GLOBAL
Insight
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RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

November 2, 2023

Bond math is more than yield

Thomas Garretson, CFA – Minneapolis

Following key events this week, we look at whether the time has finally come for fixed income investors to look beyond yield, and to the prospects of bond price appreciation and potentially lofty total returns.

This may have been one of the most important and significant weeks for global fixed income markets, and perhaps markets generally, in recent months ... even though not much actually happened.

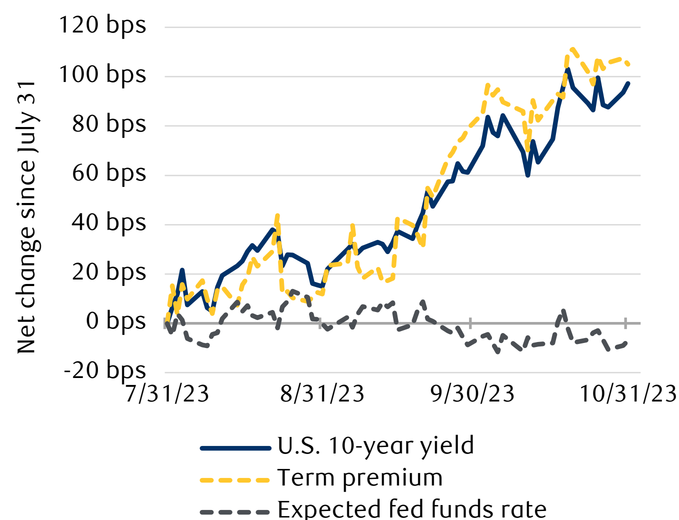
Of course, things did happen, but really only on the fringes. Yet it was enough to seemingly change the entire narrative that has prevailed over markets since central banks began their respective aggressive rate hike campaigns.

A tantalizing trifecta

There were three key events this week: the Bank of Japan's (BoJ) meeting; the U.S. Treasury Department's Quarterly Refunding Announcement; and the Federal Reserve's Nov. 1 meeting.

Markets feared the BoJ was on the cusp of abandoning its yield curve control program, which has capped the level at which policymakers would allow the 10-year Japanese government bond yield to rise before intervening at one percent. That cap was removed, but only softly so. It is now simply a reference level around which the central bank will operate with "flexibility." But with BoJ Governor Kazuo Ueda stating explicitly that he didn't expect yields to rise much further than one percent, it remains at least a soft cap. And that mattered for the second event. Rising domestic yields in Japan could cause domestic investors there to repatriate cash—largely held in U.S. Treasuries,

Deconstructing the 10-year Treasury yield: Drivers of higher yields matter to the Fed



Source - RBC Wealth Management, Bloomberg; term premium and expected fed funds rate based on Adrian, Crump & Moench model, data through 10/31/23

and a key source of foreign demand—to the Japanese market.

And that fading demand for U.S. Treasuries sets the stage for the Treasury Department's funding needs over the next three months, in our view. It was back in early August when the Treasury Department announced

For perspectives on the week from our regional analysts, please see pages 3–4.

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Priced (in USD) as of 11/1/23 market close (unless otherwise stated). Produced: 11/2/23 4:16 pm ET; Disseminated: 11/2/23 4:22 pm ET

greater financing needs on the back of rising deficits, largely due to lower-than-expected tax receipts and falling remittances from the Fed as it marched forth with quantitative tightening. The result was bigger increases to longer-dated Treasury auctions, particularly for the 10-year note and 30-year bond.

That surprise has largely contributed to the ongoing rise in Treasury yields, with the yield on the benchmark 10-year note briefly exceeding five percent in October, having traded below four percent just prior to the Treasury Department's announcement. The chart on the previous page shows a model of the 10-year Treasury yield broken down into two simple components: the market's expectations for the path of the fed funds rate, and the embedded term premium—or the yield demanded by investors for the various perceived risks of holding longer-dated bonds, including more supply and less demand. The roughly 100 basis point rise in the 10-year Treasury yield since July 31 has been entirely explained by the term premium; the expected path of the Fed's policy rate has actually declined slightly.

And that rise in yields driven by term premiums set the stage for the Fed. Higher yields, falling stock prices, and dollar strength since August have fueled starkly tighter financial conditions, to some of the tightest levels of the past year, even though the Fed has only raised rates once in the past six months. Policymakers highlighted tightening financial conditions in their policy statement. This comes at a time when Fed officials largely believe that rate hikes to this point are only just beginning to bite on economic activity. Tightening financial conditions also act with a lag on the economy, with those two factors potentially acting as a double headwind. Fed Chair Jerome Powell struck a more cautious tone than he has in some time, likely as a result. We maintain our view that the Fed is done with rate hikes, but now with only greater conviction.

