RBC Global Asset Management

Global fixed income markets

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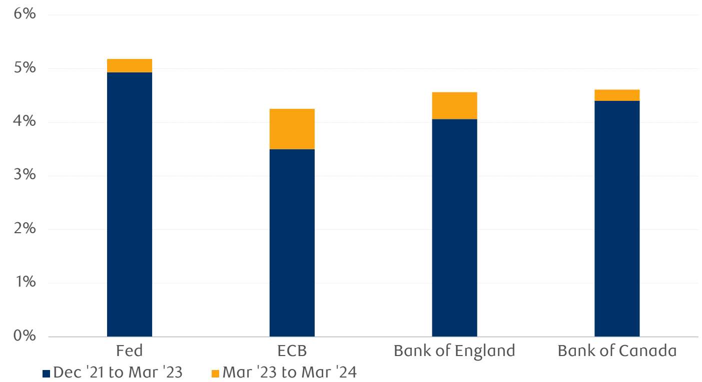
After a bright start to the year, government bonds have been coming under pressure from rising yields, as economic growth and inflation are proving much more resilient than expected. In response, central banks are likely to continue hiking interest rates through at least the middle of this year to cool still-too-high inflation and a remarkably strong labour market. That said, we expect central banks to hike policy rates much less than they did in 2022. The economy has shifted down a gear, and price rises are less rapid. We expect that inflation will slow towards 2% through the medium term and therefore believe that yields today compensate investors generously. Even with further increases in policy rates and a string of recent U.S. bank failures, we expect mid-single-digit returns from government bonds over the next 12 months, as the highest yields in over a decade should provide a buffer against losses.

The U.S. recently experienced its largest bank run since 2008 – with Silicon Valley Bank (SVB) entering receivership. In response, investors flocked to the relative safety of government bonds, driving down yields. We do not believe that SVB's failure portends a system-wide crisis as policymakers responded quickly to avoid contagion risks. Moreover, the nature of the events so far differ considerably from the catastrophic losses of 2008, when the major concern was the quality of the banking industry's assets. In SVB's case, the problems were rooted in U.S. government bonds – assets of the highest quality whose values were hit by rising interest rates rather than any real risk that the debts wouldn't be repaid.

We are reasonably confident that 2023 will not mark a third straight year of negative returns for bonds. One reason is that yields are much higher. Last year's fixed-income returns were

Exhibit 1: Policymakers are expected to hike only a bit more – Historical and expected changes in central bank interest rate



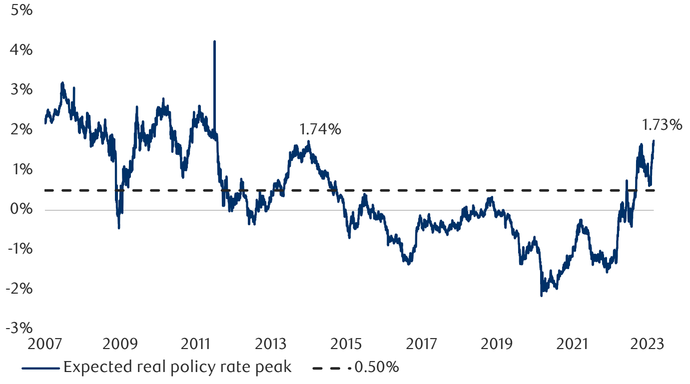
Note: As of March 2, 2023 and based on historical changes and overnight-indexed swap rates. Source: RBC GAM particularly poor due in part to the rapid and unexpected rise in interest rates that could not be offset by low starting yields. The effect of higher yields is particularly notable on short-maturity bonds: investors in a newly issued 2-year Treasury bond would experience losses over a one-year holding period only if the yield on the security more than doubled to 10.0% from the current 4.8%.

