RBC Global Asset Management

Global fixed income markets

SPRING 2022

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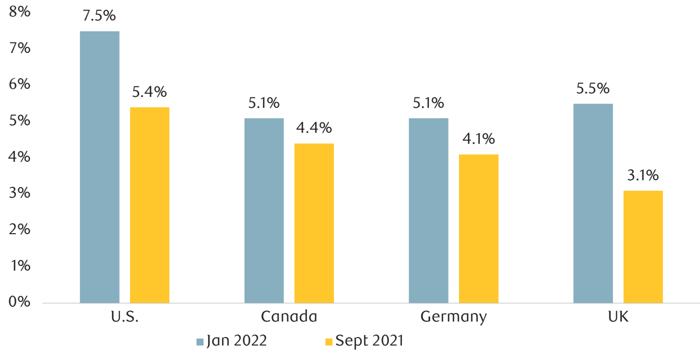
For the first time in over a decade, bond investors face a concurrent tightening of monetary policy in most major markets. Market indicators suggest that every major central bank except the Bank of Japan will raise interest rates over the next year, although Russia's invasion of Ukraine could dampen the case for higher yields if the conflict escalates. Even the European Central Bank (ECB), which has kept its policy rate negative since 2016, could lift rates at least once by the end of the year. As part of this concerted money-tightening effort, central banks will also be paring asset purchases. We believe that the U.S. Federal Reserve (Fed) will begin shrinking its balance sheet in the second half of this year. We have raised our bond-yield forecasts across markets and expect the U.S. 10-year Treasury yield to rise to the highest level since mid-2019 within the next 12 months.

Central bankers have played a key part in the changing outlook for the bond market. In early January, the Fed surprised investors by admitting that faster-than-expected inflation would require it to take a more aggressive approach to tightening policy. The inflation risk was now sufficient, the Fed said, that asset purchases would have to be cut back so as to actually reduce the size of its balance sheet rather than just slow the speed at which it would rise. Raising interest rates would not be enough.

Inflation is becoming increasingly widespread (Exhibit 1). Disruption to supply chains from the pandemic has lasted much longer and the rest of the economy has recovered much more quickly than anticipated. In what is now a historically tight U.S. labour market, workers are demanding higher wages to offset the general rise in prices. In some sectors, wages are rising as quickly as 10% a year, ahead of year-over-year inflation currently running around 7.5%.

Exhibit 1: Global consumer-price inflation
Selected year-on-year inflation rates



Note: As of February 2022. Source: National statistical offices, Bloomberg

In response, investors are pricing in as many as seven Fed interest-rate hikes this year. Against this backdrop of still-high inflation and tightening monetary policy, the most likely outcome over the next year is higher bond yields. We expect the U.S. 10-year bond yield to rise to 2.25% over the next year, compared to around 1.90% at the time of writing.

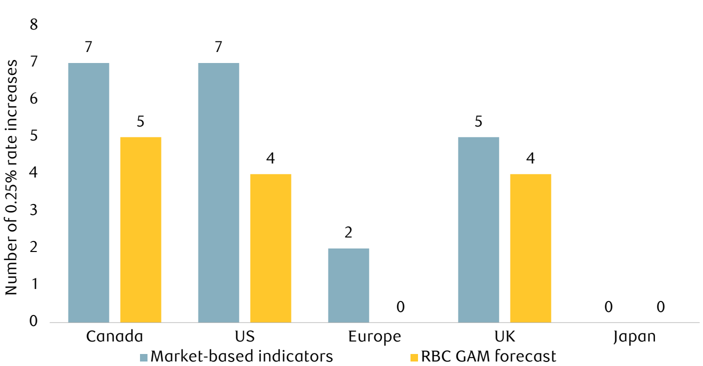
While we expect the Fed to deliver a series of interest-rate hikes, our view is that the actual number is likely to be closer to four. We expect global economic activity to slow over the next year, removing some of the urgency with which central banks will need to raise rates. The tailwind of pandemic-related spending will fall firmly into the rear-view mirror in 2022, presenting a drag on growth. Moreover, the absorption of excess capacity in the economy and labour market was likely completed in the final months of 2021, meaning that the rate of economic growth will likely fall back toward its pre-pandemic potential. In this environment, we expect that central banks will hike rates less aggressively than expected based on market indicators (Exhibit 2). In Canada, we expect four rate hikes from the Bank of Canada before the end of this year, compared with market expectations of at least seven.

