Global fixed income markets

The bond-market outlook

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

Taylor Self, MBA – Senior Analyst
RBC Global Asset Management (UK) Limited

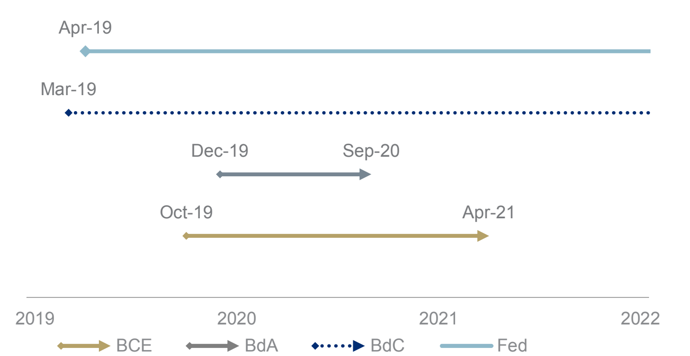
Financial markets had both a tumultuous end to 2018 and uncertain start to 2019, as slowing economic growth and political discord in the U.S. and Europe created an unfavourable environment for risk assets. Equities and corporate bonds fell precipitously while government bonds rallied, effectively fulfilling their role as a return diversifier in a balanced investment portfolio. While stocks and corporate debt have almost entirely recovered their losses since the beginning of the year, government bonds have hung on to most of the gains made when risky assets declined.

One reason for the strength of government-bond prices is that central banks have become more dovish this year, and we expect central banks will continue to be cautious as concerns about weakening economic growth linger and inflation remains modest. As a result, we believe that the U.S. Federal Reserve (Fed) has for now ended the string of fed funds hikes dating back to December 2015, and are also convinced that other central banks will step back from carrying out any plans to tighten monetary policy in the foreseeable future. We have therefore reduced our forecasts for long-term bond yields.

In the previous edition of the *Global Investment Outlook,* we forecast that the Bank of England (BOE), the European Central Bank (ECB), the Fed and the Bank of Canada (BOC) would all tighten policy sometime this year. It now appears that rate hikes will occur no earlier than late 2020, in the case of the ECB, and 2021 in the case of the BOE (Exhibit 1). No hikes at all are expected this year from either the BOC or the Fed.

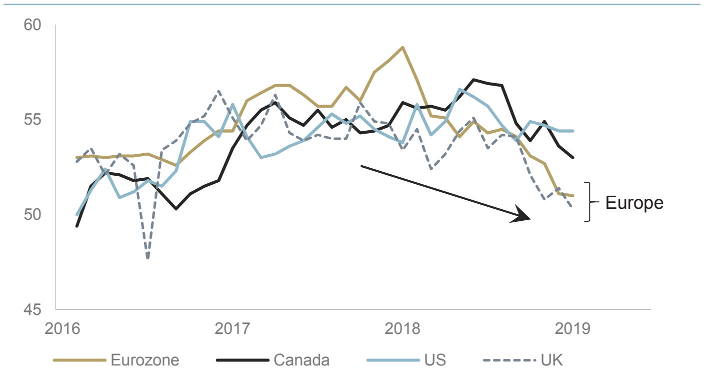
While economic growth in 2018 was impressive, the global economy has slowed noticeably (Exhibit 2), particularly in Europe, and central bankers will likely be content to wait and see how the global economy traverses this soft patch. In addition to weaker economic activity, inflation has softened. The drop in oil prices since last year has eased inflationary pressures, which should continue to moderate through the first half of 2019 (Exhibit 3). We agree with the consensus

Exhibit 1. Central banks have become much more dovish
Market expectations for date of next rate hike after January 1, 2019



Source: Bloomberg et RBC GMA, 15 février 2019.

Exhibit 2. There has been a distinct slowdown from 2018
Manufacturing Purchasing Managers' Indices



Source: IHS Markit, RBC GAM

forecast that central-bank policymakers will remain mostly on hold for the foreseeable future, as long as there is no significant and sustained increase in inflation.

