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RBC WEALTH MANAGEMENT

GLOBAL INSIGHT

SPECIAL REPORT

# Bond Market Fireworks

Fireworks have lit up bond markets this spring. Following the recent selloff, where are yields heading next?

Rajan Bansi

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# Bond Market Fireworks

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It has been a whirlwind spring in global bond markets. The ECB's massive QE program has had global spillover effects, but secular forces could keep a lid on how high yields can rise. In an enlightening interview, our head of fixed income strategies makes sense of the intense volatility that has characterized the market. He tells us what may influence the Bank of Canada's use of its toolbox and where interest rates are heading.

### Q. Recently, government bond yields have risen sharply. What have been the primary drivers in your view?

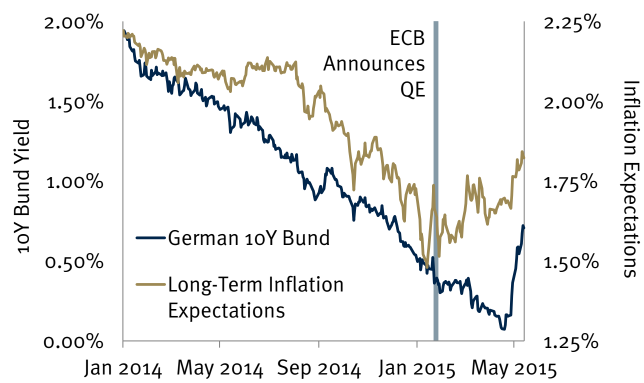
**A.** We can categorize the primary drivers as either fundamental or technical. Fundamental drivers are associated with the pace of economic growth or inflation, while technical drivers are related to the supply or demand of bonds at a particular point in time. The increase in yields we saw in April was primarily technical in nature as there wasn't enough fundamental economic data that would justify a move of that magnitude. Arguably, the bond selloff we saw in early June was a mix of technical factors as well as fundamental ones, given eurozone inflation showed an annual increase for the first time in six months and the most recent U.S. employment report was strong.

### Q. Can you be more specific about what you mean by "technical in nature?"

**A.** Sure. A bond is similar to any other marketable security in that its price is determined by supply and demand. Fundamental factors (growth and inflation) influence pricing, but so do investor demand, issuer supply, and overall sentiment (technical factors).

Since the start of 2015, there has been very strong demand for government bonds across the globe, including debt issued by the Government of Canada. Evidence of lower inflation and growth was partly behind this, but so was the European Central Bank's (ECB) quantitative easing (QE) program.

**European Inflation Expectations Reverse Course**




Source - RBC Wealth Management, Bloomberg; Long-term inflation expectations based on 5-year, 5-years forward swaps

**Playing catch-up? Rising inflation expectations is just one factor contributing to higher yields.**

# *Bond Market* Fireworks

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We don't think one can overemphasize the role of the ECB's asset purchase program in the rally in government bonds across the globe earlier this year. Recall that in March, the ECB began purchasing bonds at a pace of €60B per month, and it plans to continue doing so at this pace until at least September 2016. That represents one critical source of demand for bonds.

In addition, many institutional investors, especially hedge funds, placed very aggressive "bets" on government debt in Europe, given the ECB's program allowed it to buy bonds so long as they yielded above -0.2%. This was an additional source of demand for bonds. At the same time, there wasn't an overwhelming amount of supply, as some investors that owned bonds simply didn't want to sell and there wasn't much in the way of new issuance.

This supply/demand dynamic set the stage for a powerful rally that was almost certain to overshoot in the short term … and it did. The yield on the German 5-year, which was 0.47% in June 2014, slid all the way down to less than zero in April (hitting -0.15%). It currently sits at 0.15%, a level still representing a huge rally from where we were a year ago. But, at the same time, it also represents a significant selloff from where we were in April. And this was not just a Europe phenomenon, as most government bond markets, including the U.S. and Canada, experienced similar strong rallies followed by recent selloffs. It is true that the growth and inflation profiles of Europe and the U.S. have changed since early 2015, but those two factors on their own cannot explain the recent move in yields.

