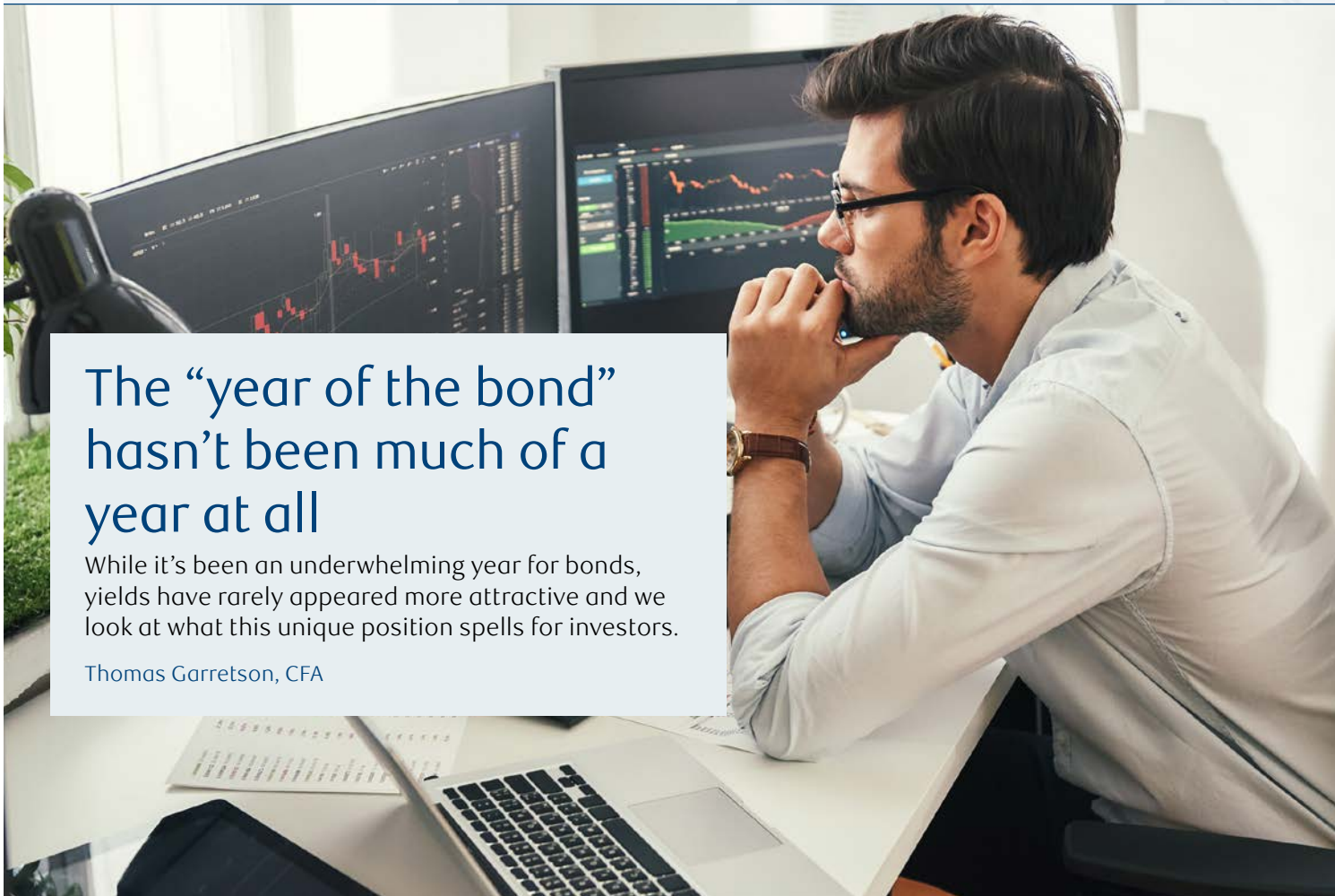


Midyear outlook focus

July 2023



The “year of the bond” hasn’t been much of a year at all

While it’s been an underwhelming year for bonds, yields have rarely appeared more attractive and we look at what this unique position spells for investors.

