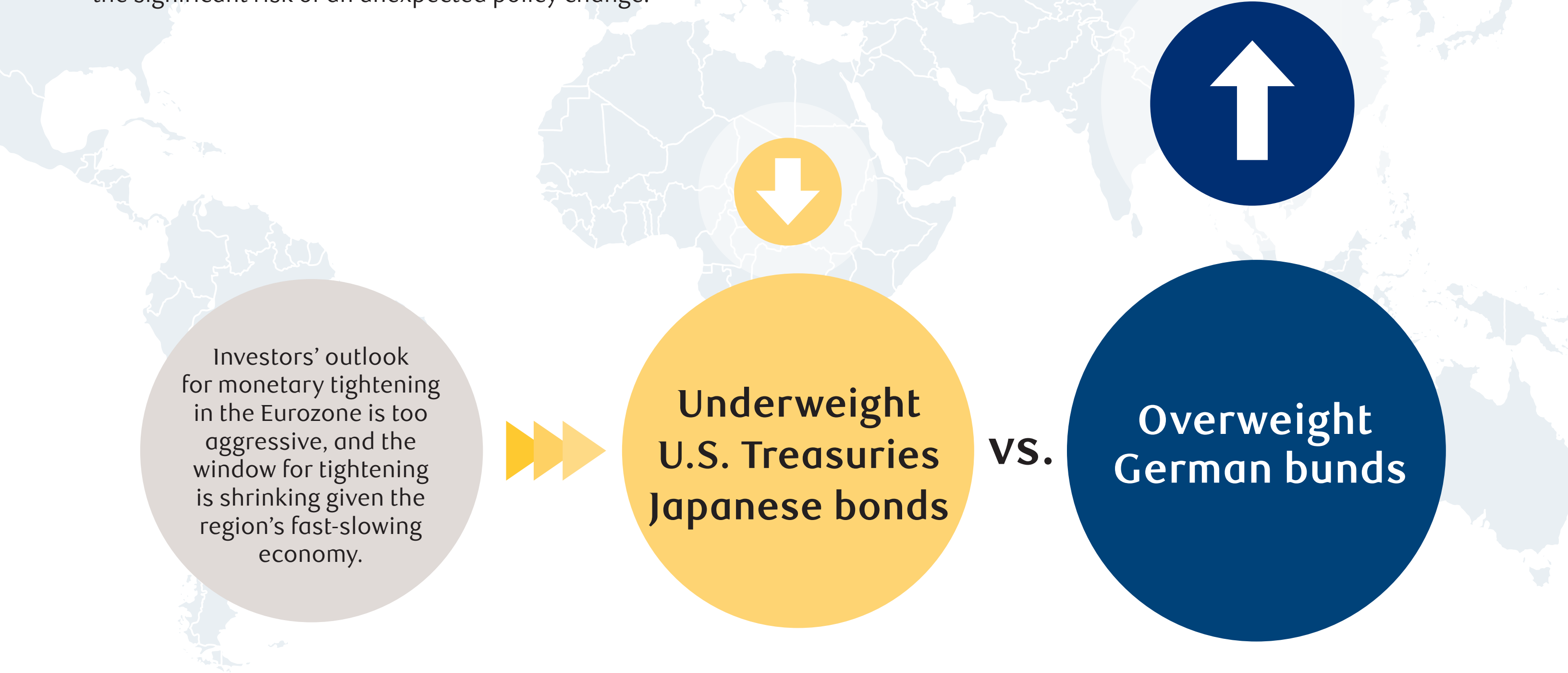
The approaching winter could be devastating for many U.K. households amid concerns that energy bills could account for 12% to 15% of median household income. The two candidates vying to replace Boris Johnson as prime minister are promising subsidies and tax cuts to help with the cost-of-living crisis, implying even greater deterioration in the government's budget deficit.

The BOE's September 15 meeting will be closely watched by investors. As with the ECB, the pressure will be on the BOE to increase rates to combat inflation, while the weakening economy dampens the appetite for economy-dampening rate hikes. Demand for labour is already starting to soften based on a fall in job vacancies for two consecutive months. Within 12 months, the U.K. could be well on the road to cutting policy rates.

Our forecast for the BOE's benchmark interest rate is 3% over the next 12 months, but we cannot rule out the possibility that punishing inflation will force the BOE lift the rate to more than 4.0% and start to roll it back to 3.0% – and all of it occurring within our forecast horizon. Our yield forecast for the 10-year gilt climbs by 0.50% to 2.75%.

Regional outlook

We believe that investors' outlook for monetary tightening in the Eurozone is too aggressive, and that the window for tightening is shrinking given the region's fast-slowing economy. We recommend a 5-percentage-point overweight in German bunds; a 2.5-percentage-point underweight to Treasuries; and a 2.5-percentage-point underweight in Japanese government bonds, whose yields have risen little and bear the significant risk of an unexpected policy change.



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