The market expects 50 to 75 basis points of hikes over the next 12 months from most central banks, a stark contrast to the hundreds of basis points of tightening delivered last year (Exhibit 1). While the year-over-year pace of inflation is still far above target in most countries, increases in prices have slowed markedly over the past six months. In the U.S., prices have been rising by a paltry 1% per year after excluding hikes in residential rents. Over the next year, we expect rent inflation to cool significantly. The impact of last year's rapid climb in energy prices due to Russia's invasion of Ukraine and supply-chain disruptions from the pandemic will also fade.

In addition to falling price pressures, economic activity has clearly downshifted. By our calculations, inflation-adjusted policy rates are as restrictive as they have been since before the global financial crisis (Exhibit 2). We also believe the full effect of the massive amount of tightening is yet to be felt in the economy. Traditional harbingers of economic downturns are signaling agreement with our assessment, as short-term bond yields have significantly exceeded those on longer-term bonds since the middle of last year. This inversion of the yield curve historically portends a recession sometime over the ensuing two years, and we expect most of the world to fall into a mild recession by late 2023 or early 2024 – suggesting support for bond prices.

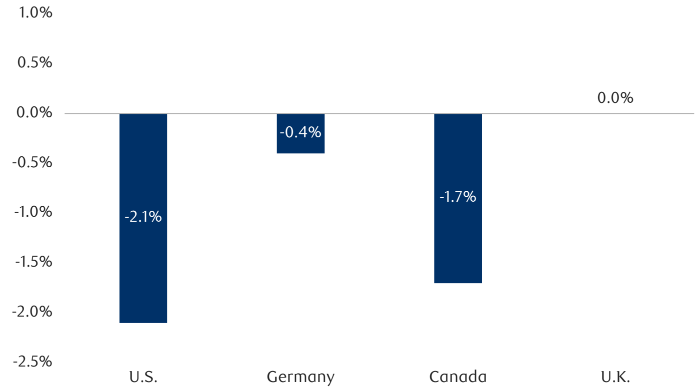
In the meantime, resilient economic activity could keep policy rates and yields higher for longer than many investors had expected even just a few months ago, as many thought the economy would be well on its way to recession by now. The economic tailwinds include remarkably strong U.S. consumer spending in the face of steeply rising borrowing costs, the positive impact on Europeans' wallets of a warm winter and energy subsidies representing more than 5% of GDP, and China's earlier-than-expected abandonment of the economy-limiting zero-COVID policy. While disinflation has gripped most of the world in the past six months (Exhibit 3), worries about inflation becoming entrenched well above target are very real. The vast majority of the inflation slowdown is due to falling energy prices and the partial unclogging of supply chains – over which policymakers have little control. Meanwhile, the effects of the expansive fiscal and monetary response to the pandemic are taking longer to relinquish their inflationary impact. Labour markets have shown little response to aggressive central-bank policy actions over the past year. Wage inflation is near 5% in most economies, which

Exhibit 2: Expected real policy rates are very restrictive – Expected peak in inflation-adjusted U.S. policy rates



Note: As of March 2, 2023. Source: Bloomberg, University of Michigan and RBC GAM calculations

Exhibit 3: Inflation is falling in most markets
6-month decline in annual inflation rates, selected markets



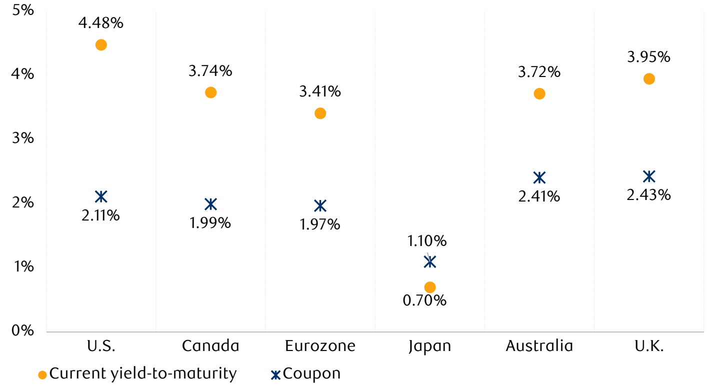
Note: From July 2022 to January 2023. Source: Bloomberg is above levels consistent with 2% inflation over the long term. In Europe and Japan, workers are set to bank their best pay raises in decades. A re-acceleration of price pressures amid a still-strong job market would present a troubling scenario for bonds as it would indicate that more rate hikes are needed than is currently expected.

