RBC Global Asset Management

Global fixed income markets

NEW YEAR 2025

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

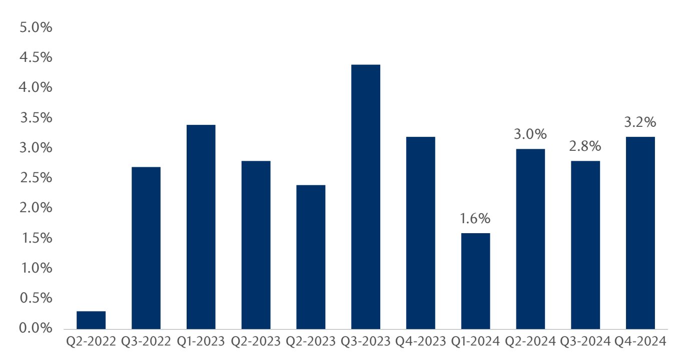
Joanne Lee, MFin, CFA
Senior Portfolio Manager
RBC Global Asset
Management Inc.

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

Bond yields have risen in most markets since the last edition of the Global Investment Outlook as investors pared expectations for deep interest-rate cuts by central banks. The re-election of Donald Trump as U.S. president and Republicans' control of Congress increase policy uncertainty for the world's largest economy and bond market. At the same time, we believe the global economy is for the most part likely to continue on its pre-election path of moderating growth and near-target inflation, a path that was set in the aftermath of aggressive monetary-policy tightening. We expect that central-bank policy rates will be lower in a year's time, as both slower growth and closer-to-target inflation permit policymakers to support their economies by easing interest rates. In turn, we forecast mid-single digit returns for bonds.

Exhibit 1: US GDP growth is solid

GDP growth rate, quarter-on-quarter, seasonally-adjusted at an annual rate



Note: As of December 3, 2024. The estimate for Q4-2024 is the Federal Reserve Bank of Atlanta's GDP NowCast. Source: U.S. Bureau of Economic Analysis, Federal Reserve Bank of Atlanta

Bond yields are higher following Trump's election victory as investors assess implications for the macroeconomic outlook. The president-elect inherits an economy that has sloughed off the constraints of an aggressive monetary-hiking cycle and continues to grow at a near-3% pace (Exhibit 1). Moreover, the sweep of the legislative and executive branches of government raises the odds that Republicans will be able to implement their campaign-trail pledges more fully. That means more economic nationalism and trade protectionism; less regulation; lower taxes; and less immigration. Higher bond yields suggest that investors expect the incoming administration's tax cuts and deregulatory zeal to provide a fillip to growth, and tariffs and economic nationalism are likely to drive up inflation.

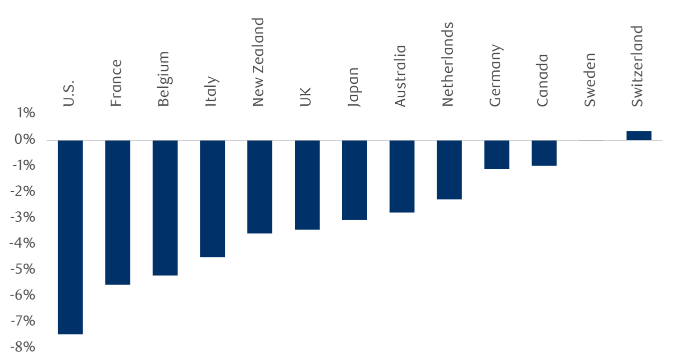
Trump also inherits a fiscal mess. The U.S. federal government runs a budget deficit of 6% of gross domestic product, which adjusted for economic conditions is the worst among major developed-market economies. (Exhibit 2). Investors known as “bond vigilantes” have so far not sought higher borrowing costs from the world’s biggest debtor nation, while other countries that have generated concerns over excessive government spending have not been so lucky. The UK and France, for instance, are both having to pay higher borrowing costs, and investor confidence in both countries is wobbling. The U.S., of course, enjoys the privilege of issuing debt in the world’s predominant reserve currency, but continued fiscal profligacy without a concrete plan to remedy the situation risks wearing investors’ patience thin at some point.

Promises to significantly curtail U.S. immigration are likely to be at least partially realized. The post-pandemic immigration surge has already waned, and by some estimates the number of immigrants, both documented and not, has halved from its 2022 peak. While we are skeptical that the most aggressive forms of immigration policy, such as forced mass deportations, are likely to be implemented, the psychological deterrent impact of these policies on an important source of labour in the U.S. will likely be a drag on economic growth.

