RBC Global Asset Management

Global fixed income markets

NEW YEAR 2024

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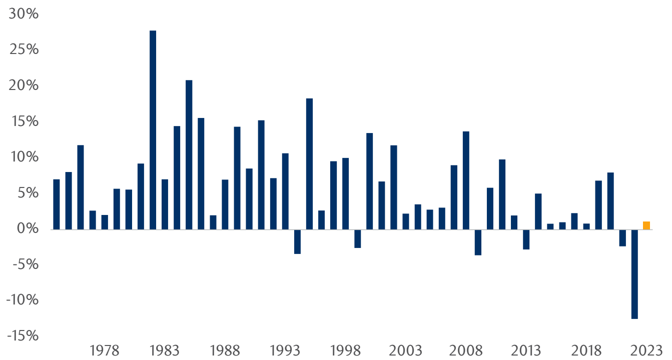
The bond market's volatile year continues in earnest. Over the past quarter, investors raised their estimates for central-bank policy rates in response to stronger-than-expected economic activity, mostly in the U.S., and still-elevated inflation. Investors are also demanding higher compensation to hold long-term bonds - a surcharge popularly referred to as the term premium – in part due to concerns about the poor state of government finances. A rising term premium and expectations for higher policy rates pushed the U.S. 10-year Treasury bond's yield to 5.02% on October 23, the highest since July 2007. As a result, investors in U.S. government bonds are flirting with an unprecedented third consecutive calendar year of losses (Exhibit 1), which would be disappointing given the low single-digit returns we had forecast a year ago.

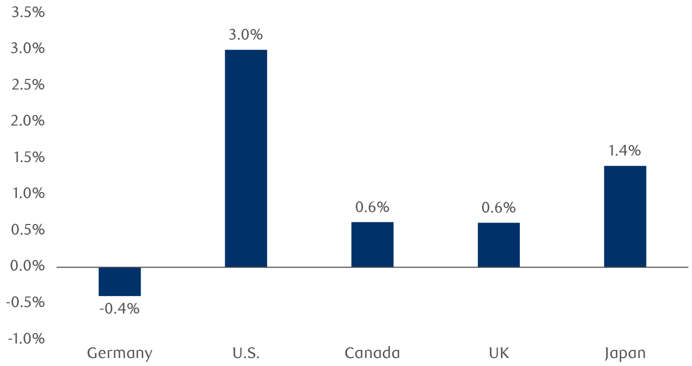
We think that investor expectations for higher yields are misplaced. Much of the world economy continues to slow, weighed down by the lagged effects of an aggressive global monetary-tightening cycle. Since the third quarter of 2022, most major economies have barely grown at all (Exhibit 2) and look likely to slow further in the year ahead. The factors

Exhibit 1: Investors might face a 3rd straight year of losses – U.S. government-bond returns



Note:Data as of December 5, 2023. Source: Bloomberg Barclays

Exhibit 2: Most countries have been growing very slowly – Economic growth since September 2022 after removing inflation



Source: National statistical offices

that have buoyed growth in the U.S., where the economy expanded by a vigorous 4.9% annualized rate between June and September, also do not appear repeatable. So, while most forecasters have withdrawn their recession forecasts over the past six months (Exhibit 3), we have increased our odds for an economic contraction.

The U.S. economy looks particularly vulnerable to a slowdown. The factors that contributed to the remarkable growth over the past 12 months - fiscal largesse, households' pandemic savings and ample banking-system liquidity - look unlikely to be repeated. Increased scrutiny of government finances and a sharply divided Congress mean we expect a modest drag from government spending over the next year. Pandemic savings also seem to be exhausted, removing an important source of consumer-spending power. Finally, liquidity in the U.S. banking system was much more ample over the past year than expected – providing a fillip to the economy. Over the next 12 months, we expect tighter monetary policy to weigh more heavily on activity as the U.S. Federal Reserve (Fed) continues to reduce its balance sheet.

In addition to a slowing economy, we think bond returns will be supported by better valuations. The latest rise in yields, driven by higher expectations for central-bank policy rates and larger term premiums, has improved valuations considerably. Real (inflation-adjusted) yields have climbed sharply, term premiums are as large as they've been in 10 years, and inflation compensation is at cyclical highs. In our view, investor expectations for these factors affecting bond yields are now too high.

