RBC Global Asset Management

INVESTOR **INSIGHTS**

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It's been a difficult start to the year for fixed income investors. Bond yields have risen over the past several months, reflecting an improvement in outlook for the global economy as vaccinations against COVID-19 are progressing.

The bond market responded with a steepening of the yield curve. The front end of the curve remains anchored by short term policy rates, but longer term bond yields have risen due to an increase in inflation expectations and, more recently, real yields and built-in term premia which compensate investors for increased uncertainty. As a result, the benchmark FTSE Canada Universe Bond Index was down 5% during the first quarter of 2021, its worst quarter since March 1994. That drop brought the 1-year return on the bond index to 1.6%, not far from pre-COVID expectations.

What is the market pricing in?

Looking ahead, based on current yield levels, we can back out that the market expects the Federal Reserve to begin raising interest rates at the end of 2022, then continuing at a pace of three rate hikes per year to peak at 2.75%. This timeline has been aggressively pulled forward over the last few months as expectations in December were for the first hike to occur in mid-2024. The assumed speed means that in 18 months, the Fed would have to:

1. Signal to the market its intent to begin reducing bond purchases or quantitative easing;
2. Start actually tapering back its bond purchases while still growing the balance sheet and minimizing market disruption;
3. Pause to assess the impact of this tapering; and
4. Start signaling and implement its first rate hike

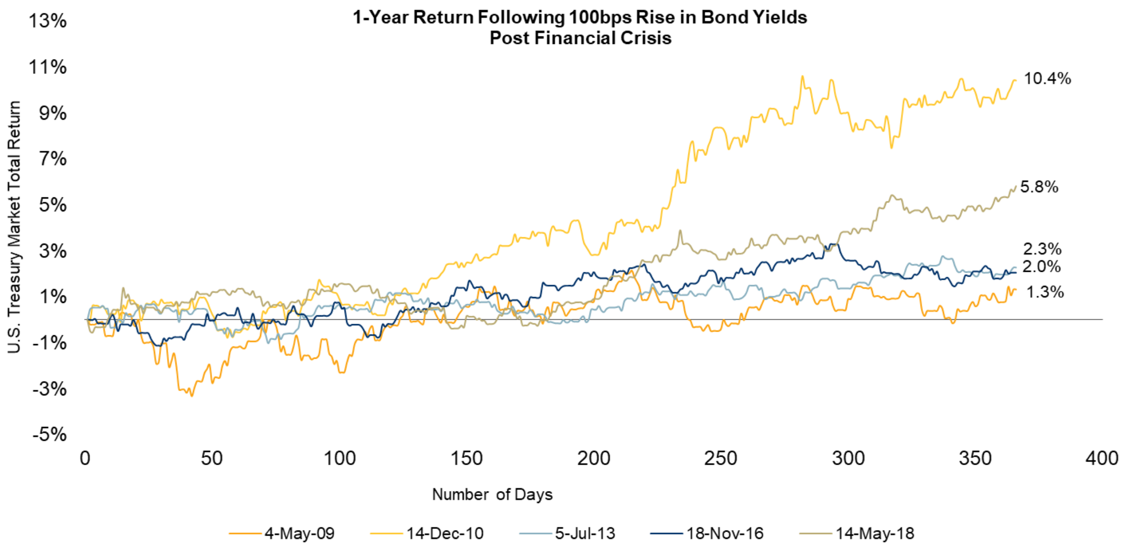
This timeline does not align or fit with Fed guidance and we believe that expectations for an aggressive hiking cycle are misplaced. They are not unusual, however. Historically, the market has frequently been too aggressive in pricing rate hikes, often as soon as the last cut is done. We saw this after the financial crisis. Shortly after the last Fed rate cut in December 2008, the market was pricing in multiple rate hikes over the following two years, when in fact, the Fed didn't hike until almost seven years later.

Stronger than expected growth data, successful rollout of the vaccination program in the U.S. reflected in record PMI numbers led to this short term optimism. Combined with an expected increase in inflation numbers over the next quarter, they drove the increase in yields we have just seen. Our eyes turn to the period following the transitory inflation spike and our expectations of more subdued growth in the latter part of the year. This setup often leads to a pullback in yields.

What are the implications of the Fed's new policy framework?

The new Average Inflation Targeting (AIT) monetary policy framework that the Fed introduced last year provides further support for a less aggressive hiking cycle. Real interest rates are likely to be kept lower in order to achieve 2% structural inflation in a post pandemic low growth world. The market doesn't yet fully understand the change in how the Fed will react to inflation under this policy framework – from proactive to reactive, and from ahead of the curve to behind it on purpose. The Fed will delay tightening until the achievement of full employment, which involves putting to work the more than 8 million unemployed Americans who lost their jobs during the pandemic.

So overall, we don't expect this recent sell-off in the bond market to continue. We're forecasting 10 year bond yields to be at slightly lower levels in 12 months as we move through what may be a point of maximum optimism for growth this year. Looking at similar periods since the financial crisis where 10 year U.S. Treasury yields rose 100 bps, the one year returns going forward from that point were always positive.



Source: RBC GAM & Bloomberg. Chart illustrates the return experiences in the 12-month period following rapid 10-year Treasury selloffs of 100bps since the Global Financial Crisis. Dates reflect when the 100 bps threshold was met, or day 0.

Thinking long term and the importance of diversification

Periods of rising bond yields can be painful in the short term for bond investors. However, higher bond yields today mean that the return prospects for bonds going forward are better today than six months ago. So long term investors can ultimately benefit from this rise in yields through higher future returns.

While returns for long sovereign bonds have been hit the hardest this year, other sectors of the fixed income market have done better, highlighting the benefit of diversification. Within our portfolio solutions, we have been able to mitigate some of the downside losses in fixed income through global diversification, shorter duration, multi-credit allocation and active management. These portfolios remain well positioned to weather these times of rate volatility while continuing to provide their traditional role of income, equity diversification and liquidity.

Publication date: April 9, 2021