Bond investors are also grappling with questions over the sustainability of government finances in the presence of much higher yields. For more than a decade, central banks have supported government-debt markets by both cutting interest rates and purchasing vast amounts of bonds. But those measures are being forcefully reversed.

Central banks are now reducing their massive balance sheets. For Europe, this year marks the largest increase in bonds outstanding, excluding central-bank purchases, since the launch of the single currency in the early 2000s. In the U.S., burgeoning tax receipts have reduced the need to issue new debt, but worries about how future deficits will be financed are intensifying. These concerns are not restricted to the U.S. Fiscally weak members of the euro area such as Italy and Spain are facing higher levels of investor scrutiny.

In most fixed-income markets, the average coupon on existing debt is still much lower than prevailing yields (Exhibit 4). As outstanding debt matures and new bonds are issued, government coupon payments will rise significantly. This process will happen faster in some markets than others. In the U.S. and Canada, for example, about 25% of the countries' outstanding debt will roll over by the end of 2024 since their governments have relatively more short-term debt. In Japan and the U.K., by contrast, that figure is barely above 10%, giving those countries a much longer period to adjust to higher financing costs. Under current policy, the share of the U.S. federal government's annual expenditures taken up by interest payments could double over the next decade to 12% from 6% now, according to the Congressional Budget Office. While borrowing costs are also expected to climb in Canada, the relatively healthy fiscal picture means that debt-to-GDP ratios are projected to decline even in fairly negative economic scenarios. Towards the end of the summer, the U.S. Congress approaches another budget showdown over the debt ceiling. We are fairly sanguine regarding the odds of a government shutdown, but the event could bring attention to just how poor the long-run fiscal position of the U.S. government is.

Exhibit 4: Government bond yields are much higher than coupons – Current coupon rate versus prevailing market yields



Note: As of March 2, 2023. Source: Bloomberg, RBC GAM calculations

Overall, we expect that a combination of strengthening economic activity, a resilient labour market and modest disinflation will prompt central bankers to continue hiking interest rates through the middle of this year, and then pause. In our view, policy rates in most markets are already high enough to dampen growth, and with price pressures easing, the risks to overtightening versus letting inflation become entrenched are more finely balanced than they were in 2022. Growth and inflation are already much slower than a year ago, and we expect that most economies will eventually slip into recession. As investors shift their attention from inflation and aggressive tightening to flagging growth, bonds should do well.

Direction of rates

We expect the Fed to hike at least two more times this year, to 5.25% from the current level of 4.75%, before going on an extended pause.