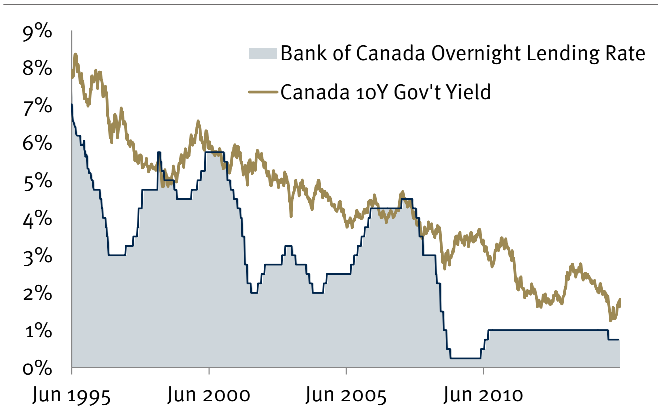
### Q. So, eurozone QE didn't just impact European debt markets?

**A.** Exactly. We saw the same thing happen with U.S. QE as these massive programs have pretty meaningful spillover effects that are global in nature.

### Q. I have a two-part question regarding the future of interest rates in Canada. Where do you see rates in 12 months, and where do you see rates in 5–10 years?

**A.** The common theme in our answer would be that we look for rates to be higher in both cases, but probably not as high as most people think. We need to frame our expectations with regard to interest rates and acknowledge that rates represent the

**Terminal Policy Rates & Peak 10-Year Yields**




Source - RBC Wealth Management, Bloomberg

Each tightening cycle has seen lower peaks for policy rates and 10Y yields—we see that continuing.

reality at a point in time. While we saw much higher interest rates in the 1980s and 1990s versus current levels, this fact on its own is not a guarantee rates will ever return to those levels.

The most difficult call is with regard to rates over the next 12 months. The Bank of Canada (BoC) sounded balanced in its most recent assessment. Should growth show clear signs of picking up, a rate hike of 25 basis points (bps) to reverse the cut we saw earlier this year is likely. But, such a hike, were it to occur, would likely be in 2016, and for the rest of the year, we would expect the BoC to be on hold. Should growth falter or inflation fall significantly from current levels, another rate cut isn't out of the question, which is not our base case. Across the yield curve, a strong argument can be made that bond yields accurately reflect growth and inflation and any further move higher is likely limited to something in the 25 bps range.

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Over the long term, we believe rates will certainly go higher from current levels, but we think we will see yield levels well below what we saw in the 1980s and 1990s. There are a lot of reasons for this, but one of the most important drivers is demographics. An aging population, which is what we have in Canada (and in the U.S., U.K., Europe, Japan, and China too), borrows less (reducing supply of bonds) but invests in fixed income more to preserve capital (increasing demand for bonds), which likely keeps yields lower than they otherwise would be.

Let's also consider the disinflationary role of technology. It seems every day there's a new disruptive "app" that provides consumers with greater choice to experience a service, such as taking a taxi or renting a vacation home, in a manner that saves them money. This is as disinflationary as it is amazing. But, there's more. Think about how 3D printing could revolutionize manufacturing and how robotics already has. All of these factors drive inflation lower, which will also work to keep bond yields in check. One wild card is, of course, energy prices.

I realize I haven't answered your question yet with regard to the long term. We don't think a comparison to the 1990s in Canada is relevant because of how different the fiscal situation was at that time. Instead, the tail end of the last economic cycle (in 2006) is more relevant. The yield on the Canadian 10-year peaked around 4.50% towards the end of the last cycle, and this time we think it will peak at around 3.50%. Similarly, the overnight rate is likely to peak around 3.00% or 3.25% in this cycle, which would also be about 100 bps below its prior cycle peak.

**Q. Thanks for your time.**

**A.** You're welcome.

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|---|---|---|---|---|
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| Hold [Sector Perform] | 713 | 41.05 | 125 | 17.53 |
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