Policy-rate expectations are considerably above what we would consider appropriate over the long term. Bond-market pricing suggests the fed funds rate will stay close to 4.00% for the next 10 years. Expectations for European policy rates are similarly lofty at nearly 3.00%. In both markets, market pricing for policy rates far exceeds estimates of neutral policy rates (the rate that neither stimulates nor dampens economic growth) and does not entertain the possibility of a serious recession over the next decade.

We think real yields at current levels offer a compelling investment case for bonds. The real yield on a 10-year inflation-protected security in the U.S. is 2.5%, compared with the Congressional Budget Office's estimate of potential real GDP growth of 1.8%. Real interest rates look even more egregiously high versus projected labour-force growth, which sits at just 0.4%. Labour-force growth is a "hard-data" version of potential GDP, since all the workers who will enter the labour force over the next 10 years have already been born.

Exhibit 3: Odds of a U.S. recession have fallen

Median probability of a recession over the next year

Note: Data as of December 5, 2023. Source: Bloomberg

Bonds, in our view, are offering investors more than fair compensation through today's higher term premiums, which are consistent with historical relationships such as volatility implied by options on interest rates. We expect volatility in the bond market to eventually decline, and the term premium should fall as well.

Compared to the rise in policy-rate expectations and the term premium, inflation expectations have risen only modestly. We think this is because central banks have shown a credible commitment to keeping inflation close to 2%. We expect inflation to continue to gradually fall over the next 12 months – closer to 2% over time. There are arguments that inflation might trend higher over the long term – in part due to climate change, deglobalization, rising wages, and consumer expectations for higher prices. But those considerations should be accompanied by the admission that bond yields already imply an attractive compensation for inflation of nearly 3% over the longer term.

In this environment, what kind of returns should bond investors expect? For the year ahead, we expect mid-to-high single-digit returns, with decent odds of a low double-digit return in some markets. Part of this higher-return expectation is explained by higher starting yields. If bond yields are unchanged a year from now, a starting assumption for an investor in U.S. government bonds would be a 5% return.

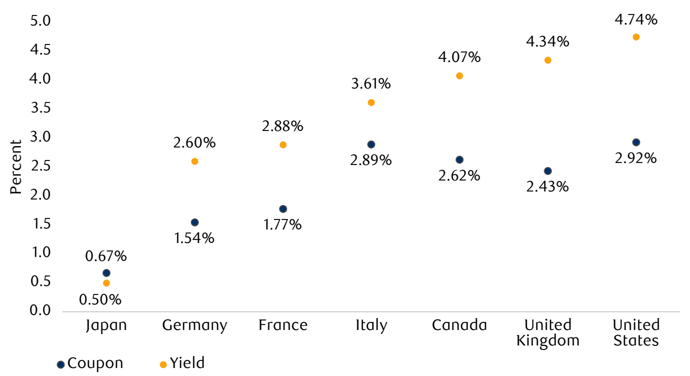
This starting yield is itself generous, but also acts as a buffer against further yield increases and as a springboard for returns should yields decline as we expect. For example, if the yield on the U.S. 10-year Treasury bond were to rise by 100 basis points over the next year, investors would show a loss of 2.3%. If yields fell by the same amount, the total return would be 13%.

For most of the past year our positive call on bonds has rested mostly on a view that a markedly slowing economy would lead to lower bond yields. But the past quarter's move higher in bond yields has also improved valuations, further supporting the case for bonds. To be sure, our belief that a recession likely looms has become more open to challenge. Most forecasters have spent the past few months ratcheting down their odds of a U.S. recession over the next 12 months, and the consensus is for no recession. Our view remains the opposite: we expect a recession and, given the passage of time since the beginning of the hiking cycle, the chances of a recession have risen. In our view, this bolsters the return potential for government bonds.

To our mind, the major risks to the bond market lie with inflation and government deficits. While investors' concerns about runaway inflation have largely abated, and inflation expectations remain within historical norms, the risk is that inflation stalls in the 3%-4% range. We believe that wages remain the biggest risk to central banks achieving their inflation targets. Moreover, we believe a recession is probably necessary to slow wage gains in a timely manner. Absent a continued slowdown in price pressures, the environment would be ripe for most central banks to resume their hiking cycles, and for bond investors to drive yields even higher. This is the type of inflation environment that drives our thinking on realistic "worst-case" scenarios for bonds.

