

The short-term thinking driving long-term bonds

Atul Bhatia, CFA – Minneapolis

The recent rise in longer-term U.S. Treasury yields, despite an economic backdrop that looks supportive for the asset class, has given rise to a range of theories. We examine supply and demand forces in the bond market, and discuss what the current situation could mean for individual investors with long investment horizons.

Recent fundamental data on the U.S. economy is mostly supportive for long-term bonds, in our view. Inflation is down from 2022 levels, consumer balance sheets are growing more fragile, and U.S. budget growth appears likely to slow, while the Federal Reserve has indicated that interest rates are unlikely to rise further and that price stability will take precedence over growth considerations when it comes to cutting. All in all, we believe the emerging picture of slower growth with an anti-inflation central bank should be good for government securities with long-term maturities.

But markets have been marching to a different drummer, with yields on 30-year Treasuries rising sharply in September. While various theories have been put forward to explain the price move, we think the answer is a simple—and, in our view, temporary—lack of available risk appetite for longer government debt.

For individual investors who are saving for their children's college or their own retirement, we believe today's fixed income opportunities should serve as a compelling reminder of the power of a long-term time horizon.

The usual suspects

Before delving into our view of what is behind the recent price action, it's worth dealing with some of the other theories we've heard.

Higher inflation is frequently cited, but that explanation is inconsistent with other market signals. The Fed's preferred measure of medium-term inflation expectations has barely budged in September, with a trivial 10 basis point rise in the 5y5y inflation swap (a market-derived measure of annual expected inflation between 2028 and 2033). In addition, the market's direct projection of inflation over 30 years—the yield differential between fixed-rate and inflation-adjusted government bonds—has likewise moved only a fraction of the overall change in yields. We think it's hard to argue that markets are spooked by inflation while investors forego “easy money” from inflation-linked investments.

Another idea we hear floated is that default fears driven by rising U.S. debt levels are pushing investors out of longer bonds. But that view ignores both the strengthening dollar and still-high global stock prices. In addition, Japan's experience, with debt-to-GDP ratios routinely twice that of the U.S., is a contemporaneous counterexample of low bond yields and high debt.

The real culprit

We think the biggest driver of the shift higher in yields is simply the lack of available risk appetite among the investors who have historically been key buyers of the asset class.

For perspectives on the week from our regional analysts, please see [pages 3–4](#).

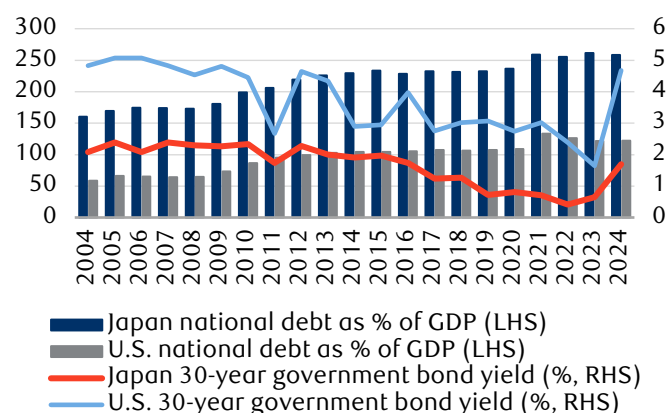
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Bonds on both sides of Pacific ignore debt levels

Japan has a higher debt ratio and lower 30Y yield than the U.S.



Source - RBC Wealth Management, International Monetary Fund, Bloomberg; debt-to-GDP values for 2024 are based on IMF projections and bond yields reflect 9/26/23 closing levels

The largest holders of Treasuries are the Fed and overseas institutions. The Fed is currently engaged in quantitative tightening, and thus intentionally allowing its Treasury holdings to decrease. China's policy is less transparent, but the country's demand for U.S. government bonds has traditionally been linked to its policy of buying dollars. Recent news reports indicate the Chinese government has switched to supporting the yuan, potentially leaving China a net seller of dollars, and likely Treasuries as well. Outside of China, currency-adjusted Treasury yields are far from compelling for Japanese investors.

