SUMMER 2017

GLOBAL FIXED INCOME MARKETS

Direction of rates

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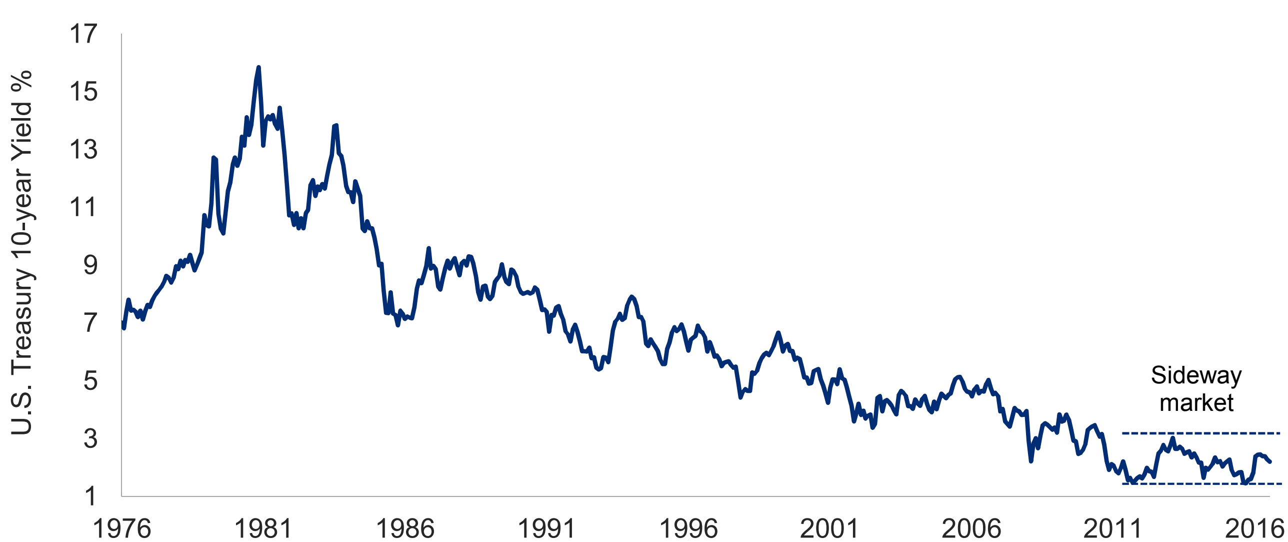
Over the past six years, U.S. Treasury yields have been trapped within a range, and calls for the death of the bond bull market continue to be wrong. We are sympathetic to the position that the bond bull, which started in the 1980s, must end at some point. However, the stabilization in yields should not be interpreted as foreshadowing a sustained rise. Our view is that bond yields could move sideways for an extended period, given the indebtedness of the global economy and banking-system regulations that are propping up demand for developed-market government bonds (Exhibit 1). In this environment, bond yields could temporarily break through the range, only to be pulled back within it.

Exhibit 1: U.S. 10-year yield has been trapped within a range over the last six years



Source: Bloomberg

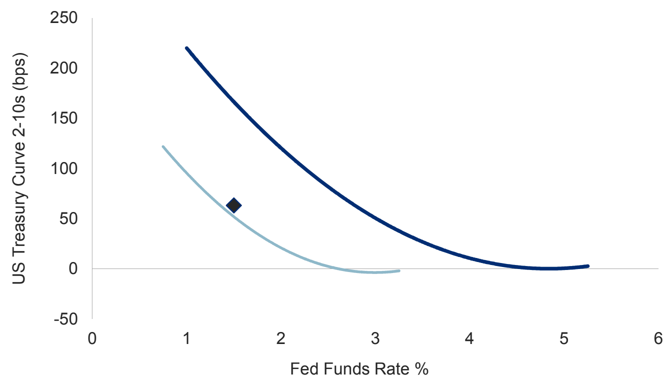
We are keeping our bond-yield forecasts largely unchanged and expect most central banks to consider tighter monetary policy as economic growth firms. The Fed is picking up the pace of monetary tightening and the European Central Bank (ECB) may scale back bond purchases heading into German elections in September. The Bank of Japan (BOJ) is likely to keep holding down the yield on the 10-year Japanese government bond (JGB) since inflation remains below its target, so don't take BOJ's musings about exiting quantitative easing too seriously. The Bank of England (BOE) will vary policy based on subdued growth and preparations for Brexit. The Bank of Canada (BOC) may hike once within our forecast horizon, reflecting the stronger global expansion.