Given swelling optimism, the S&P 500 has gained 4.7 percent since Oct. 27, while the 10-year Treasury note yield has now fallen around 32 basis points from the October high to 4.67 percent.

Off the short end

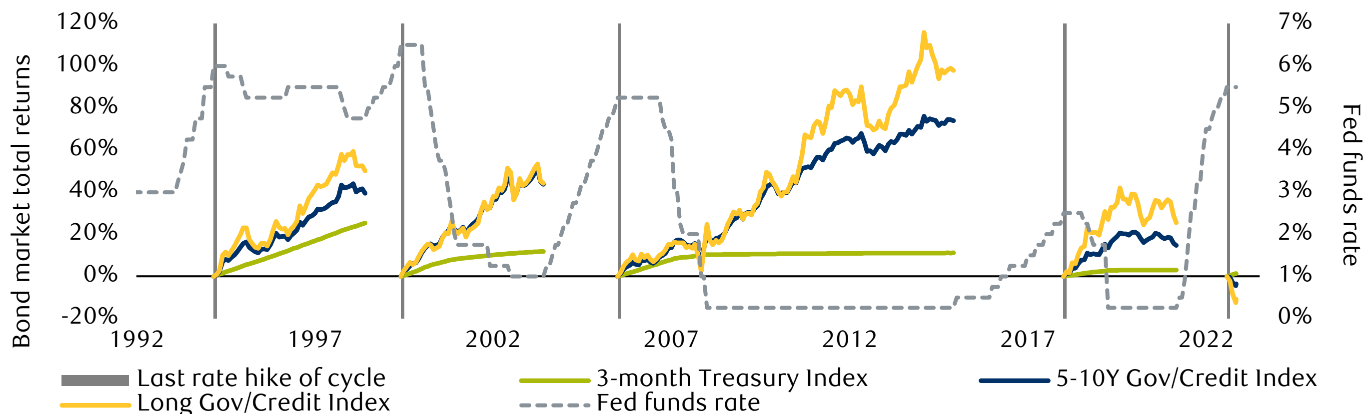
With even greater confidence that the Fed has indeed delivered the final rate hike of this cycle back in July, we believe it's time to take portfolio positioning more seriously as markets turn their focus to the next phase of the cycle.

Since the Fed began raising rates in March 2022, being in cash, money market funds, or short-dated Treasury bills has clearly been the optimal strategy. Over that stretch, the Bloomberg U.S. Treasury Bellwethers 3 Month Total Return Index has gained 5.8 percent, whereas the Bloomberg U.S. Long Gov/Credit Index has dropped a significant 24.1 percent.

The chart below may look convoluted, but it tells a simple and perhaps unsurprising story: when the Fed is done raising rates, bonds start to perform. And often handsomely so. But, in our view, it also shows that it could mark the point at which investors should start exiting bond positions in short-dated securities in favor of intermediate and longer-dated bonds. In all previous cycles, the last Fed rate hike has marked the point at which bonds with more duration—or interest rate risk—outperform cash and cash equivalents.

The bond math is simple: the average yield on the Bloomberg 5-10Y Gov/Credit Index is currently 5.4 percent, with an average dollar price far below par at just $87. When markets fully price not just the end of rate hikes, but the timing of the first rate cut, yields would likely fall, and bond prices—which move inversely to yields—would rise. That price appreciation on top of coupons earned would only amplify total returns. On the flip side, we think reinvestment risk exists from staying too short and rolling over short-dated bonds into an ever-lower yield environment. It's still early days, but if the Fed's July rate hike does prove to be the last, then recent market action has been at odds with history. Recent negative bond performance presents appealing entry points, and we think the intermediate 3- to 10-year part of the yield curve offers the most attractive risk/reward tradeoff at the moment.

