RBC Global Asset Management

Global fixed income markets

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After two years of declines, government bonds are enjoying somewhat of a renaissance in 2023. The rebound is due to slowdowns in economic activity and inflation, and expectations among investors including us that most regions will enter a recession later this year. Against this backdrop, major central banks are unlikely to raise policy rates much further in the near term, providing a tailwind to bond returns for the remainder of the year. We forecast mid- to high single-digit returns in most government-bond markets over the next 12 months.

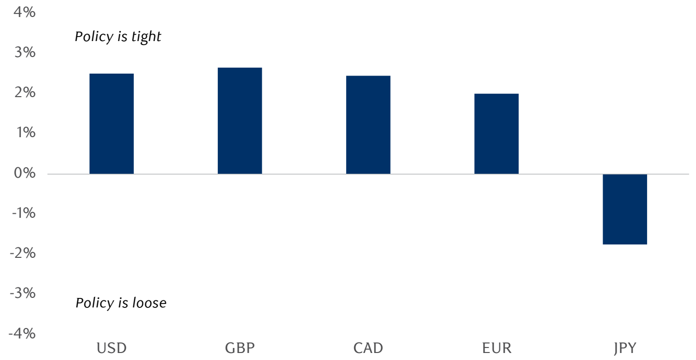
Currency-hedged global government bonds returned 2.6% for Canadian investors between the end of December 2022 and the end of May 2023, marking a better-than-average start to the year and providing a welcome respite for investors after the worst ever start in 2022. The last time bonds performed as poorly for a full year was in 1994, followed by a blockbuster 1995 when global government bonds returned 19.3%. Barring a much more significant economic downturn, however, we do not expect similarly heady returns for bonds in 2023.

Why the change of fortune for government bonds? For one thing, central banks are likely near the end of their policy-tightening cycles. Central banks hiked interest rates by hundreds of basis points last year, causing bond yields to rise, and rates are now clearly in what policymakers regard as restrictive territory (Exhibit 1). Absent another stretch of unexpectedly rapid inflation, it is unlikely that rates will rise like they did last year.

While annual price rises remain well above central-bank targets, inflation in most markets looks to have peaked. When measured over the last six and nine months, the pace of price gains is even closer to central-bank targets. Most of this improvement is driven by easing pressure on supply chains as the global pandemic ebbed, according to calculations by economists at the Federal Reserve Bank of New York, and by lower energy prices.

Exhibit 1: Interest rates are restrictive

Actual central-bank policy rates versus estimated neutral rates



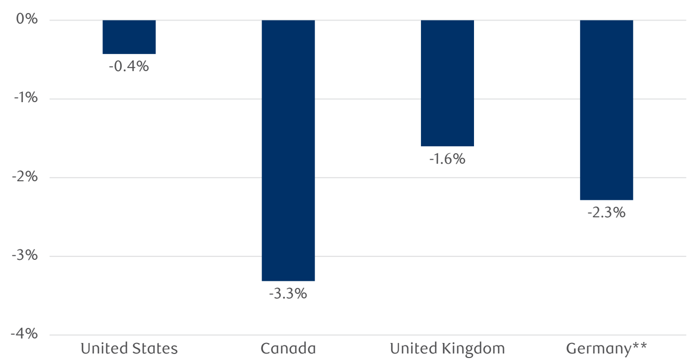
Note: As of May 31, 2023. Source: National central banks, Bloomberg, RBC GAM calculations

With supply chains as a source of disinflation largely exhausted, central bankers are rightly focused on curbing demand via the labour market, which remains surprisingly robust after the most aggressive policy-tightening cycle since the 1980s. Unemployment rates are at or near multi-decade lows and workers around the world are enjoying the best wage gains in a generation. However, the recent wins for workers increase the risk that inflation becomes entrenched at a permanently higher rate because rising wages feed directly into companies' costs, and strong demand allows companies to continue passing these on via higher prices.

Countries with high unionization rates, such as those in Europe and, to a certain extent, Canada, are at particular risk of bigger wage increases in the coming years. We think these concerns are legitimate but note that the passthrough to non-unionized wages and inflation tends to be lower when the economic backdrop is weaker.