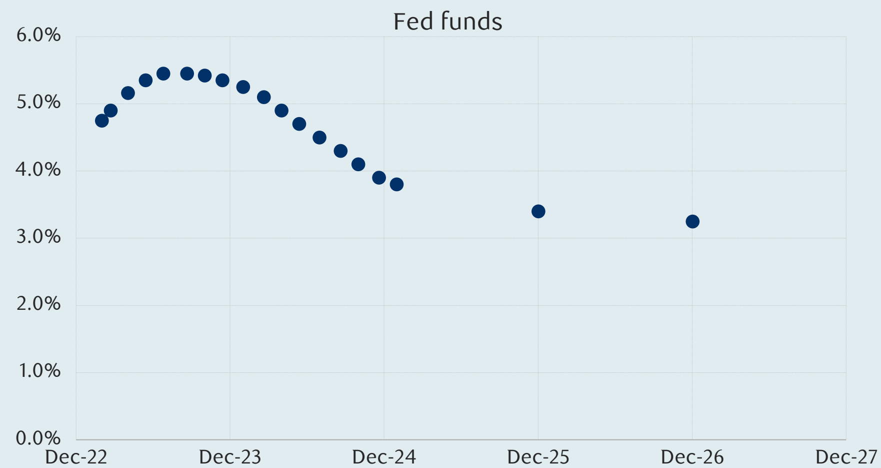
United States

Resilient consumer demand and a still-tight labor market are upsetting widely held predictions that the U.S. would be in a recession in the first half of 2023. Prices also continue to climb uncomfortably quickly, recording a 6.4% annual rise in January. With price rises appearing to be stuck at a high level and the economy performing much better than expected, investor expectations for how much the U.S. Federal Reserve (Fed) might have to raise policy rates have reached new highs, hitting 5.40% in early February. What's more, expectations for when the Fed would begin cutting rates have also moved further into the future. Policymakers are now expected to remain on hold at above 5% for 12 months or more (Exhibit 5). Meanwhile, the Fed continues to shed substantial quantities of Treasury bonds and mortgage-backed securities from its balance sheet.

Most of the main drivers of inflation such as pandemic-related supply-chain snarls, and bursts of energy and food inflation due to the war in Ukraine are fading. The primary driver of measured inflation in the U.S. is currently rents, but these are now falling too, and we expect this factor to provide a significant downdraft to inflation as 2023 progresses.

With inflation falling and policy rates in restrictive territory, the Fed will likely be much more cautious with policy changes over the next year. We expect the Fed to hike at least two more times this year, to 5.25% from the current level of 4.75%, before going on an extended pause. We also expect the 10-year Treasury yield to be around 3.75% in a year's time, near where it is now.

Exhibit 5: Rates are expected to remain high for some time
Expected future values of the fed funds rate



Note: As of March 2, 2023. Source: Bloomberg, RBCGAM calculations

We expect the ECB to hikes rates to 3.50% and the 10-year German bund yield to reach 2.25% sometime over the next year.

Eurozone

The eurozone, somewhat improbably, avoided what was once considered a near-certain recession to end 2022 as a land war on its borders and a crushing increase in energy costs were offset by large-scale fiscal spending and a very warm winter. At this point, it is tough to say whether the outcome is a triumph of European economic dynamism or another indictment of the folly of economic forecasting. The region's inflation levels are among the highest in the developed world, reaching 8.6% in January, and labour markets are tight. Growth in Europe should be further bolstered by the opening of the economy in China, its largest trading partner. As a result, the European Central Bank's (ECB) remit seems straightforward over the next 12 months – hike rates. Policymakers in the single-currency area are expected to deliver the most policy tightening of any major developed-market central bank over the next 12 months with the benchmark interest rate expected to reach 3.90% by this time next year from 2.50% now. The tightening of monetary policy will extend to the balance sheet in 2023, adding to downward pressure on the eurozone economy.

Looking ahead, we believe that investors' expectations for the eurozone economy are too rosy. We think policy rates are already tight, leading us to believe that the ECB will hike fewer times than many investors think. The most aggressive tightening cycle ever from the ECB seems to be filtering quickly through the banking system. Further hikes by the ECB will likely push the German yield curve into a deep inversion – with short-term bond yields rising well above long-term ones – and this is reflected in our forecasts. We expect the ECB to hikes rates to 3.50% and the 10-year German bund yield to reach 2.25% sometime over the next year.

Our year-ahead forecast for the policy rate in Japan is 0.10% and we expect the 10-year bond yield to be 0.70%, up from the current -0.10% and 0.50%, respectively.