For bond investors, the key will be the reaction of the U.S. Federal Reserve (Fed) to the economic crosswinds. Investors began paring expectations for rate cuts before the election (Exhibit 3) as the odds of a Trump victory rose. Now that Trump has been elected with a Republican Congress, it is unclear just how much more these easing expectations can be reduced barring an unexpected upswing in inflation and activity beyond that implied by tariffs and tax cuts. At this point, we think it unlikely that the Fed changes course from a path of deliberate easing.

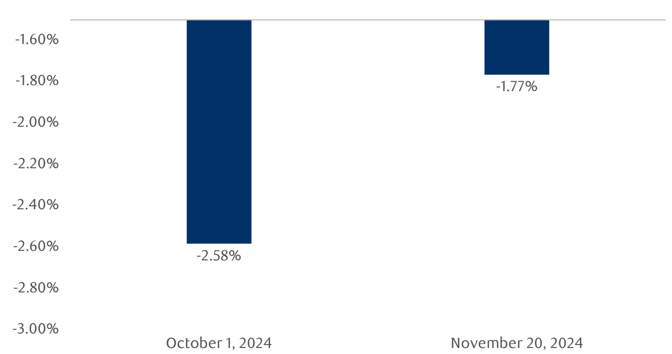
The Fed’s chair, Jerome Powell, insisted at a November 7 press conference that he would not pre-judge the substance or impact of any policy changes under the new administration and vowed not to change course on interest-rate policy unless required by economic developments. Powell was explicit that, as policymakers, “we don’t guess, we don’t speculate, and we don’t assume.” This is a change from Powell’s approach to the first Trump administration, before he was appointed Fed chair: As a member of the Fed’s policy-making arm in 2016, he bumped up his inflation and growth assumptions soon after Trump won the election. We believe Powell’s focus on keeping market expectations in check is genuine and partially reflects the Fed’s concern that interest rates are high enough to crimp economic growth. The

Exhibit 2: U.S. exceptional for the wrong reasons fiscally – Cyclically adjusted balance (% of potential GDP)



Note: Forecasts for 2025. Source: IMF Fiscal Monitor October 2024

Exhibit 3: Investor expectations for peak-to-trough drops in the fed funds rate



Source: Bloomberg, RBC GAM calculations

Fed's famous "long and variable lags" have yet to manifest themselves in the U.S. economy. Even with the Fed's current round of policy easing, interest rates remain higher than they are on most outstanding debt including mortgages and corporate bonds (Exhibit 4). Over time, borrowing costs for governments, corporations and households are likely to continue rising as new debts are taken on.

Outside the U.S., economic growth is slower, and it is more obvious that central banks need to cut interest rates. In the G10, most central banks have cut interest rates at least as much or more than the Fed. (Exhibit 5).

Certainly, we expect some of the policy easing that has taken place thus far to eventually bolster economic activity – those long and variable lags at work again. What we do not expect is a big pick-up in fiscal spending. In fact, our forecasts are for modest fiscal consolidation over the next year, posing a headwind to growth overall. Many governments have been slow to kick the habit of high pandemic-level spending, and this fiscal consolidation is overdue. However, an unplanned expansion in fiscal deficits would likely put upward pressure on yields as a strengthening economy and perhaps higher inflation curtail the desire of central bankers to ease policy.