We are seeing early signs of labour-market weakness. Businesses are telling survey makers that they intend to hire fewer workers and that they are posting fewer job ads. Wage growth is also slowing even though workers have yet to fully earn back their loss in purchasing power (Exhibit 2). The slowdown is particularly pronounced among lower-wage workers, who were in the shortest supply coming out of the pandemic but tend to be affected first as a recession approaches.

Exhibit 2: After inflation,wages are below March 2020 levels – Change in average take-home pay since March 2020



Note: As of May 31, 2023. Latest value for Germany is December 2022.
Source: Bloomberg, National statistical agencies, RBC GAM calculations

Our models for what bonds yields "should be" support the argument for good returns over the next year. Bonds yields are mostly at the upper estimates of what we consider fair value. In the U.S., we typically expect bonds to yield 2.50% to 3.50% over the long term, based on expected policy rates and some compensation for interest-rate risk. With the U.S. 10-year Treasury yield near 3.50% at the time of writing, we think investors are more than fairly compensated for owning bonds.

Bond yields are even more attractive in Europe, where German bund yields are at decade highs. The European Central Bank (ECB) continues to indicate its intention to hike interest rates in the face of too-high inflation. However, we think expectations are too rosy for the European economy,

> "Debt payments that gobble up a growing share of national budgets will sap government spending, crowd out private investment and crimp consumer outlays."

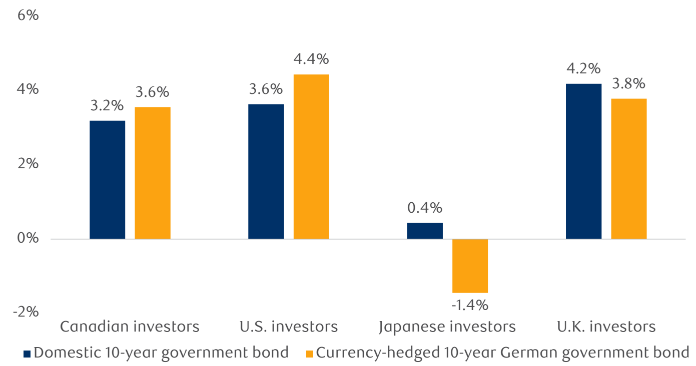
which enjoyed immense fiscal stimulus last year and barely avoided recession. Investors' expectations for Europe are especially jarring compared with their views on the U.S. We do not think that investors should expect the ECB and the U.S. Federal Reserve (Fed) to keep policy rates at similar levels over the long term, as they expect now. In general, we expect the difference in long-run policy rates between the U.S. and Europe to differ based on their potential economic growth. Europe's potential GDP growth has long been below that of the U.S., and we expect this trend to continue. In addition to the potential for European yields to decline relative to other markets, Canadian and U.S. investors are well-compensated for holding European bonds, with currency-hedged bond yields more attractive than their own markets (Exhibit 3).

One country with stunningly low bond yields is Japan, where inflation is at multi-decade highs. In contrast to policymakers at other central banks, Bank of Japan (BOJ) officials have made just one modest adjustment to their framework for controlling bond yields over the past year: raising the top of the target range for the 10-year government bond yield by 0.25% last December. Wage growth has since accelerated and expectations for future inflation are rising, according to surveys. The BOJ's new governor, Kazuo Ueda, has announced a review of the current policy framework.

We expect monetary policy to eventually be normalized in Japan, but such tightening will not be easy to achieve as the country has grown dependent on rock-bottom interest rates. In fact, the Japanese financial system could face many of the same problems as those plaguing U.S. regional banks if rates start to rise. Just as surging bond yields have wiped billons of dollars from the value of U.S. banks' Treasury holdings, so would they pose a threat to Japanese banks' holdings of domestic government bonds. There are few easy options for Japan.

We would be remiss to not mention the U.S. debt-ceiling discussions. The current impasse is likely to be resolved by the time we go to press, and we expect the debt ceiling to be raised or suspended. Regardless of the outcome, the episode should serve to highlight the seriousness of the long-term fiscal challenges facing the world's largest economy.