Direction of rates

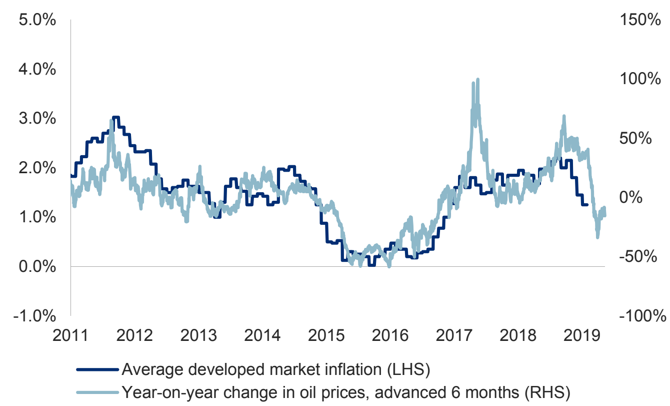
U.S. – We expect that the U.S. Federal Reserve (Fed) will keep interest rates on hold in 2019, in contrast to our prior forecast for the Fed to deliver two increases by the end of this year. We had already anticipated that the pace of policy tightening in the U.S. would slow in 2019 as the Fed tacked to a more neutral policy stance. The Fed is the only major central bank that has raised rates above emergency levels since the financial crisis. After eight rate hikes, the current policy setting sits near most estimates of neutral.

With interest rates on hold, investors will pay more attention to the Fed's balance sheet, which has shrunk about 10 percent from its 2007 high of US$4.5 trillion. While the Fed has tried hard to divorce balance-sheet policy from interest-rate policy, investors are becoming increasingly concerned that further Fed balance-sheet shrinkage will have a negative effect on asset prices, and we believe that the Fed will therefore end the process of reducing its balance sheet earlier than had been projected, probably sometime this year. Another argument for a large balance sheet is that the Fed's current framework for controlling overnight interest rates requires substantial excess reserves in the banking system to be effective, and a larger-than-expected balance sheet will remove one of the long-term factors putting upward pressure on U.S. bond yields. With the Fed holding rates unchanged, we are expecting the 10-year Treasury yield to fluctuate around 2.50 percent over the forecast horizon. This is a reduction from our previous forecast of 3.00 percent.

Germany – The Eurozone faces a period of uncertainty given the scheduled departure of Mario Draghi as ECB president at the end of October. Our view is that his exit will not have a significant impact on the ECB's approach to policy, as the central bank came to terms with its responsibility for ensuring the continuity of the euro and broader European political integration in the aftermath of the European 2011-2012 sovereign-debt crisis. These days, ECB policymakers are in near-unanimous agreement that unconventional monetary-policy measures will likely become a permanent feature of monetary policy.

In the shorter term, slowing economic activity and lower oil prices have increased the ECB's difficulty in pushing inflation towards the central bank's 2 percent target. With the policy rate still set at emergency levels, we don't expect any change over the next 12 months.

Exhibit 3. Developed-market inflation and oil prices
G4 inflation and oil prices



Source: Bloomberg, RBC GAM

Aside from policy-rate changes, the ECB will continue efforts to support European banks, especially in Italy, through a program designed to create liquidity for encouraging business loans (LTROs). The extension of the LTRO program, which was slated to expire later this year, will support prices for government bonds, especially those issued by Italy, Spain and Portugal.

In line with lowered expectations for ECB rate hikes, bund yields have fallen. The yield on the 10-year German benchmark security was recently just above 0 percent, but yields could struggle to rise meaningfully as long as investors are counting on the ECB to backstop the long-term financial health of the Eurozone. Our 12-month forecast for the 10-year bund yield is 0.25 percent, down sharply from the previous forecast of 0.75 percent.

Japan – After almost five years of continuous monetary stimulus, inflation remains stubbornly below the Bank of Japan's (BOJ) 2 percent target. Meanwhile, the Japanese central bank has purchased over 50 percent of the outstanding Japanese government bonds (JGBs), meaning that its holdings dwarf those of other central banks adjusted for the size of their economies (Exhibit 4). Serious questions will at some point be asked about how - and whether - the BOJ can ever reduce its balance sheet. For now, we believe the BOJ will stay committed to an extraordinarily loose monetary policy that uses open-ended bond purchases to control the shape of the yield curve. Modest policy changes, such as taking steps to steepen the yield curve, could be made to moderate some of the negative effects of low interest rates on bank profitability. We do not expect the BOJ to adjust its short-term policy rate over the next 12 months, and we expect the 10-year yield to fluctuate within the BOJ's target range of plus or minus 0.20 percent.