We also believe that the effect of reduced central-bank asset purchases on government bond yields will be modest. While asset purchases can push down long-term bond yields by signaling that policy rates will remain low for a long period, a shrinking balance sheet does not indicate the opposite. In fact, we think that balance-sheet shrinkage could substitute for interest-rates hikes and may reduce pressure on the central bank to raise rates.

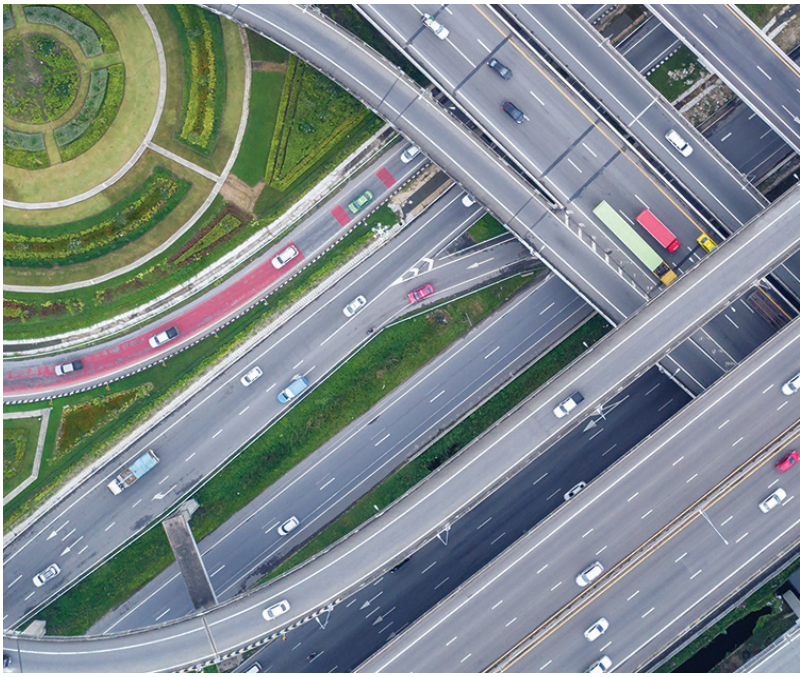
The gap between short-term and long-term bond yields, known as the yield curve, has narrowed considerably and is now remarkably flat, suggesting that economic momentum will slow. Interest-rate hikes increase the probability of a deeper slowdown in growth or even a recession. We therefore expect the yield curve will continue to flatten over the next year.

While high inflation and rising benchmark rates make a strong case for bond yields to rise, we believe that long-run trends in the bond market still play an important role as the world emerges from the pandemic. We have long highlighted the impact of higher global debt loads, demographics, income inequality and technological change on bond markets. These are trends that predate the pandemic, in many cases have been exacerbated by it, and are likely to persist for the foreseeable future. So while yields are likely to be higher in the next year, we expect these rises to be relatively modest. In turn, bond-market investors should expect returns in the low single digits.

Exhibit 2: Expected central-bank interest-rate hikes – Interest-rate increases expected between March and December



Note: As of February 2022. Source: Bloomberg, RBC GAM



Direction of interest rates

We expect the U.S. 10-year Treasury yield to rise to around 2.25% over the next 12 months, from around 1.90% at the time of writing.

U.S. – With inflation spreading beyond pandemic-affected sectors and into the broader economy, as well as a very hot labour market, the U.S. Federal Reserve (Fed) should gradually move away from emergency levels of policy accommodation. We expect the Fed to hike interest rates at least four times by December. In addition, the Fed is likely to begin shrinking its balance sheet in the summer. The bond market is pricing in at least six hikes by December. We believe that cooling economic activity and price pressures over the course of this year will remove some of the need for aggressive monetary-policy tightening and therefore expect fewer hikes than market indicators would suggest. Moreover, a more aggressive approach to balance-sheet reduction could be pursued in lieu of hiking the policy rate. We expect the U.S. 10-year Treasury yield to rise to around 2.25% over the next 12 months, from around 1.90% at the time of writing.

Over the next 12 months we expect the BOC to raise the overnight rate four times to 1.50%, and 10-year yields to rise to 2.25%.