Exhibit 3: Currency-hedged European bond yields are attractive to some



Note: As of May 31, 2023. Source: Bloomberg, RBC GAM calculations

Thanks to the expansion of government spending over the past decade and tax cuts, the U.S. deficit before interest payments (the "primary" deficit) has ballooned to 6%-7% of GDP, up from around 3%, and the deficit is likely to expand further in the years ahead. Given rising deficits and interest costs, the Congressional Budget Office (CBO) projects that the ratio of debt to GDP will balloon within a decade and that interest payments could account for around 40% of all U.S. government spending by the middle of this century. Debt payments that gobble up a growing share of national budgets will sap government spending, crowd out private investment and crimp consumer outlays.

These fiscal concerns are not particular to the U.S. With few exceptions, many governments embarked on remarkable debt binges in recent decades, fueled by ever-lower interest rates. However, higher rates threaten to upset a growth model that has come to rely on ever more and ever cheaper debt. Substantially higher bond yields present a challenge to governments seeking to shore up long-run fiscal sustainability. In our view, this outlook bodes well for bonds as high debt loads weigh on economic growth and tighter fiscal policy constrains activity.

Direction of rates

We expect the target for the fed funds rate to fall to 4.75% sometime over the next year. The yield on the 10-year Treasury bond will be slightly lower as well, falling to 3.25% from around 3.60% at the time of writing.

United States

The Fed raised its target range for the fed funds rate to 5.00% to 5.25% in May, capping a combined 500 basis points of hiking since March 2022. With the labour market and inflation still much too hot for the liking of policymakers, we think there is a risk of further hikes over the next few months. However, while the jobs market and price rises are currently too high for comfort, there is substantial uncertainty over where the economy is headed. Based on most of our assumptions, policy is already tight. Tighter monetary policy takes time to slow economic growth, and we believe that full effect of the past year's hikes is only now beginning to be felt. The yield curve is deeply inverted and has been for over a year now. Historically, such inversions precede a recession in the U.S. by 12 to 18 months. What's more, a banking crisis spurred by deposit flight and losses on Treasury securities suggests the probability of a deep recession is higher than we would normally expect.

The U.S. jobs market already shows signs of cooling, even if the unemployment rate has not meaningfully risen. News reports of layoffs are spreading beyond technology to other areas of the economy. These developments require a more cautious approach from U.S. policymakers.

Over the course of the next year, we think an extended pause in the tightening cycle, alongside continued cooling in inflation and shallow recession, will permit an eventual easing of monetary policy. After peaking this summer, we expect the target for the fed funds rate to fall to 4.75% sometime over the next year. The yield on the 10-year Treasury bond will be slightly lower as well, falling to 3.25% from around 3.60% at the time of writing.

We see the ECB eventually cutting rates within our forecast horizon to 3.50%. Yields on 10-year German bunds, 2.45% in the middle of May, should retreat to 2.25%.

Eurozone

The ECB hiked its benchmark interest rate on May 4, as both economic activity and inflation were firmer than expected even a few months ago. Policymakers also signaled a more aggressive timeline for trimming the central bank's balance sheet. Both steps will tend to push up bond yields across the eurozone and come as European governments' borrowing needs are magnified by the extension of energy subsidies. On a longer-term horizon, we think that expectations for both policy rates and the European economy need to be pared. As in the U.S., bank lending-officer surveys indicate that rate hikes are quickly being passed on to borrowers and that demand for loans is falling. Unlike the U.S., the banking system is a much more important cog to the smooth functioning of the European economy, as a larger portion of companies rely on bank loans rather than debt and equity raised in financial markets.

While inflation in Europe remains quite hot, and wage growth is running well above a level consistent with the ECB's inflation target of 2%, we see encouraging signs that inflation has peaked. Wage demands have been much more modest than feared, and we think the pace of wage hikes could start to fall, especially as energy costs have abated. Restrictive policy rates should temper economic activity into 2024 and leading indicators indicate the economy is already cooling as the second half of this year approaches. With this in mind, we see the ECB eventually cutting rates within our forecast horizon to 3.50%. Yields on 10-year German bunds, 2.45% in the middle of May, should retreat to 2.25%.

We expect one hike in the policy rate to 0.00% from -0.10% now. A loosening of the yield-curve control framework suggests that the yield on the 10-year Japanese government bond will rise to 0.75% from 0.44% now.