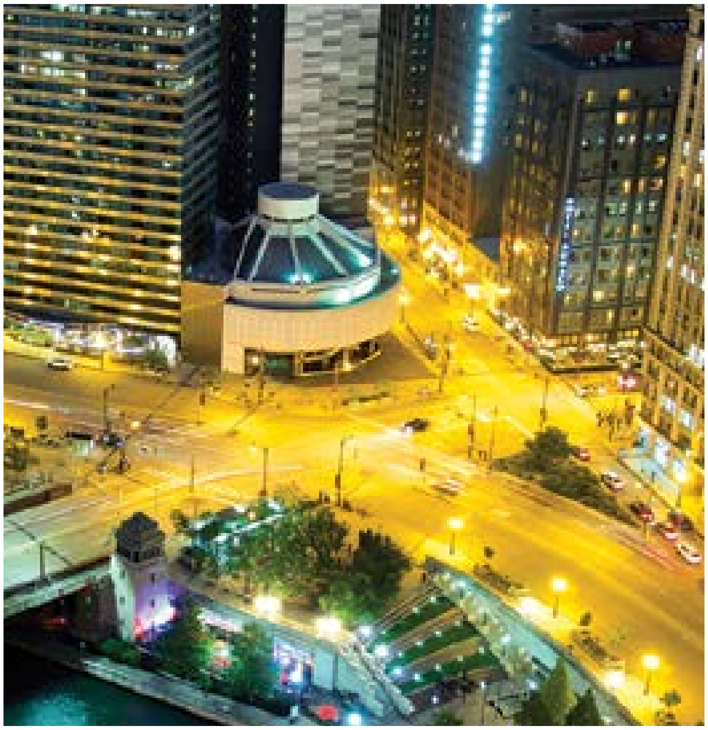
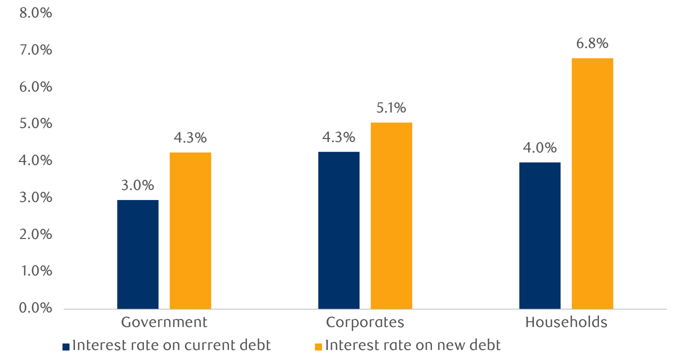


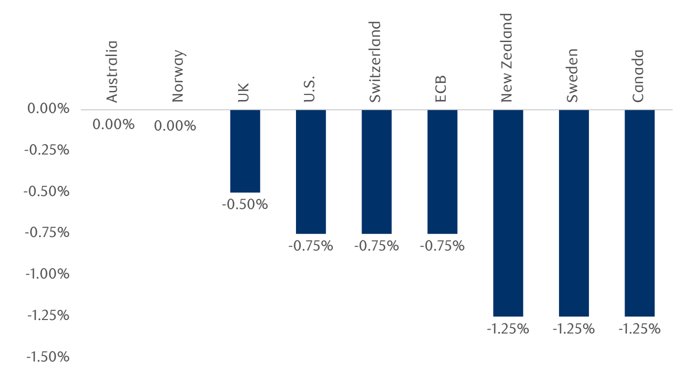
Exhibit 4: Borrowing costs are still rising for most, even after rate cuts



Note: As of December 3, 2024. For Corporates and Government, these represent the yield-to-maturity and coupon rates on the Bloomberg Barclays US Investment Grade Universe Bond Index and the US Treasury Universe Index respectively. For households, we refer to the implied rate on the existing mortgage stock versus the market rate on new 30-year mortgages. Source: Bloomberg, US Treasury, Fannie Mae and Freddie Mac

Exhibit 5: Policymakers have been cutting rates

Decline in policy interest rates from their respective highs



Note: As of December 4, 2024. Source: Central banks, RBC GAM calculations

Direction of rates

For U.S. 10-year bonds, we expect yields to be 4.00% at some point within the next year.

United States

As expected, the Fed eased monetary policy for the second consecutive meeting on November 8, lowering the target range for the fed funds rate to between 4.50% and 4.75%. The Fed continues to ease policy from what it considers to be an extremely restrictive setting, in line with the sharp fall in inflation. While the unemployment rate declined in October, it appears that the data was heavily affected by back-to-back major hurricanes. For its part, the labour market continues to soften but is not soft. Much had been made of the triggering of the so-called Sahm Rule, which has historically coincided with the U.S. being in a recession or on the verge of one. Based on unemployment claims and announced layoffs, however, the economy is showing few signs that it is in a recession. Inflation has generally continued to cool but remained a touch too high at 2.6% year-on-year in October, as measured by the Fed's preferred gauge. The start of the Trump administration early next year has called into question the Fed's plan to continue easing policy rates to something closer to neutral, which it estimates to be between 2.50% and 3.00%. The Fed's policymaking arm has refused to expound on its views of Trump's likely policy mix of tax cuts, tariffs, deregulation and immigration curtailment, which would together tend to generate tighter rather than looser policy.

We expect that the Fed's target range for the fed funds rate will fall to between 3.50% and 3.75% sometime over the next year, which represents at least one more rate cut than investors expect. For U.S. 10-year bonds, we expect yields to be 4.00% at some point within the next year.

We forecast the 10-year bund yield to be 2.25% within a year, compared with 2.09% now.