Fixed income duration strategy after the last Fed rate hike



Source - RBC Wealth Management, Bloomberg U.S. Gov/Credit Bond indexes; data through 11/1/23

UNITED STATES

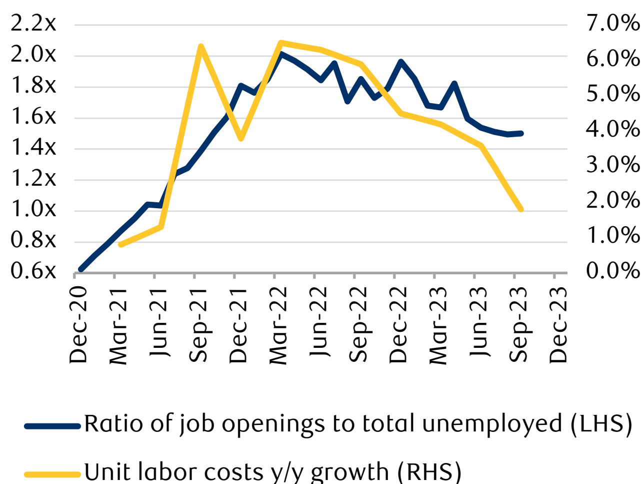
Alan Robinson – Seattle

- **U.S. stocks entered November on a strong footing** after posting monthly declines in August, September, and October—the first three consecutive months of declines since the COVID-19 pandemic. Investors adopted the "bad news is good news" mantra, as generally weaker economic data implied tamer inflation and lower interest rates were likely ahead. Commentary from Fed Chair Jerome Powell was also perceived as dovish, encouraging risk-on behavior.

- **The benchmark S&P 500 Index posted its strongest four-day rise of the year** through midday Thursday, after having entered correction territory the prior week, down 10% from its July peaks. The rise was also supported by very negative sentiment indicators at the start of the week that triggered contrarian buy signals. Seasonality helped, as November and December have historically been the best two-month period for stocks, often driven by corporate buyback windows reopening as earnings season progresses. RBC Wealth Management Inc. Technical Strategist Robert Sluymer noted that stocks rebounded off important technical support during the week, suggesting broader upside participation is possible for stocks through Q4 2023 and into Q1 2024.

- **With over two-thirds of S&P 500 companies having reported Q3 2023 earnings by midweek, results appeared to be "good enough."** Analyst consensus now expects 4% q/q earnings growth for the quarter, which would end the streak of three consecutive quarters of earnings declines for the index as a whole. However, guidance for the next few quarters was subdued, with management teams expressing concerns over a potential recession in 2024.

Key labor market indicators turning lower, labor costs now below inflation target



Source - RBC Wealth Management, FactSet, U.S. Bureau of Labor Statistics; monthly data through 9/30/23 (reported 11/2/23).

- **Weaker-than-expected economic data reported during the week** included ISM manufacturing surveys, consumer expectations, and a weak ADP jobs report ahead of the key monthly nonfarm payroll report to be released on Nov. 3. One bright spot came from better-than-expected productivity gains, up an annualized 4.7% q/q in Q3. But closer analysis reveals this result was driven by decelerating unit labor costs; combined with steadily declining jobs postings (see chart), this suggests to us that moderating wage gains are likely to dampen inflation in the new year.

CANADA

Josh Nye & Luis Castillo – Toronto

- **Canada's economy is slowing**. The preliminary September GDP estimate shows Canada's economy failed to grow for a fourth straight month. Higher interest rates are taking a toll on highly indebted households with retail and home sales declining for three straight months. GDP has been flat or down in three of the past four quarters with a productivity slowdown offsetting strong population and employment growth. Slower growth has cooled Canada's previously overheating economy with the Bank of Canada (BoC) noting supply and demand are nearing better balance, although the labour market is still tight. Wage growth also remains too strong, and disinflationary momentum has been slower than expected despite softening demand. Sluggish growth is expected to persist over the next year, causing some excess supply to emerge, which should help bring inflation back down to target. Until there is clear evidence that core inflation is slowing, we think the BoC is unlikely to entertain the notion of rate cuts.

- **The slowing economy is reflected in the loonie**. Short-term interest rate differentials (the difference between interest rates of one country versus another country) have historically played a role in currency fluctuations, promoting flows to a country's higher-yielding currency from yield-seeking investors. A U.S. economy hitting significantly higher GDP growth numbers relative to Canada has created an expectation that the Canadian economy may not be able to sustain the pace of financial tightening delivered by the Federal Reserve for much longer. This has led short-term Canadian rates to drop more precipitously than U.S. rates over the past couple of weeks. This rate advantage in the U.S. relative to Canada has reached its highest level since April, pulling the Canadian dollar towards some of its lowest levels relative to the U.S. dollar since late 2022. We expect this dynamic to continue as higher inflation expectations in the U.S. relative to Canada will likely warrant a more hawkish posture from the Fed relative to the BoC. With the Canadian consumer significantly more indebted than their U.S. neighbor, we see a relatively shorter runway for additional rate hikes in Canada.