Other so-called natural buyers of longer-maturity bonds, including pension funds and individual investors, have already made large moves into the asset class and are seeing marked-to-market drawdowns. Even investors who share our view on the strong long-term fundamentals supporting bonds may not have space left in their asset allocations to add here.

When there is a dislocation between market forces of supply and demand, we normally expect faster-moving leveraged investors like hedge funds to fill the void. We can think of several reasons why that may not be happening now.

First, the inverted yield curve means buying longer-maturity debt is expensive for these traders, because they pay more on borrowed funds than the bonds generate in income. That situation, known as negative carry, is abhorrent to most traders. Longer maturities are also volatile, and since institutional traders' performance is often measured by volatility-adjusted returns, adding an asset with lower yields and higher volatility is a potential double hit. This is especially impactful on risk appetite as we approach Q4, when many institutional investors look to protect returns heading into the end of the year.

It is critically important, in our view, for investors to remember that these types of dislocations often end with

a sharp reversal—either when the risk constraint clears, or when prices reach a point where the risk-reward is too compelling to ignore.

Fundamentals eventually drive valuation, in our experience, and we think bond fundamentals look strong.

The case for bonds

To start, the Fed appears to be winning the war on inflation. With inflation well below last year's levels, we believe the central bank will maintain its resolve even if growth slows and unemployment rises. Central banks and their leaders, after all, are ultimately judged largely on their ability to achieve price stability, and we think that gives policymakers the institutional and personal incentives to sustain restrictive policy as long as necessary.

In terms of growth, the dynamism of the pandemic era is fading. As of this writing, the U.S. government is approaching a potential shutdown; even if the government remains open, we think expansionary changes in fiscal policy are highly improbable in the near term. Corporations are also unlikely to spend aggressively, as more and more companies need to refinance pandemic-era debt at today's higher rates.

Consumer spending—the largest component of the U.S. economy—is also under pressure. A recent Fed report found that only the top 20 percent of households by income have any remaining pandemic savings. Lower-income households are thus facing larger credit card balances, more expensive debt servicing, higher gas prices, and the imminent resumption of student loan payments with little or no excess cushion.

That leaves the growth outlook dependent on employment. Labor markets have outpaced consensus expectations for some time, but there are initial signs of softening in both hard data and anecdotal reports. More generally, the increasingly narrow base of growth leaves markets susceptible to a potential bond-positive growth scare, in our view.

Finally, we think bond valuations are attractive both in absolute terms and relative to equities, a topic we discussed in detail in a recent [article](#).

Is time on your side?

Institutions are forced to think about portfolio returns over artificially short time horizons—often as little as three months, and rarely more than a year. Individual investors, on the other hand, typically have only one or two key dates in mind, and these are often years or decades in the future. This gives the individual huge power to look for assets that are attractively priced over the medium term, even if the short-term outlook is hazy or negative. In our view, that describes today's fixed income market in a nutshell.

UNITED STATES

Michael Roedl – Minneapolis

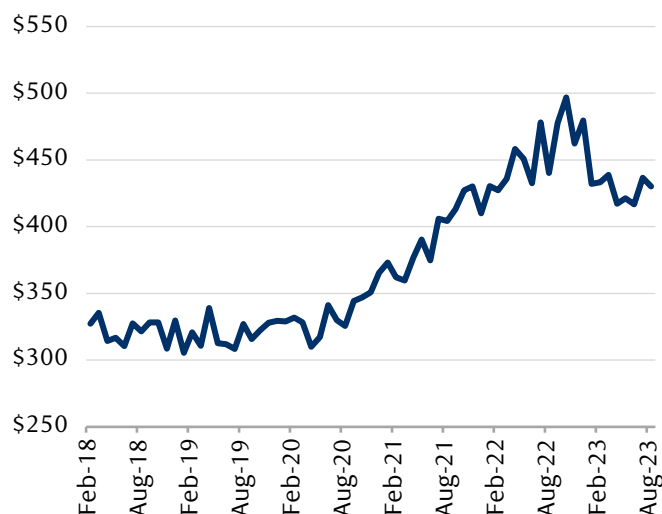
■ **New home sales in the U.S. dropped to a five-month low in August**, as historically elevated mortgage rates and persistently high prices continued to weigh on housing demand across the country. Purchases of new single-family homes plunged 8.7% to an annualized monthly pace of 675,000, the largest drop since September of last year. Homebuilders are actively offering incentives to help offset these challenges, but mounting headwinds for the American consumer are keeping many prospective homebuyers on the sidelines. According to a report from the Census Bureau, the median sales price for new homes is edging lower at \$430,300, although current prices remain well above pre-pandemic levels.