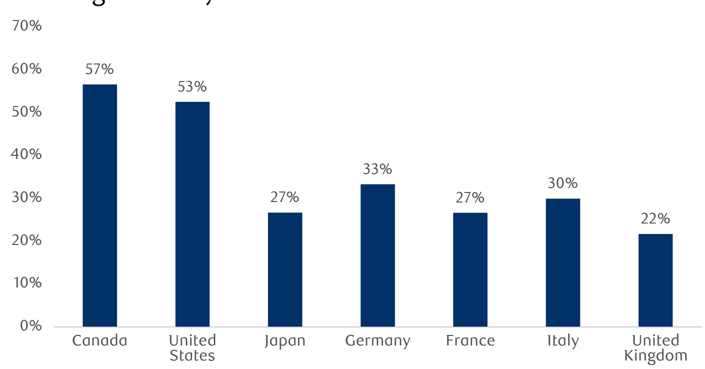
Fiscal and bond-supply concerns are also on our radar. The budget situation in most major Western countries is poor, and governments will be issuing substantial amounts of debt under current spending and revenue projections. What is peculiar about the run-up in borrowing is that it is occurring outside of an economic downturn. Moreover, market yields are now much higher than existing coupon payments, meaning that governments face rising interest costs as existing debt reaches maturity and is replaced with new, higher-cost debt. (Exhibit 4). As a result, interest costs will continue to rise over time even if there is no increase in the amount of debt outstanding. In some countries, this rise in borrowing costs will start to hit quite quickly. In the U.S. and Canada, nearly 50% of currently outstanding government debt will reset to higher rates by the end of 2025 (Exhibit 5). For now, we think these rises are manageable. The U.S. debt-to-GDP ratio will rise without significant changes to spending or taxation, but the situation is much different than that faced by the eurozone's weaker economies such as Italy and Greece in the early 2010s. These countries had deep-rooted structural growth problems that preceded concerns about debt sustainability – a factor that does not affect the U.S.

Exhibit 4: Current market yields are far above government payments due on coupons



Note: Data as of: December 5, 2023. For all publicly-held bonds and bills. Par-weighted coupon – for bills, market yields were used. Source: Bank of America

Exhibit 5: Governments need to renew lots of debt before January 1, 2026 – Share of outstanding bonds and bills maturing within 2 years



Note: Data as of December 5, 2023. Source: Bank of America

Direction of rates

We expect the fed funds rate to fall to 4.75% within the next 12 months. Our one-year forecast for the U.S. 10-year Treasury is 4.00%, about 30 basis points below yields at the time of writing.

United States

The U.S. Federal Reserve (Fed) is likely to extend the pause in its interest-rate hiking cycle after raising the target range for the fed funds rate to 5.25% to 5.50% in July. The labour market has started to show more consistent signs of weakness, with the unemployment rate rising, wage growth slowing and workers having a harder time finding new jobs. As a result, market expectations for further hikes over a 12-to-24-month horizon have been pared. The market now expects that the Fed is essentially done tightening policy and will start cutting rates by the middle of next year.

Policymakers are likely to be slow to acknowledge the possibility of significant policy easing in order to ensure that inflation does not meaningfully re-accelerate. Price pressures in some parts of the U.S. economy, particularly in service businesses, remain relatively frothy. The Fed is unlikely to meaningfully ease policy as long as wage gains remain close to 4% per year, which we estimate to be above a level consistent with 2% inflation. Moreover, while the Fed believes its current policy stance is sufficiently restrictive, it has been surprised by the resilience of economic activity.