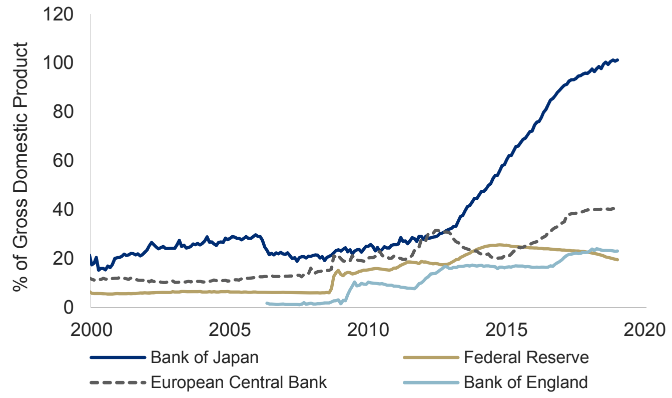
U.K. – The Bank of England (BOE) has been reluctant to raise interest rates from emergency levels due to uncertainty surrounding Brexit, which has weighed on the U.K. economy and held back inflation and economic activity. Accordingly, expectations for the BOE's next hike have been moved further back. We do not anticipate that the BOE will change its policy rate before the end of this year. We have lowered our 10-year gilt-yield forecast to 1.00 percent from 1.75 percent, reflecting a very cautious BOE against a backdrop of weakening growth and slowing inflation, as well as continued Brexit uncertainty.

Canada – The Bank of Canada (BOC) raised its short-term benchmark interest rate by a total of 75 basis points in 2018, but by the start of this year seemed much less inclined to continue boosting rates given slowing domestic growth. The BOC recently cut its economic-growth forecasts for Canada and said it will assess the impact of lower oil prices and tighter financial conditions on the economy before deciding how to proceed. The BOC's core inflation measures all sit below 2 percent, and are therefore too low to prod the bank into additional moves. Nor is the current pace of economic expansion robust enough to prompt the BOC to act: both global and domestic growth are forecast to be lower in 2019, with the latter subject to declines in oil production and a softer housing market. As a result, we expect the central bank to stand pat on policy rates for now, with the BOC's caveat that "the policy interest rate will need to rise over time into a neutral range to achieve the inflation target."

International interest in bonds issued by Canadian entities was lacklustre for much of 2018 as currency weakness, softening commodity prices, pipeline delays and trade worries had investors shying away from the Canadian market. Towards the end of year, however, broader global-growth concerns sent investors searching for safe havens such as Canadian bonds. Provincial bonds have experienced healthy inflows, and the provinces have been frequent issuers in other currencies thanks to favourable market conditions.

The consensus view is that there will be one more rate hike by the BOC in 2019, late in the year. We believe that the BOC is likely finished raising policy rates and could be on hold into 2020. Our forecast is for 10-year government bonds yields to trade modestly higher at 2.00 percent, 40 basis points lower than our previous forecast.

Exhibit 4. The Bank of Japan stands out amongst its peers
Central bank balance sheet size as a share of GDP



Source: Respective central banks, statistical agencies, RBC GAM

Regional preferences

We recommend overweighting U.S. Treasuries by 5 percentage points, against 2.5 percent underweight positions in both German bunds and JGBs. The gap between U.S. and German bond yields remains wide by historical standards. Moreover, based on economic-growth differentials, U.S. yields are too high and under pressure to fall, or European yields are too low and more likely to rise. In Japan, government bond yields have fallen to the bottom of the BOJ's target range for yield-curve control, and we therefore believe being underweight JGBs offers another potential path for attractive relative returns.

For more on our current view and outlook, please consult the full version of *The Global Investment Outlook* posted on our website at http://www.rbcgam.com/gio.

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