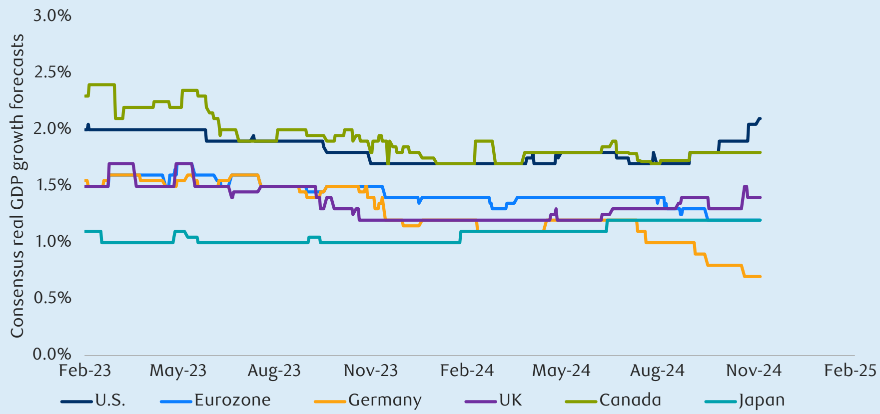
Eurozone

The European Central Bank (ECB) cut its key policy rate by 25 basis points at consecutive meetings in September, October and December, lowering the rate to 3.00% from 3.75%. The rate should drop to 1.75% sometime over the next year as inflation cools and economic growth remains relatively sluggish.

Investors have become particularly pessimistic about the economic outlook for Europe over the next year (Exhibit 6). The single-currency bloc certainly has its challenges. Most governments are entering a period of fiscal consolidation, presenting a headwind to economic growth, and Germany's mighty industrial base is struggling. In France, concerns over the fiscal and political situation have increased since the central government collapsed in early December. Adding uncertainty is the recent scheduling of snap elections in Germany due to be held in February. At this stage, we do not think the outcome of the vote is likely to have much impact on economic growth. Investors are unenthusiastic about Europe's economy these days, given uncertainty about the war in Ukraine and the potential impact of the new U.S. administration. Investors' pessimism is currently reflected in their expectations for ECB rate cuts.

Alongside the expected decline in the ECB policy rate, we forecast the 10-year bund yield to be 2.25% within a year, compared with 2.09% now.

Exhibit 6: Investors are very pessimistic about Europe in 2025



Note: As of December 4, 2024. Source: Bloomberg consensus economic forecasts

Yields on Japanese bonds should continue to rise, with the 10-year bond yield reaching 1.50% versus about 1.04% at the time of writing.

Japan

The Bank of Japan (BOJ) has remained on hold since July when it hiked rates for the second time this year. Policymakers have been reluctant to take further steps on rates after the BOJ's actions led to surge in the value of the yen and a 12% one-day collapse in Japanese equities. Inflation has come off the boil but remains high relative to the past three decades. What's more, households and corporations expect prices to keep rising, and initial forecasts for annual spring wage negotiations portend another historic increase.

We expect policymakers to raise the policy rate to 0.75% at some point over the next year. Yields on Japanese bonds should also continue to rise, with the 10-year bond yield reaching 1.50% versus about 1.04% at the time of writing.

The Canadian 10-year government bond will likely trade near 3.25% at some point over the next 12 months.

Canada

The Bank of Canada (BOC) accelerated its pace of interest-rate cuts by slashing the policy rate in 50-basis-point increments in both October and December to 3.25% from 4.25%, citing concerns that the economy is weakening.

Moreover, inflation is much lower than it was a year ago. The central bank's preferred measure of core inflation is just above 2%. Inflationary pressures are no longer broad-based, and the labour market has also softened with increasing unemployment. In addition, growth in domestic demand has eased and is expected to slow further due to government plans to scale back immigration in a bid to slow population growth. With inflation and growth continuing to decline, further policy easing in 2025 is likely to be warranted.

There are clear economic differences between the U.S. and Canada, and a stronger U.S. economy suggests to us that over the next year interest rates will come down faster in Canada than in the U.S. Our base case forecast for the BOC's policy rate is lower than what is expected by investors based on market indicators. We expect that the BOC policy rate will fall to 2.75%, which is 100 basis points lower than the fed funds rate. The current policy divergence is not extreme as, historically, the divergence ranged between 100 and 200 basis points. The Canadian 10-year government bond will likely trade near 3.25% at some point over the next 12 months.