■ **U.S. consumer confidence fell to a four-month low in September against a backdrop of rising prices**, most notably food and gasoline costs. Even though recent data suggests an economic soft landing is potentially on the table, Americans appear increasingly preoccupied with concerns about their finances and employment prospects. While resiliency in the labor market has helped support wages, hiring activity is losing pace and job cuts are on the rise in certain areas of the economy.

■ In a market of rising interest rates and generally poor fixed income performance across the board this year, leveraged loans have been one of the few bright spots, with total returns in the asset class hovering around 10% year to date. Investors largely shunned leveraged loans last year, but ongoing economic resilience is fueling appetite for the sector; elevated short-term rates have made the floating-rate instrument more popular, with yields approaching double digits, according to the

U.S. home prices are drifting lower, but remain well above pre-pandemic levels

Median sales price (in thousands)



Source - RBC Wealth Management, Bloomberg; data through 8/31/23

Morningstar US Leveraged Loan Index. **In our view, leveraged loans are an area where risk-tolerant investors may find near-term value, although we remain cautious on our long-term outlook** as the asset class can be susceptible to default risk during economic downturns.

CANADA

Estefani Ayazo, CFA & Sean Killin – Toronto

■ **Investors are awaiting the release of Canada's Gross Domestic Product (GDP) for July alongside preliminary August data.** The report is expected to provide insights into how the economy has held up, given the lingering effects of wildfire-related disruptions and labour turmoil in federal civil services. With higher interest rates softening growth momentum, Statistics Canada has forecast stagnant growth in July. Real GDP growth in Q2 2023 came in at an annualized -0.2%, below the +1.2% consensus estimate. A higher unemployment rate and softer job creation are also producing headwinds to growth in Q3. On the other hand, retail sales rebounded 2.0% y/y in July after contracting 0.6% y/y in June, suggesting household spending remains resilient despite higher borrowing costs. Amid the opposing forces of weaker labour market trends and resilient consumption, RBC Economics has forecast a 0.5% annualized GDP decline in Q3.

■ **Resilient Canadian economic activity supported business optimism earlier this year, but recent trends have changed the tone** as higher interest rates and still-elevated inflation have seemingly had their impact on the corporate outlook. The Canadian Federation of Independent Businesses' (CFIB) monthly business barometer, a survey-based measure that reflects business owners' expectations for their firms' performance over the next 12 months, fell 6.0 points to 48.7 in September. This is the first time since the pandemic that the monthly survey came in below 50.0, indicating that most owners are pessimistic on the outlook for their businesses. A shortage of skilled labour and insufficient domestic demand were the largest factors in play limiting sales and production growth. As the cost of capital rises, working capital shortages are another major headwind to production growth. Energy and wage costs drove the majority of respondents' cost constraints.

EUROPE

Frédérique Carrier – London

■ **The UK's S&P Global/CIPS Composite Purchasing Managers' Index (PMI) sank to its lowest level, 46.8, since the onset of COVID-19.** The survey also indicated that employment is deteriorating at the fastest pace since that time.

■ With such dispiriting economic news, **markets pared back their expectations for another Bank of England rate increase**, and they are now pricing in a less-than-50% probability of an increase at the next meeting in November. This and the fear of recession conspired to weaken the pound further, to 1.22 versus the U.S. dollar.