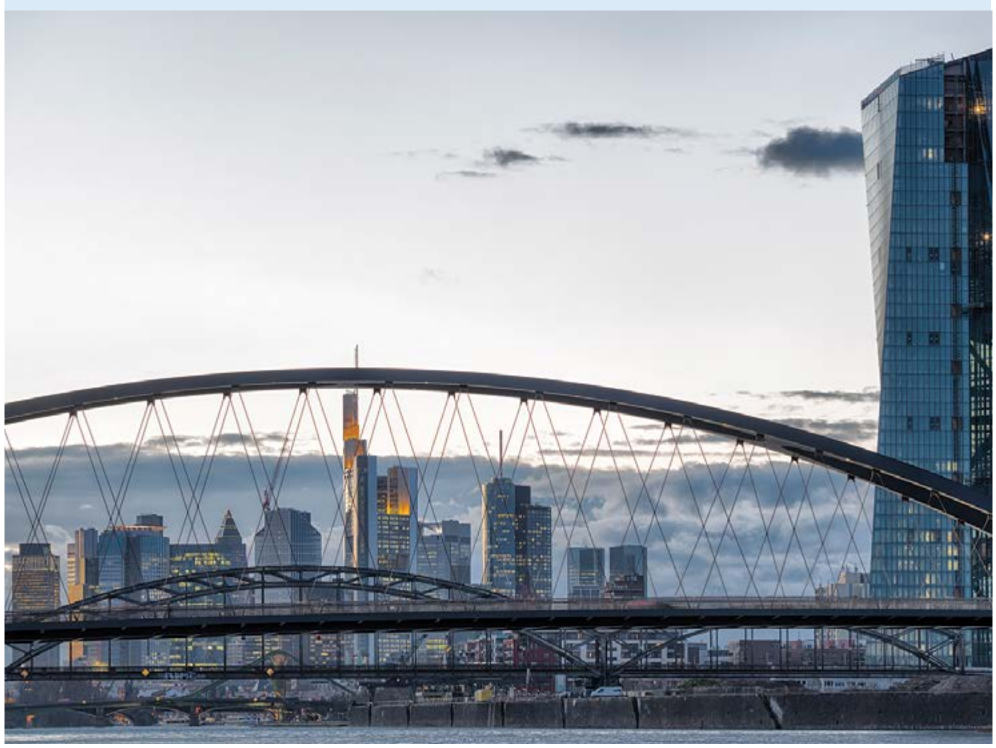
We see the pause in policy lasting until at least May of next year, absent a much-stronger-than-expected downturn in activity. We expect the fed funds rate to fall to 4.75% within the next 12 months. Our one-year forecast for the U.S. 10-year Treasury is 4.00%, about 30 basis points below yields at the time of writing.

Our forecast for 10-year bund yields is 2.50%.

Eurozone

The eurozone economy is clearly struggling given higher policy rates. While Europe's economy managed to avoid a widely expected recession in the immediate aftermath of the start of the war in Ukraine, mostly thanks to enormous fiscal transfers and a fortuitously warm winter, it has since stagnated. An expected fillip from China's recovery from the pandemic has failed to materialize, and fiscal transfers and the positive impact of a resumption of supply chains have largely run their course. The European Central Bank (ECB) hiked its policy rate by 25 basis points to 4.00% in September and continues to hold rates at levels not seen since before the global financial crisis 15 years ago.

Preventing policymakers from pivoting to rate cuts to support growth is an inflation rate that continues to run uncomfortably hot in the euro area. While the worst has probably been avoided, rapid wage growth is a particular area of concern as it can create a self-sustaining cycle of above-2% price rises that the ECB is keen to avoid. We think still-high inflation will keep policymakers from considering cuts until the middle of next year, before reducing the policy rate by 100 basis points by December 2024. Bond yields in Germany already reflect a poor outlook for growth and some investors expect cuts as 10-year government bond yields sit at 2.45%, well below the current policy rate. With so much gloom already priced into long-term bonds, we don't see yields falling much further over the next 12 months. Our forecast for 10-year bund yields is 2.50%.



We expect the policy balance rate to rise to 0.10%, from -0.10% now. Our forecast is for the yield on the 10-year Japanese government bond to be about 1.00% within a year's time, up from 0.67% at the time of writing.

Japan

The Bank of Japan (BOJ) continued to tighten monetary policy over the past quarter, further loosening its seven-year-long grip on government-bond yields. Instead of capping 10-year government yields at 1.00% with a promise to buy unlimited amounts of bonds, this level is now simply a "reference point." The shift is perhaps happening not a moment too soon, since both inflation and inflation expectations in Japan continue to rise. While modest compared with much of the developed world, price pressures in the country are at multi-decade highs. What's more, there are stronger signs in Japan than anywhere else that public attitudes toward expected price rises are changing.

We believe that further tightening of monetary policy in Japan is warranted barring a significant slowdown in economic activity. We expect the policy rate to rise to 0.10%, from -0.10% now. Our forecast is for the yield on the 10-year Japanese government bond to be about 1.00% within a year's time, up from 0.67% at the time of writing.

We forecast the policy rate will remain at 5% until mid-2024, and that the BOC will pivot to cutting rates in the third quarter of 2024, ultimately lowering the benchmark rate to 4.00% sometime within the next year.