Japan

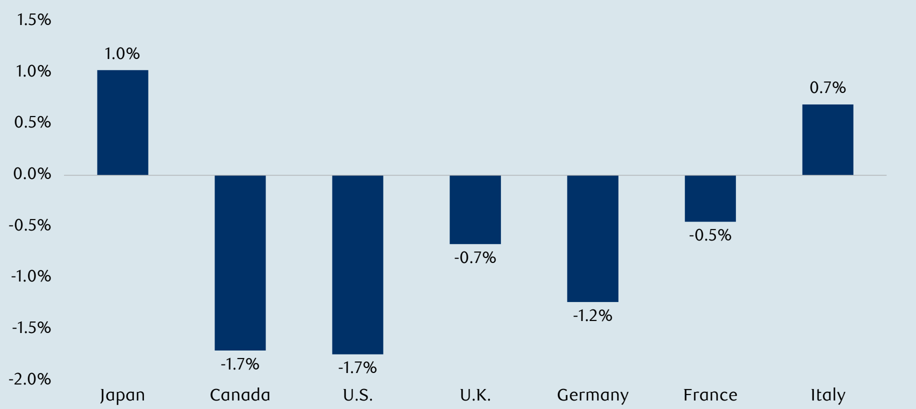
The pressure on the yield-curve control (YCC) framework has eased this year as speculators reduced bets that the BOJ would quickly make additional hikes to the target. The 10-year bond yield now sits well below the top of the target band, and BOJ intervention has subsided considerably. For the first time in several years, Japanese investors are flocking homeward to the domestic bond market. The gaping difference between the BOJ's still-accommodative policy stance and those of its developed-market peers means that currency-hedged yields on foreign bonds are very unattractive for Japanese investors (Exhibit 4). A 20-year Japanese government bond offers a yield near 1.02%, compared with a -1.70% yield on a hedged 20-year U.S. Treasury.

In April, the BOJ announced a review of the current policy framework of large-scale asset purchases and the tight control of bond yields. The launch of the review reduces the odds of a rapid normalization of monetary policy. Nevertheless, we expect the BOJ to make gradual changes to its target level for bond yields and its forward guidance. Inflation remains strong in Japan and workers received their biggest pay bump since 1992 during the important spring wage negotiations. We do not think that policymakers will handcuff themselves to the year-long review timeline if presented with clear evidence that policy should be changed more quickly.

Over the next year, we expect one hike in the policy rate to 0.00% from -0.10% now. A loosening of the yield-curve control framework suggests that the yield on the 10-year Japanese government bond will rise to 0.75% from 0.44% now.

Exhibit 4: Foreign government bond yields are lower than Japanese ones

Japanese 20-year government bond yield versus currency-hedged yields of select other government bonds



Note: As of May 31, 2023. Source: Bloomberg, RBC GAM calculations

We forecast the policy rate will reach 5.00% in 2023, before the BOC cuts the policy rate to 4.00% sometime in 2024. We expect the Canadian 10-year government bond yield will fall to 2.75% over the next 12 months.

Canada

The Bank of Canada (BOC) hiked interest rates yet again at its meeting on June 7, after keeping rates on hold since February. This brings the policy rate to 4.75%. We expect one further hike from the BOC this year as BOC Governor Tiff Macklem and his colleagues assess the impact of rate hikes on inflation and the economy. The Canadian economy remains surprisingly resilient given strong population growth from immigration and government spending. However, a tight labor market and sustained 4% to 5% wage growth are not consistent with achieving the BOC's 2% inflation target, and sticky inflation, especially in services, makes policymakers nervous. Macklem has emphasized it is too early to contemplate rate cuts. That said, signs of financial stress are beginning to appear. Heavily indebted consumers are feeling the financial pain of increased monthly mortgage payments and persistently rising food prices and are tightening their belts accordingly. We forecast the policy rate will reach 5.00% in 2023, before the BOC cuts the policy rate to 4.00% sometime in 2024. We expect the Canadian 10-year government bond yield will fall to 2.75% over the next 12 months.