EUROPE

Rufaro Chiriseri, CFA – London

- **The Bank of England (BoE) voted 6-3 in favour of keeping the bank rate unchanged at 5.25%**, in line with our expectation, on Thursday—marking the second consecutive pause this hiking cycle. The BoE's decision and forward guidance echoed similar pauses by the U.S. Federal Reserve and the European Central Bank. A small but significant addition in the Monetary Policy Committee's (MPC) statement indicated policy rates will be at these levels "for an extended period of time." We think this suggests a central bank that wants to push back on current market pricing of interest rates being cut by nearly 25 basis points (bps) by September 2024. **BoE Governor Andrew Bailey stated that policymakers cannot become complacent on inflation** and if they maintain this policy stance for long enough, they "will squeeze inflation." While the MPC's statement leaves a hiking optionality, we think the bar remains high for further hikes and this is likely the peak for interest rates, absent any persistent large surprises in inflation or wage data. Bond markets reacted positively as the 10-year Gilt rallied by around 12 bps to reach 4.37%, while the pound sterling bounced against the U.S. dollar to 1.2225 before falling to 1.2170.

- Compared to the estimates found in the central bank's August Monetary Policy Report (MPR), **the November MPR forecasts GDP growth will deteriorate further and be flat in Q3. However, growth is expected to modestly recover to 0.1% in Q4**. The MPR forecasts inflation to fall significantly in October when the effect of the energy regulator's (Ofgem) price cap is reflected in the data. The BoE projects inflation to average around 4.6% in Q3 2023, slightly below the August forecast, before falling to 2% by the end of 2025.

- **Euro area GDP contracted by 0.1% in Q3**, in line with the recent decline seen in economic activity data. **However, euro area inflation is heading in the right direction**—both preliminary headline and core inflation fell in October to 2.9% and 4.2%, respectively. The drop was driven by a combination of lower energy prices and base effects on the year-over-year calculation from October last year.

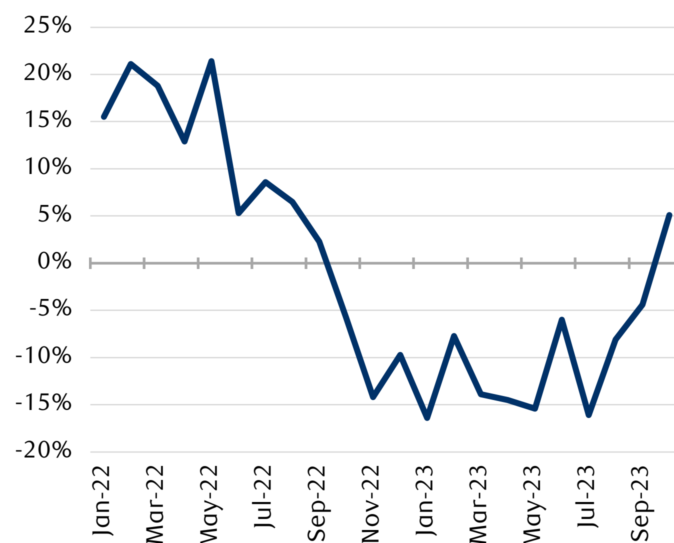
ASIA PACIFIC

Emily Li – Hong Kong

- **South Korea's exports rose for the first time since late last year. Not only does this point to a favorable outlook for the nation's economic growth, we think it also suggests global demand is displaying resilience**, given South Korea's role as a key exporting country. Exports in October increased by 5.1% compared to the previous year. Adjusting for working-day differences, average daily shipments also saw a notable increase of 7.6%. This improvement is likely to instill confidence among policymakers that South Korea's economic growth will be in line with their forecasts for this year, and growth may be even better next year if international and domestic demand remains resilient or strengthens.

South Korea's exports recorded positive growth for the first time since late last year

South Korea's exports year-over-year growth



Source - RBC Wealth Management, Bloomberg; data range January 2022 to September 2023

- **China's factory activity declined in October, returning to a state of contraction, while the expansion of the services sector unexpectedly slowed**. This indicates to us that the overall economy remains fragile and requires policy support. The official Manufacturing Purchasing Managers' Index fell to 49.5 in October from 50.2 in September, according to the National Bureau of Statistics. It's important to note the data is influenced by seasonality, primarily due to an eight-day public holiday at the beginning of October. However, it also reveals that manufacturing demand continues to be weak.