Canada – The Bank of Canada (BOC) has begun raising interest rates after nearly two years of holding them as low as practically possible. A tight labour market and a feverish housing market indicate that higher rates are warranted. However, increased geopolitical risk following Russia's invasion of Ukraine in late February could favour a more cautious approach. The BOC has indicated that it is likely to become more "data dependent" after the first few rates hikes, but the wild card will be the BOC's approach to reducing its balance sheet. The BOC has said only that rate hikes will precede efforts to reduce the balance sheet, known as quantitative tightening, and policymakers have said they do not plan to sell bonds to achieve balance-sheet reduction. We expect a cautious approach, with balance sheet run-off starting gradually in April. Investors are pricing in seven 25-basis-point hikes over the next 12 months, which we think is unlikely. Over the next 12 months we expect the BOC to raise the overnight rate four times to 1.50%, and 10-year yields to rise to 2.25%.

U.K. – The Bank of England (BOE) hiked its benchmark interest rate to 0.50% at its February meeting, and we expect policymakers to continue raising the bank rate over the course of this year. Inflation accelerated to 5.5% in January as the economy struggles with surging energy prices and higher business costs due to Brexit. The BOE also appears poised to substantially reduce the size of its balance sheet later this year. Unlike peers, the BOE's balance-sheet reduction will likely involve sales of longer-maturity government bonds. We think this could put upward pressure on medium- and long-term bond yields. In addition, we expect that the BOE's plan to quickly unwind its sizeable corporate-bond holdings could increase the yield premium that investors require to hold them. We expect the BOE to hike rates to 1.50% by year-end, and the 10-year gilt yield to hit 1.55% over the same period, from 1.45% at the time of writing.

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Eurozone – Alongside its developed-market peers, the eurozone appears poised to remove monetary-policy accommodation over the next year. Inflation in the eurozone rose to 5.1% in January, the highest level in a quarter-century, boosted by higher energy prices. Continued fiscal expansion should support growth that has been higher than in recent years. Our expectations for the eurozone's economy are most affected by the Russo-Ukraine war. Russia is the largest supplier of energy to the eurozone, and any disruptions would increase already high levels of inflation. What's more, the wide use of inflation-indexation in European wage contracts means at least some of this inflation is likely to feed into higher wages. We think that most of this year's adjustment in monetary policy by the European Central Bank (ECB) will come through reduced asset purchases rather than interest-rate hikes. While we would not be surprised to see rate hikes before the end of 2022, we think they are more likely to start in 2023. We forecast no change to the ECB's policy rate this year, and yields on German 10-year to be around 0.15% within the next year.

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Japan – The inflation plaguing much of the developed world seems to have mostly bypassed Japan. We think that the Japanese economy will struggle to generate meaningful sustained inflation through the long term, and do not expect a meaningful change in monetary policy over the next 12 months. At the same time, rising global bond yields will tend to push up Japanese yields, albeit less than elsewhere due to the Bank of Japan's efforts to cap the 10-year yield at 0.25%. We forecast the 10-year government bond yield at 0.15% in a year's time.