Japan

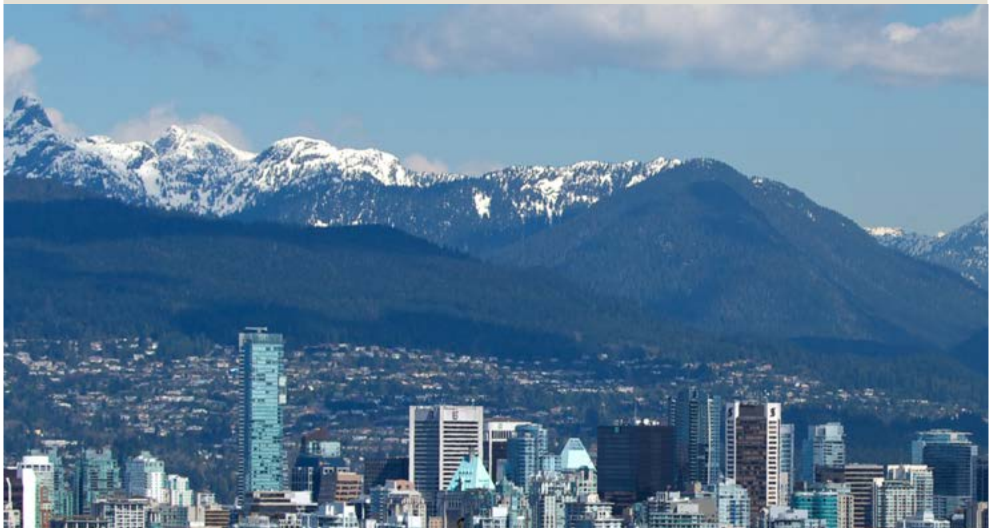
Japanese monetary policy is undergoing a sea change. Not only is inflation at multi-decade highs, with prices rising 4.3% year-over-year in January, but the architect of the Bank of Japan's (BOJ) current policy of near-zero interest rates, massive bond purchases and yield-curve control (YCC), Hurohiko Kuroda, is about to be replaced after 10 years at the helm of the bank. The new governor, Kazuo Ueda, is a former member of the BOJ's board and a supporter of the current policy stance. For now, policymakers remain convinced that the bulk of the current inflation pressures in Japan will pass, as they are primarily related to the legacy of last year's collapse in the yen versus the dollar. The yen's fall pushed up the costs of production for businesses that rely heavily on imported raw materials.

While this is not the first time that pronounced yen weakness has raised input costs, it is the first time in recent memory that higher input costs have had such a marked inflationary impact on consumer prices and wages. After surprising markets by raising the top of its target band for the 10-year Japanese government-bond yield in December, the BOJ will in our view make further adjustments before abandoning attempts to control bond yields altogether. Eventually, we expect that the central bank will raise policy rates above zero for the first time since 2016. Our year-ahead forecast for the policy rate in Japan is 0.10% and we expect the 10-year bond yield to be 0.70%, up from the current -0.10% and 0.50%, respectively.

We forecast the policy rate will remain at 4.50% over the balance of the year, and expect the Canadian 10-year government bond will yield 3.00% over the next 12 months.

Canada

The Bank of Canada (BOC) raised its policy rate by 0.25% to 4.50% in January, and Governor Tiff Macklem signaled at the time that it would likely leave rates where they were for at least several months. The view of the BOC, and one that we share, is that a slowdown in the pace of rate hikes is warranted. Economic activity and inflation slowed meaningfully over the course of last year, and policymakers feel more comfortable erring on the side of caution now that the risks of raising rates too much versus raising them too little have become more balanced. Macklem said it's too early to begin contemplating rate cuts and that further rate hikes should be expected if inflation or economic activity prove more resilient than forecast. While some of the most disruptive effects of the pandemic are easing, businesses continue to pass on significant cost increases to consumers. As in most countries, the Canadian labour market remains very tight, raising the risk that businesses will have to offer bigger wage increases in order to attract and retain workers. We forecast the policy rate will remain at 4.50% over the balance of the year, and expect the Canadian 10-year government bond will yield 3.00% over the next 12 months.