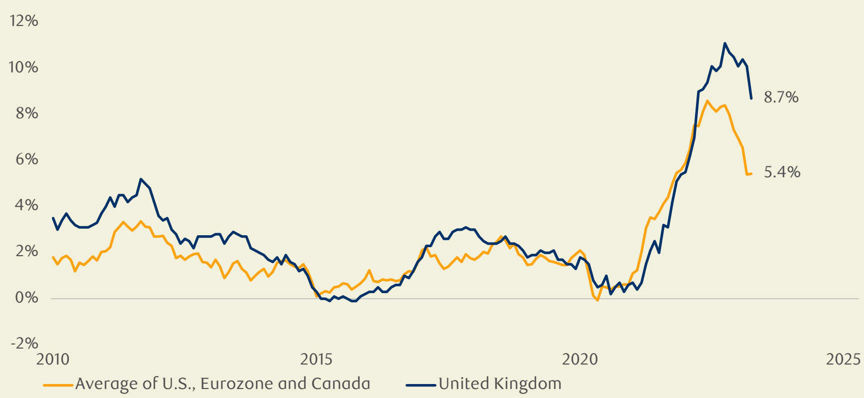
We expect the 10-year gilt yield to be around 3.75% in a year's time, compared with 4.18% now.

United Kingdom

The Bank of England (BOE) was the first major central bank to embark on rate hikes as inflation took off last year in the wake of the COVID-19 crisis, and we believe that the BOE will be the last major central bank to stop raising rates. In our view, the U.K. faces the most serious long-term threat of elevated inflation. The country has historically struggled with higher-than-target inflation more than its developed-market peers (Exhibit 5). Inflation has only cooled modestly over the past six months, but demands for higher wages are persistent and labour disruptions widespread.

Exhibit 5: The U.K. has typically struggled more with high inflation

U.K. yearly inflation rate versus developed-market peers



Note: As of May 31, 2023. Source: Bloomberg, RBC GAM calculations

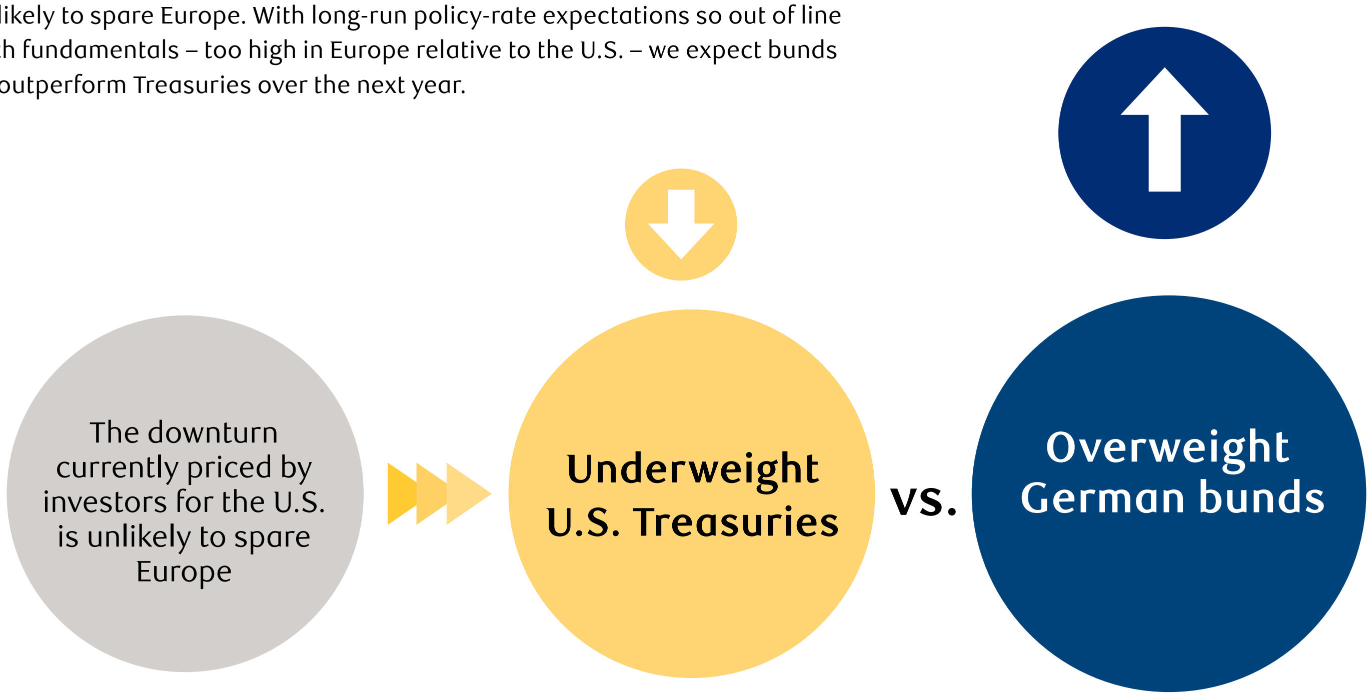
In early May, BOE Governor Andrew Bailey acknowledged that the U.K. is experiencing a wage spiral, and that policymakers are at risk of failing to prevent price rises from taking firmer root. The situation has been made worse by one of the long-term costs of Brexit – the loss of Europe as an important source of labour. The after-effects of the pandemic are also compounding what is already a bad situation as older workers and long-COVID sufferers have dropped out of the labour force.