Canada

We believe the Bank of Canada (BOC) has finished the current round of rate hikes after increasing the policy setting by 475 basis points to 5.00% since March 2022. The Canadian economy is starting to acutely feel the lagged impact of tighter financial conditions, with growth in gross domestic product (GDP) coming in at zero over the past several months.

Given record high levels of debt and high interest rates, Canadian households are cutting back their spending. According to the BOC, approximately 60% of residential mortgages are coming due for renewal over the next three years, and the money used to make higher mortgage payments will be unavailable to support consumption. The full impact of a rate hike is generally not felt until 12 to 18 months after the fact, suggesting we are just now feeling the full brunt of last year's aggressive rate moves. With elevated interest rates, businesses are holding back investments and borrowings. Economic weakness over the next few quarters will likely further reduce inflation.

We forecast that the policy rate will remain at 5% until mid-2024, and that the BOC will pivot to cutting rates in the third quarter of 2024, ultimately lowering the benchmark rate to 4.00% sometime within the next year. We forecast that Canadian 10-year government bonds will yield 3.0% at some point over the next 12 months.

United Kingdom

We expect the Bank of England (BOE) to pause its interest-rate hiking cycle, before starting to cut the policy rate in the second half of next year. Economic growth continues to be dismal, in part due to weak demand from the country's largest trading partner, Europe, the dampening effect of higher interest rates and fiscal restraint. Household consumption and business investment are likely to remain lackluster in the coming quarters, a lagged response to the 500 basis points of interest-rate hikes delivered since December 2022.

On the inflation front, October prices rose 4.6% compared from a year ago, a sharp deceleration from the 6.7% annual rise recorded in September. The bulk of the decline was due to falling energy prices. The slowdown in price pressures bolsters the case for the BOE to hold its policy rate steady. However, core inflation, which excludes volatility food and energy prices, is still rising at 5.7%, far above the BOE's 2% target. We believe stagflation is a real risk for the UK. Wage growth remains very high and this will make it more difficult to lower inflation from the current 5%-6% pace to 2%-3%. In view of the higher-than-average inflation risk, we think the BOE will be on hold for longer than most other central banks, at least until the economy is in a deep slowdown. We pencil in 75 basis points of rate cuts in the BOE policy rate to 4.50% from the current 5.25%, most of which will likely take place in the latter part of our forecast horizon.

Our forecast for the 10-year gilt yield to drop to 4% a year within a year, slightly below the prevailing yield at the time of writing.

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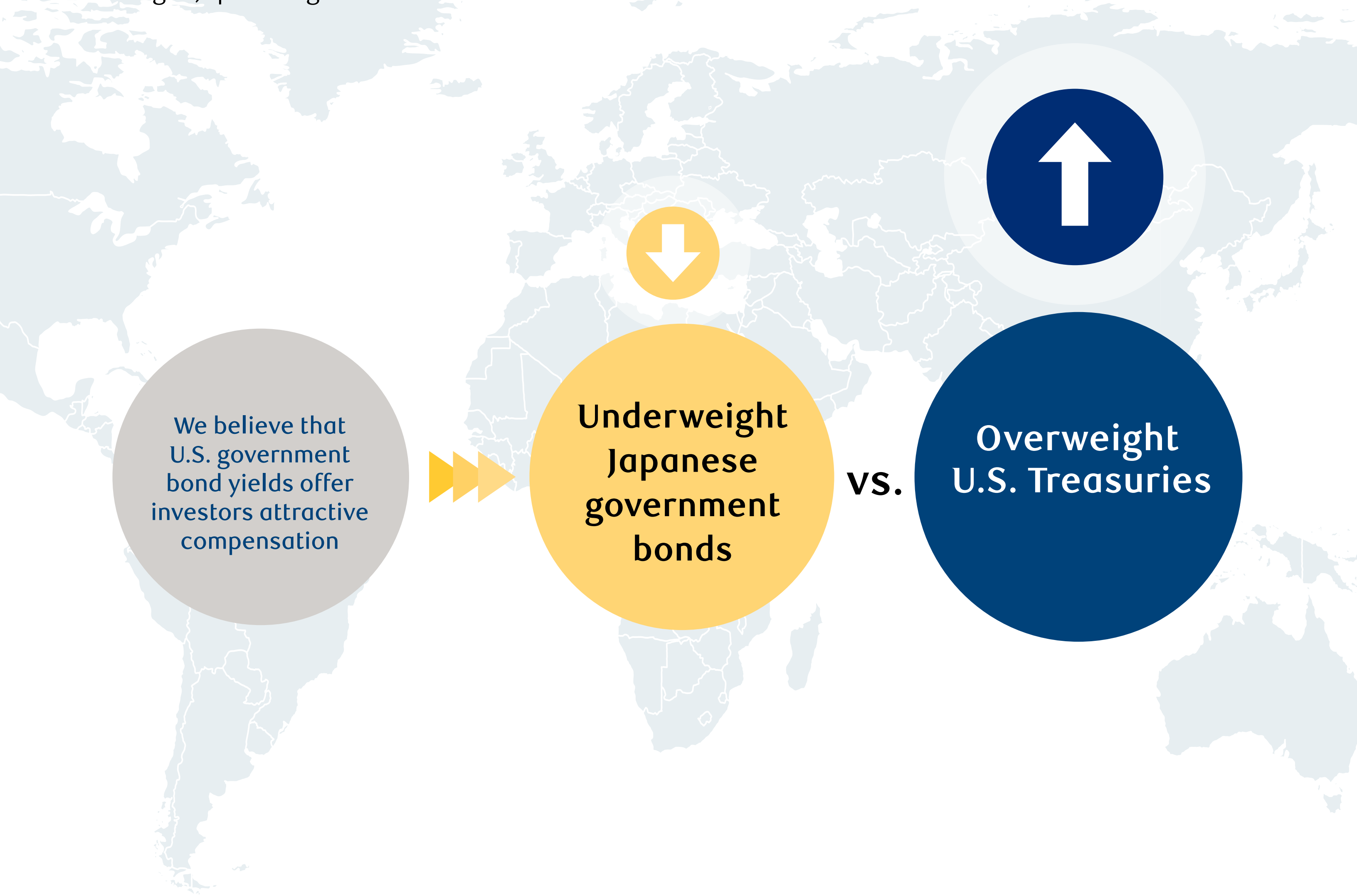
Regional outlook