U.S. – We expect the Fed to deliver three hikes in the fed funds rate over the next 12 months. The focus for the Fed will then shift to gradually reducing the amount of assets on its balance sheet. The gradual approach should prevent U.S. rates from rising much more relative to those in other major economies. This approach will also buy time for the Fed to assess the potential impact of any Trump fiscal-stimulus package and regulatory reforms to stoke inflation, and also for the Fed to assess the effect of higher rates on the overall economy. For more on the Fed's asset holdings, please see the article "The Federal Reserve's Balance Sheet" in this *Global Investment Outlook*.

Our expectation of future policy tightening is very similar to expectations currently priced in the market. Our models suggest that the yield gap between 2-year and 10-year Treasuries will narrow to 65 basis points over the next 12 months from 100 basis points currently (Exhibit 2), and the yield curve should flatten as policy rates continue to rise. Our forecast is that the 10-year yield will rise to 2.50% sometime in the next 12 months, and in our view there is a risk that this rate trades above 3% before falling back to our forecast levels. The fed funds rate will rise to 1.63% from about 0.88% currently.

Germany – The ECB bond-purchase program remains the factor holding down government-bond yields across Europe, as the central bank manages its assets around European elections. In the period leading up to the French presidential election, for example, the ECB acquired proportionately more French bonds than German bunds to prevent French yields from rising further versus those on German securities. We see the ECB continuing to use quantitative easing to manage financial stability across the Eurozone. Having said that, the brightening economic outlook in Europe means that the ECB may reduce the size of its bond-

Exhibit 2: Yield curve is expected to flatten to 65bps from current the 95bps



Source: RBC GAM

buying program by year-end, as bund yields should be higher. We expect ECB policymakers to keep the benchmark deposit rate at negative 0.40%, and our forecast for the 10-year bund yield remains unchanged at 0.75%.

Japan – The BOJ may become more flexible with policy, which centers on controlling the yield curve, as Treasury yields rise and the ECB prepares to pare the pace of bond purchases. With global growth continuing at its recent pace, we expect the BOJ to keep its official target on the 10-year JGB at 0.00%, but to allow it to stray higher to 0.10%. We maintain our deposit-rate forecast at negative 0.10%.

Canada – The Canadian economy has had a strong start to the year, enough so that BOC Governor Poloz has said that further rate cuts are unlikely for now. However, Poloz warned that the impact of any protectionist trade policies proposed by the U.S. could have a significant negative impact on growth. The other focus continues to be household indebtedness and the overheated Toronto housing market. The Ontario government announced measures in April aimed at ending speculation and relieving longer-term supply shortages. We don't expect policy rates to start rising until at least mid-2018, when the BOC estimates the output gap will close.

International investors continue to seek out Canadian bonds given that Canada is one of only a dozen countries with a AAA credit rating and that its political and financial backdrop is relatively stable. The comfort level for foreign investors has led to a shift from the safest Government of Canada securities to the extra yield offered by the provinces. This strong foreign demand lines up nicely with the increased funding needs of the provinces and allows for

INTEREST RATE FORECAST: 12-MONTH HORIZON
Total Return calculation: May 31, 2017 – May 30, 2018

U.S.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.63%	1.85%	2.25%	2.50%	3.10%	0.29%
Change to prev. quarter	0.25%	0.10%	0.25%	0.00%	0.00%	
High	1.88%	2.50%	3.00%	3.25%	3.75%	(3.37%)
Low	0.88%	0.90%	1.25%	1.60%	2.30%	5.60%
Expected Total Return US$ hedged: 0.45%						