We are keeping 10-year gilt yields forecast at 4.25%, expecting bond market to recover from sell-off started in late September.

United Kingdom

The Bank of England (BOE) delivered its second policy-rate reduction of the year in November, cutting the benchmark interest rate to 4.75% from 5.00%. The BOE's governor has adopted a gradual approach to rate reductions, citing the need to assess the inflationary and growth impacts of government plans to boost taxes and spending. UK gilts, meanwhile, joined the global bond sell-off since September, but surged again after the government plans for additional borrowing, announced October 30, pushed yields still higher and caused gilts to underperform. Our view is that higher yields suggest an improvement in the macroeconomic outlook and that current yields present an opportunity to accumulate bonds at levels that should provide attractive income. We note, however, that household and corporate interest burdens will probably weigh on consumption.

Our expectation is that gilts will outperform their peers in the coming 12 months. At the time of writing, investors expect the BOE's policy rate to drop to 4.15% in a year. We are keeping our forecast at 4.00% in alignment with expectations for a gradual easing cycle. We are also keeping 10-year gilt yields forecast at 4.25%, expecting bond market to recover from sell-off started in late September.

Regional recommendation

We expect returns in Japan to lag those in the U.S. and Europe. High starting yields near 4.25% and continued interest-rate cuts should enable the U.S. bond market to outperform. We recommend being 5.0% overweight Treasurys and 5.0% underweight Japanese government bonds.

High starting yields near 4.25% and continued interest-rate cuts should enable the U.S. bond market to outperform.

Underweight Japanese government bonds

vs.

Overweight U.S. Treasuries

Interest-rate forecast: 12-month horizon

Total-return calculation: December 2, 2024 – December 1, 2025

U.S.	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.75%	3.40%	3.60%	4.00%	4.40%	4.99%
Change to prev. quarter	(0.50%)	(0.20%)	(0.15%)	0.25%	0.00%	
High	5.00%	4.85%	4.90%	5.00%	5.10%	0.28%
Low	2.25%	2.50%	2.75%	3.25%	3.80%	9.11%
Expected Total Return US$ hedged: 4.9%						

Germany	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.75%	1.60%	1.85%	2.25%	2.60%	0.22%
Change to prev. quarter	(0.75%)	(0.40%)	(0.25%)	(0.10%)	(0.10%)	
High	3.25%	3.00%	2.85%	3.00%	3.00%	(3.85%)
Low	1.50%	1.25%	1.50%	2.00%	2.50%	2.15%
Expected Total Return US$ hedged: 1.9%						

Japan	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.00%	1.30%	1.50%	2.80%	(4.10%)
Change to prev. quarter	0.00%	0.05%	0.05%	0.00%	0.15%	
High	1.00%	1.20%	1.40%	1.75%	2.80%	(4.58%)
Low	0.25%	0.50%	0.50%	0.75%	2.00%	6.27%
Expected Total Return US$ hedged: 1.5%						

Canada	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.75%	2.80%	2.90%	3.25%	3.45%	2.23%
Change to prev. quarter	(0.50%)	(0.45%)	(0.40%)	0.00%	(0.20%)	
High	4.00%	3.90%	3.80%	4.00%	3.90%	(1.42%)
Low	2.00%	2.40%	2.50%	2.75%	2.85%	5.30%
Expected Total Return US$ hedged: 3.7%						

U.K.	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.00%	3.90%	4.00%	4.25%	4.70%	5.16%
Change to prev. quarter	(0.25%)	(0.10%)	0.10%	0.00%	(0.20%)	
High	5.00%	5.10%	5.00%	5.00%	4.85%	1.53%
Low	3.00%	2.90%	3.15%	3.50%	4.25%	10.44%
Expected Total Return US$ hedged: 4.8%						

Source: RBC GAM

Disclosure

For institutional use only - not for public distribution

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to investors in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc. (RBC GAM Inc.), RBC Global Asset Management (U.S.) Inc. (RBC GAM-US), RBC Global Asset Management (UK) Limited (RBC GAM-UK), RBC Global Asset Management (Asia) Limited (RBC GAM-Asia) and RBC Indigo Asset Management Inc. (RBC Indigo), which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC GAM Inc. (including PH&N Institutional) and/or RBC Indigo, each of which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC GAM-US , a federally registered investment adviser. In Europe this document is provided by RBC GAM-UK, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC GAM-Asia, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate and permissible, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions in such information.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

Publication date: December 15, 2024

(12/2024)