It is important to note that the U.K.'s exceptionally strong inflation is not the result of a strong economy, and that fact makes the U.K. the most viable candidate for stagflation among G7 nations. A permanently damaged relationship with the country's most important trading partner, Europe, means that we have meaningfully lowered our expectations for the U.K. economy over the long run.

We expect concerns about inflation to keep the BOE hawkish over the better part of this year. The central bank could raise its benchmark rate to 5% before it shifts to cutting rates sometime before the middle of 2024. We forecast that the bank rate will be 4.75% in a year's time, up from 4.50% at the end of May. Moreover, the central bank is likely to be more hawkish than its peers, leading us to expect relatively poor returns for currency-hedged gilts versus other markets. We expect the 10-year gilt yield to be around 3.75% in a year's time, compared with 4.18% now.

Regional outlook

We recommend that investors overweight German bunds and underweight U.S. Treasuries. The downturn currently priced by investors for the U.S. is unlikely to spare Europe. With long-run policy-rate expectations so out of line with fundamentals – too high in Europe relative to the U.S. – we expect bunds to outperform Treasuries over the next year.



Interest rate forecast: 12-month horizon

Total Return calculation: May 31, 2023 – May 24, 2024

U.S.	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.75%	3.50%	3.30%	3.25%	3.70%	5.45%
Change to prev. quarter	(0.50%)	(1.00%)	(0.80%)	(0.50%)	(0.10%)	
High	6.00%	5.25%	4.75%	4.50%	4.30%	0.30%
Low	2.50%	2.50%	2.50%	2.50%	3.30%	9.25%
Expected Total Return US$ hedged: 6.1%						

Germany	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.50%	2.50%	2.40%	2.25%	2.25%	3.41%
Change to prev. quarter	0.00%	(0.50%)	(0.20%)	0.00%	0.05%	
High	4.50%	4.00%	3.80%	3.50%	3.00%	(3.97%)
Low	2.00%	1.75%	1.75%	1.75%	1.80%	10.81%
Expected Total Return US$ hedged: 6.1%						

Japan	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.00%	0.20%	0.40%	0.75%	1.55%	(2.91%)
Change to prev. quarter	(0.10%)	(0.05%)	(0.10%)	0.00%	(0.20%)	
High	0.25%	0.60%	0.80%	1.25%	2.30%	(12.31%)
Low	(0.10%)	0.00%	0.20%	0.40%	1.25%	1.63%
Expected Total Return US$ hedged: 1.5%						

Canada	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.00%	3.50%	3.00%	2.75%	2.90%	5.61%
Change to prev. quarter	(0.50%)	0.00%	0.00%	(0.25%)	(0.10%)	
High	5.25%	5.00%	4.25%	4.00%	3.90%	(1.42%)
Low	2.00%	2.00%	2.00%	2.00%	2.25%	11.44%
Expected Total Return US$ hedged: 6.5%						

U.K.	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.75%	3.25%	3.40%	3.75%	4.00%	9.95%
Change to prev. quarter	0.75%	(0.25%)	0.15%	0.25%	0.05%	
High	5.50%	4.75%	4.25%	4.25%	3.90%	8.72%
Low	3.00%	2.00%	2.00%	2.25%	3.25%	20.75%
Expected Total Return US$ hedged: 12.9%						

Source: RBC GAM

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