GERMANY

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.40%)	(0.10%)	0.20%	0.75%	1.30%	(1.98%)
Change to prev. quarter	0.00%	0.00%	0.00%	0.00%	0.00%	
High	0.00%	0.50%	0.80%	1.25%	1.60%	(5.66%)
Low	(0.40%)	(0.50%)	(0.25%)	0.00%	0.50%	5.97%
Expected Total Return US$ hedged: (0.16%)						

JAPAN

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.10%)	(0.05%)	(0.07%)	0.10%	0.95%	(1.00%)
Change to prev. quarter	0.00%	0.05%	(0.02%)	0.00%	0.00%	
High	0.00%	0.10%	0.10%	0.25%	1.10%	(3.05%)
Low	(0.10%)	(0.10%)	(0.10%)	(0.10%)	0.60%	3.45%
Expected Total Return US$ hedged: 0.82%						

CANADA

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.00%	1.25%	1.75%	2.30%	(0.67%)
Change to prev. quarter	0.25%	0.10%	0.10%	0.00%	(0.10%)	
High	1.25%	1.65%	1.90%	2.35%	2.85%	(5.46%)
Low	0.25%	0.25%	0.40%	0.90%	1.60%	6.34%
Expected Total Return US$ hedged: (0.51%)						

U.K.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.25%	0.30%	0.75%	1.25%	2.00%	(2.34%)
Change to prev. quarter	0.00%	(0.30%)	(0.25%)	(0.25%)	(0.25%)	
High	0.50%	1.00%	1.50%	2.00%	2.50%	(9.28%)
Low	0.00%	0.00%	0.25%	0.50%	1.40%	6.49%
Expected Total Return US$ hedged: (1.09%)						

Source: RBC GAM

issuance outside of Canada, most recently in U.S. dollars, euros and Australian dollars. This year is shaping up as the biggest ever for provincial bond issuance. The record, C$27 billion in 2009, was due to investors scrambling for high-quality securities during the credit crisis. Today the demand stems from the fact that quantitative easing in Europe and Japan is leading investors to seek higher yields elsewhere.

Canadian bonds have outperformed Treasuries since the start of the year. This makes sense as the BOC is likely to keep the policy rate unchanged at 50 basis points for most of the year, while investors are pricing in tightening by the Fed. Lower oil prices and housing-market concerns support the BOC's preference for staying put on rates. We note that the relationship between the price of oil and the direction of interest rates has generally been highly correlated, but is less so now. For longer-term maturities, valuations of Canadian securities now seem stretched.

We are forecasting a 25-basis-point increase in the BOC policy rate to 75 basis points late in our 12-month horizon. However, our 10-year government bond forecast is unchanged at 1.75%.

U.K. – Recent data suggest that inflation is ebbing after the Brexit vote led to a series of higher-than-desired readings caused by a plunge in the pound. Attention is shifting from currency effects to prospects for economic growth and the impact of Brexit negotiations following last week's general election. The BOE is standing by to support the economy given that businesses are delaying investments amid uncertainty about the U.K.'s relationship with its biggest trading partner, the EU. Further significant softening in investment sentiment, economic activity and consumption could prompt the BOE to deliver another round of easing in 2018. For the time being, we expect the BOE to maintain the status quo by keeping its policy rate at 0.25%, and we decrease our 10-year gilt yield forecast to 1.25%, a 25-basis-point drop.

Regional preferences

We are changing our regional recommendation to underweight German bunds by 5 percentage points, up from a 2.5-percentage-point underweight last quarter, and move to neutral on JGBs from a 2.5-percentage-point underweight. Our overweight on U.S. Treasuries remains at 5 percentage points. We expect bund yields to rise more than those on U.S. Treasuries as investors gradually price in the possibility that the ECB will begin its exit from quantitative easing toward the end of the forecast horizon.

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