- **HSBC Holdings plc (5 HK) announced a fresh buyback program** covering an additional US$3 billion of its shares, taking total stock repurchases for the year to US$7 billion, despite Q3 results missing market expectations.

- **Ping An Insurance Co. (2318 HK) announced profits fell** 5.6% y/y for the first nine months of the year, hurt by market volatility and rising costs.

- **Kweichow Moutai Co. (600519 CH)**, a leading Chinese liquor company, **has regained prominence in China's equity market as it recently emerged as the most traded stock**. On Wednesday, turnover exceeded 16 billion yuan, marking the highest level in a year.

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,237.86	1.1%	10.4%	9.9%	-8.1%
Dow Industrials (DJIA)	33,274.58	0.7%	0.4%	1.9%	-7.3%
Nasdaq	13,061.47	1.6%	24.8%	19.9%	-16.3%
Russell 2000	1,669.70	0.4%	-5.2%	-9.8%	-29.2%
S&P/TSX Comp	19,079.00	1.1%	-1.6%	-2.2%	-10.2%
FTSE All-Share	3,967.55	0.3%	-2.6%	1.0%	-4.5%
STOXX Europe 600	436.57	0.7%	2.7%	5.3%	-8.8%
EURO STOXX 50	4,091.71	0.8%	7.9%	12.1%	-4.4%
Hang Seng	17,101.78	-0.1%	-13.5%	10.7%	-32.0%
Shanghai Comp	3,023.08	0.1%	-2.1%	1.8%	-14.7%
Nikkei 225	31,601.65	2.4%	21.1%	14.2%	6.6%
India Sensex	63,591.33	-0.4%	4.5%	4.0%	5.7%
Singapore Straits Times	3,076.77	0.3%	-5.4%	-1.7%	-4.4%
Brazil Ibovespa	115,052.96	1.7%	4.8%	-1.6%	9.0%
Mexican Bolsa IPC	49,787.84	1.5%	2.7%	-2.1%	-3.6%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.734%	-19.7	85.9	69.2	317.8
Canada 10-Yr	3.921%	-14.3	62.1	67.4	217.3
UK 10-Yr	4.499%	-1.3	82.7	102.9	343.7
Germany 10-Yr	2.764%	-4.2	19.3	63.3	286.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	5.65%	0.0%	-2.8%	0.1%	-15.3%
U.S. Investment-Grade Corp	6.35%	0.0%	-1.9%	2.4%	-17.2%
U.S. High-Yield Corp	9.49%	0.0%	4.6%	6.1%	-6.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,982.72	-0.1%	8.7%	20.3%	10.6%
Silver (spot $/oz)	22.95	0.5%	-4.2%	16.9%	-4.6%
Copper ($/metric ton)	8,029.00	0.0%	-4.0%	4.0%	-19.7%
Oil (WTI spot/bbl)	80.44	-0.7%	0.2%	-9.0%	-4.3%
Oil (Brent spot/bbl)	85.02	-2.7%	-1.0%	-10.2%	0.4%
Natural Gas ($/mmBtu)	3.49	-2.3%	-21.9%	-38.9%	-32.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	106.6630	0.0%	3.0%	-4.3%	13.6%
CAD/USD	0.7218	0.2%	-2.2%	-1.6%	-10.7%
USD/CAD	1.3854	-0.2%	2.2%	1.6%	12.0%
EUR/USD	1.0569	-0.1%	-1.3%	7.0%	-8.9%
GBP/USD	1.2148	0.0%	0.5%	5.8%	-11.1%
AUD/USD	0.6395	0.9%	-6.1%	0.0%	-15.0%
USD/JPY	150.9300	-0.5%	15.1%	1.8%	32.4%
EUR/JPY	159.5400	-0.5%	13.6%	9.0%	20.6%
EUR/GBP	0.8701	0.0%	-1.7%	1.2%	2.4%
EUR/CHF	0.9590	-0.4%	-3.1%	-2.9%	-9.1%
USD/SGD	1.3683	-0.1%	2.2%	-3.3%	1.5%
USD/CNY	7.3160	0.0%	6.1%	0.5%	14.4%
USD/MXN	17.7710	-1.5%	-8.9%	-10.0%	-14.7%
USD/BRL	4.9555	-1.6%	-6.2%	-3.7%	-12.9%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

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Source - Bloomberg; data as of 11/1/23

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			Investment Banking Services Provided During Past 12 Months	
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