We believe that U.S. government-bond yields offer investors attractive compensation, and that a slowdown in the economy should lead to lower yields over the next 12 months. In contrast, Japan's transition to a post-yield-curve-control monetary-policy stance is still in its early stages and we expect further yield rises. We therefore recommend being overweight U.S. Treasuries and underweight Japanese government bonds.



Interest-rate forecast: 12-month horizon

Total-return calculation: November 30, 2023 – November 30, 2024

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.75%	4.00%	3.90%	4.00%	4.25%	5.96%
Change to prev. quarter	0.25%	(0.10%)	0.15%	0.50%	0.35%	
High	6.50%	6.25%	6.00%	6.00%	6.00%	(2.76%)
Low	3.00%	2.85%	3.25%	3.50%	3.90%	8.99%
Expected Total Return US$ hedged: 5.4%						

Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.00%	2.50%	2.25%	2.50%	2.85%	1.60%
Change to prev. quarter	(0.75%)	(0.50%)	(0.50%)	(0.10%)	0.35%	
High	4.50%	4.00%	3.75%	3.60%	3.60%	4.78%
Low	2.00%	1.75%	1.75%	1.75%	2.25%	10.26%
Expected Total Return US$ hedged: 3.1%						

Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.10%	0.40%	0.50%	1.00%	1.85%	(1.16%)
Change to prev. quarter	0.10%	0.20%	0.10%	0.25%	0.15%	
High	0.50%	1.00%	1.25%	1.75%	2.50%	(9.72%)
Low	(0.10%)	0.01%	0.25%	0.50%	1.40%	5.41%
Expected Total Return US$ hedged: 3.6%						

Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.00%	3.30%	3.10%	3.00%	3.20%	5.72%
Change to prev. quarter	(0.25%)	(0.45%)	(0.15%)	0.00%	0.10%	
High	5.75%	5.50%	5.25%	5.00%	4.75%	(4.05%)
Low	2.50%	2.60%	2.60%	2.75%	3.00%	7.84%
Expected Total Return US$ hedged: 5.0%						

U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.50%	4.00%	3.80%	4.00%	4.75%	4.87%
Change to prev. quarter	(0.75%)	(0.75%)	(0.70%)	(0.25%)	0.25%	
High	6.25%	6.00%	5.80%	5.75%	5.50%	(4.63%)
Low	3.50%	3.00%	2.75%	3.00%	4.00%	13.07%
Expected Total Return US$ hedged: 4.7%						

Source: RBC GAM

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