We expect the Bank of England's policy rate to be unchanged a year from now, at 4.00%. We also forecast 10-year gilt yields at 3.50%, down from around 3.80% at the time of writing.

United Kingdom

The U.K. economy has outperformed our expectations, mirroring the unexpected upturn in activity seen on the continent. Inflation is a particularly pernicious problem in the U.K., which has been buffeted by Brexit aftershocks and a weaker pound. Shortages of labour are as acute as anywhere in the developed world and mean that businesses are hiking wages at the fastest pace in over 20 years. The average worker's pay packet is growing at nearly 7%, easily exceeding a level consistent with 2% inflation over the long term. Thankfully, the BOE has been among the most aggressive central banks over the past year in both raising interest rates and reducing its balance sheet. Doing so has increased borrowing costs for the government, businesses and consumers – likely curtailing an even more vicious upturn in price pressures.

Over the year ahead, we expect the U.K. economy to lag most of its peers. The U.K. is the only G7 economy that has failed to regain its pre-COVID size. The economy is much weaker than it would have been had it remained in the EU, the government faces a persistent credibility gap and inflation is crushing household purchasing power. We expect the Bank of England's policy rate to be unchanged a year from now, at 4.00%. We also forecast 10-year gilt yields at 3.50%, down from around 3.80% at the time of writing.

Regional outlook

We recommend that investors be overweight German bunds and U.S. Treasuries, and underweight Japanese government bonds. Policy normalization is very advanced in both the U.S. and Europe, leaving limited room for yields to continue rising on a relative basis. We expect Japan, meanwhile, to continue its nascent adjustment, which should weigh on bond prices.

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Underweight Japanese bonds vs. **Overweight German bunds U.S. Treasuries**

Interest rate forecast: 12-month horizon

Total Return calculation: February 28, 2023 – February 28, 2024

U.S.	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	5.25%	4.50%	4.10%	3.75%	3.80%	4.76%
Change to prev. quarter	0.25%	(0.25%)	0.00%	0.05%	0.20%	
High	6.00%	6.00%	5.50%	5.00%	4.95%	(1.30%)
Low	3.00%	2.75%	2.50%	2.25%	2.55%	13.40%
Expected Total Return US$ hedged: 5.0%						

Germany	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.50%	3.00%	2.60%	2.25%	2.20%	5.47%
Change to prev. quarter	0.50%	0.25%	(0.20%)	(0.15%)	0.00%	
High	4.50%	4.00%	3.25%	3.00%	2.40%	2.21%
Low	2.00%	1.80%	1.40%	1.25%	1.25%	21.44%
Expected Total Return US$ hedged: 8.4%						

Japan	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.10%	0.25%	0.50%	0.75%	1.75%	(3.57%)
Change to prev. quarter	0.20%	0.15%	0.40%	0.50%	0.10%	
High	0.25%	0.50%	0.80%	1.25%	2.50%	(12.23%)
Low	(0.10%)	(0.10%)	0.20%	0.40%	1.40%	1.41%
Expected Total Return US$ hedged: 1.1%						

Canada	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.50%	3.50%	3.00%	3.00%	3.00%	5.30%
Change to prev. quarter	0.00%	(0.50%)	(0.30%)	0.00%	0.00%	
High	5.50%	5.50%	4.70%	4.50%	4.30%	(3.35%)
Low	2.50%	2.25%	2.00%	2.00%	2.20%	12.04%
Expected Total Return US$ hedged: 5.5%						

U.K.	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.00%	3.50%	3.25%	3.50%	3.95%	6.28%
Change to prev. quarter	(1.25%)	(1.25%)	(1.75%)	(1.00%)	(0.05%)	
High	5.50%	4.75%	4.25%	4.00%	3.75%	5.80%
Low	3.00%	2.60%	2.50%	2.50%	3.00%	17.40%
Expected Total Return US$ hedged: 8.0%						

Source: RBC GAM

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