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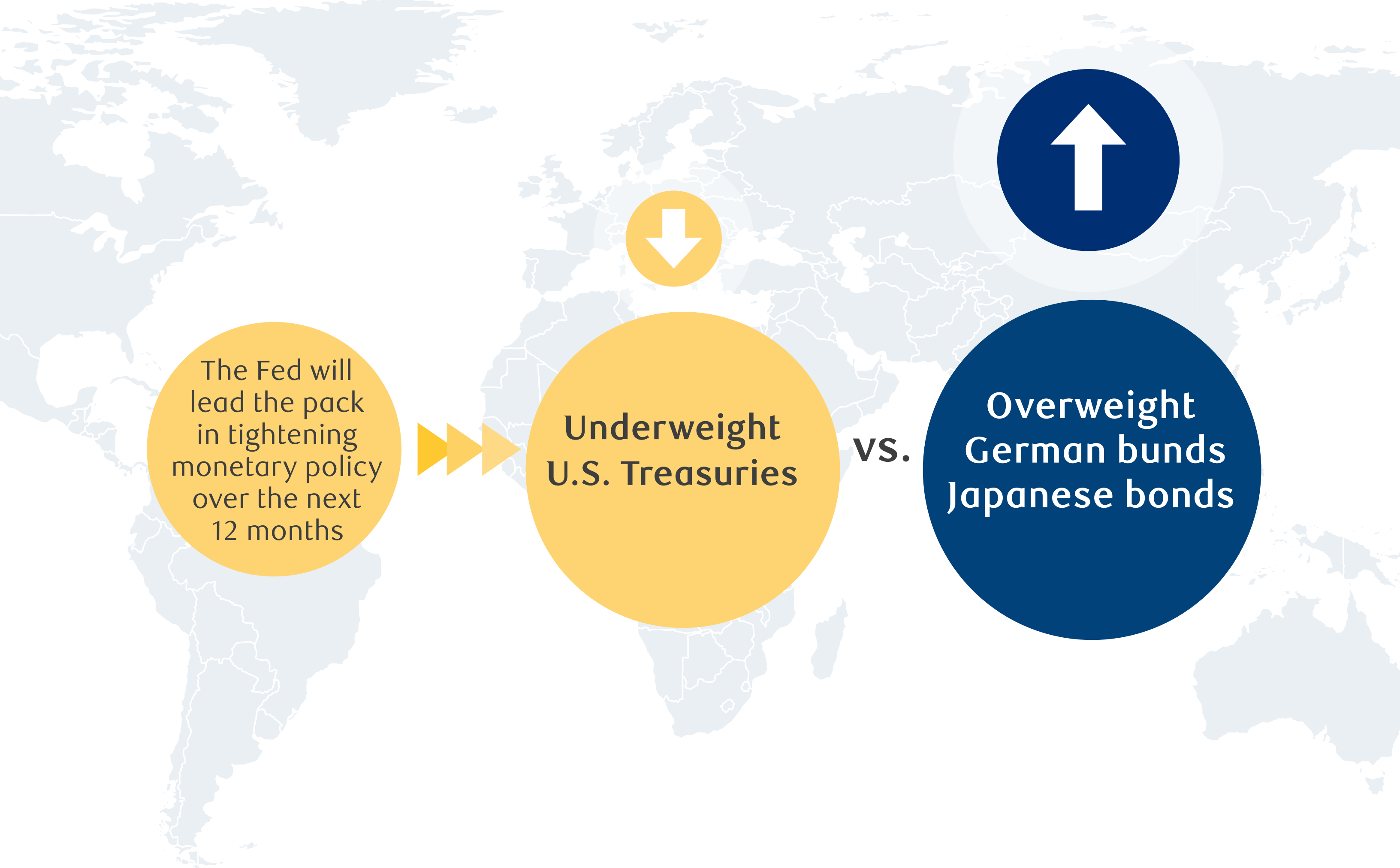
Regional outlook

We believe that the Fed will lead the pack in tightening monetary policy over the next 12 months, increasing the attractiveness of eurozone and Japanese government securities. We are underweight U.S. Treasuries and overweight German bunds and Japanese government bonds.



Interest rate forecast: 12-month horizon

Total Return calculation: February 28, 2022 – February 28, 2023

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.25%	1.75%	2.00%	2.25%	2.50%	(0.29%)
Change to prev. quarter	0.88%	1.00%	0.50%	0.45%	0.30%	
High	1.75%	2.50%	2.65%	2.75%	2.90%	(3.45%)
Low	0.63%	0.80%	1.00%	1.10%	1.30%	8.22%
Expected Total Return US$ hedged: 0.2%						

Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.50%)	(0.30%)	(0.10%)	0.15%	0.30%	1.20%
Change to prev. quarter	0.00%	0.00%	0.15%	0.20%	0.05%	
High	(0.25%)	0.00%	0.30%	0.45%	0.70%	(3.21%)
Low	(0.50%)	(0.40%)	(0.25%)	(0.10%)	0.10%	3.54%
Expected Total Return US$ hedged: 2.0%						

Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.10%)	0.00%	0.10%	0.15%	0.80%	2.38%
Change to prev. quarter	0.00%	0.10%	0.15%	0.05%	0.05%	
High	(0.10%)	0.05%	0.15%	0.30%	0.90%	0.70%
Low	(0.10%)	(0.10%)	(0.10%)	(0.10%)	0.40%	8.84%
Expected Total Return US$ hedged: 3.5%						

Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.50%	1.50%	1.80%	2.00%	2.20%	0.85%
Change to prev. quarter	0.75%	0.00%	0.00%	0.00%	(0.10%)	
High	2.00%	2.10%	2.30%	2.50%	2.80%	(3.66%)
Low	0.75%	0.80%	1.00%	1.00%	1.25%	9.41%
Expected Total Return US$ hedged: (1.3%)						

U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.50%	1.30%	1.40%	1.55%	1.60%	0.98%
Change to prev. quarter	0.90%	0.70%	0.40%	0.30%	0.10%	
High	1.50%	1.80%	2.00%	2.25%	2.15%	(7.44%)
Low	0.50%	0.60%	0.80%	1.00%	1.25%	7.30%
Expected Total Return US$ hedged: (1.0%)						

Source: RBC GAM

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Publication date: March 15, 2022