■ **However, the FTSE 100 at 3.1% and FTSE All-Share at 2.6% have outperformed the S&P 500 (-3.6%) and MSCI World (-3.2%) over the past month.** We attribute the outperformance to the pound weakening, which mitigates an important headwind for equities given that companies in the indexes generate the majority of their revenues abroad. Moreover, the UK's blue-chip equity index, the FTSE 100, typically outperforms when value stocks outperform growth stocks given the index's bias to "old economy" industries such as energy, mining, and banks. This dynamic has been supportive recently, with rising oil prices helping to buoy the Energy sector.

■ **Economic news across the Channel is not much better.** Euro area bank lending to corporations fell 0.4% m/m in August on a seasonally adjusted basis. This suggests to us that weak economic activity and higher interest rates will crimp business investment in the short term. By contrast, household borrowing ticked up marginally over the same period, though it has slowed markedly compared to before the European Central Bank started to increase interest rates.

■ **Economic indicators confirm a cautious prognosis for the eurozone economy.** While no longer deteriorating, and beating consensus expectations, the HCOB (Hamburg

Commercial Bank) Composite PMI remains in contraction territory.

ASIA PACIFIC

Emily Li – Hong Kong

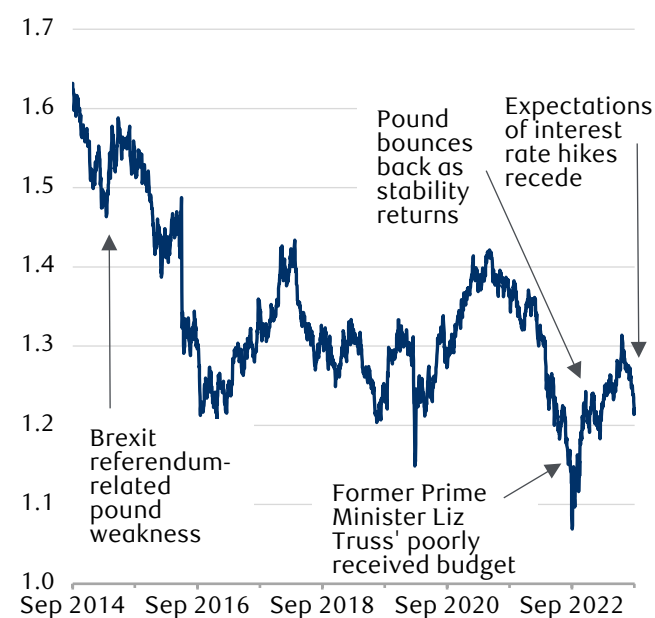
■ **Cainiao Smart Logistics Network Ltd., the logistics unit of Alibaba Group Holding Ltd. (9988 HK), filed for its Hong Kong initial public offering on Sept. 26.** CITIC Securities, Citigroup, and JPMorgan Chase are joint sponsors, according to the prospectus. Cainiao could potentially become the first unit of Alibaba to go public since Alibaba's restructuring announcement. The IPO could raise at least US\$1 billion, according to Street projections. Alibaba intends to retain more than 50% of the unit's shares and keep Cainiao as a subsidiary, according to the filing.

■ **Tesla Inc.'s (TSLA US) China subsidiary is under an anti-subsidy probe by the European Union.** The objective of the investigation is to assess the extent to which Tesla and domestic manufacturers in China, including BYD Co. (1211 HK), SAIC Motor Corp. (600104 CH), and Nio Inc. (NIO US), have received subsidies, with the aim of determining the need for appropriate countervailing measures. The measures are intended to create a fair competitive environment for the EU's EV industry, based on news reports including the Financial Times. TSLA US's share price dropped by low-single digits after the announcement of the investigation.

■ **China Evergrande Group (3333 HK) has cancelled key creditor meetings scheduled for the upcoming week and has expressed the need to reevaluate its proposed restructuring plan.** This development introduces additional uncertainty to what could potentially be one of the most significant restructuring processes in China's recent history. On Sept. 28, the company, along with its property services and electric vehicle units, suspended trading in Hong Kong, following a Bloomberg report about founder Hui Ka Yan being taken away by police.

Pound weakens again

Pound sterling versus U.S. dollar



Source - RBC Wealth Management, Bloomberg; data range: 9/25/14 - 9/25/23

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