Thomas Garretson, CFA

For important and required non-U.S. analyst disclosures, see [page 6](#).

All values in U.S. dollars and priced as of market close, June 23, 2023 unless otherwise stated.

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MIDYEAR OUTLOOK Focus



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The “year of the bond” hasn’t been much of a year at all

What was supposed to have been the great bond rally of 2023 instead has been a lukewarm performance. Yet bond yields have rarely appeared more attractive, in our view, while at the same time they should provide strong capital appreciation potential for portfolios should bond prices rally if and when central banks pivot back toward rate cuts.

Key points

- The banner year for bonds that we expected in 2023 after a dismal performance in 2022 hasn’t materialized thus far, but we continue to expect bonds to post steady gains as rate hike cycles near their end points.
- Inflation remains elevated globally, but we now have sufficient data in hand to suggest that the tide has indeed turned lower. Central banks will stay on high alert, but a more cautious policy approach should limit economic risks.
- We expect yields to fall in the back half of the year, but only modestly so as resilient economies are unlikely to see tight central bank policy give way to rate cuts—extending the window for investors to put money to work at historically high yields.

With 2022 marking one of the worst years on record for bond markets as the Bloomberg Global-Aggregate Index fell over 16%, we expected bonds to bounce back and then some in 2023. But through the first six months of the year that same index has clawed back ... just 2%.

So has the “year of the bond” been canceled, or has it simply been delayed?

As we see it, the singular thing still standing in the way of higher bond prices—and therefore lower yields, which move inversely to prices—has been hawkish central banks remaining firm in their resolve to bring inflation down via still-rising policy rates.

And before bonds can begin the kind of rally that we have been anticipating, inflation will need to be well and truly on its way back toward target levels, in our view.

Public enemy No. 1

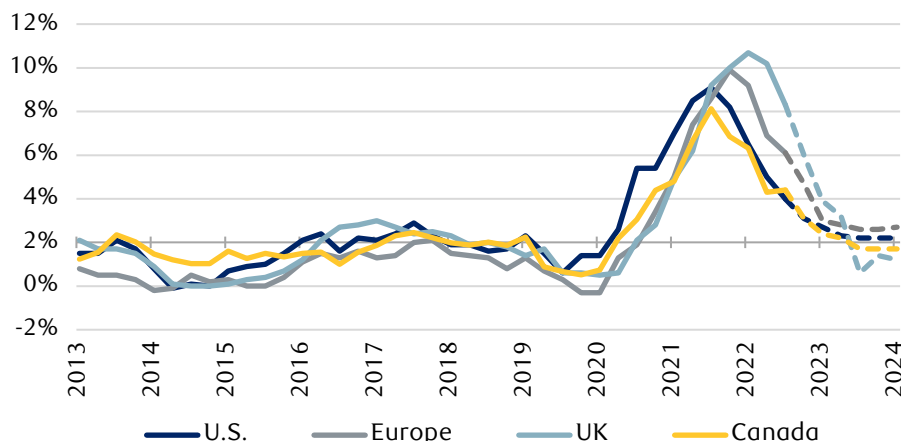
Has inflation been arrested yet? While no major central bank has yet been confident enough to declare it has the suspect in custody, most have cautiously suggested that they believe to have the perp surrounded.

As with any standoff, the last thing those in charge want to risk is escalating the situation. The Bank of Canada most recently provided other major central banks with an example of perhaps what not to do. Its rate hike pause early this year lasted for just two policy meetings until an uptick in inflation and economic activity spurred policymakers back into action with another rate hike in June.

MIDYEAR OUTLOOK FOCUS

The “year of the bond” hasn’t been much of a year at all

Inflation seen returning to near target levels by early 2024



Note: Dashed lines show RBC Capital Markets quarterly forecasts.

Source - RBC Wealth Management, Bloomberg

But as it is clear to us that the worst of the post-pandemic inflation breakout is almost certainly in the rearview mirror, the question now is how long it will take to fall all the way back to target levels. RBC Capital Markets expects that most major economies will see inflation back toward more normal levels by early 2024, which we think should keep any potential central bank rate cuts at bay until roughly the same time.

Performance recap & outlook

While the total returns delivered by bonds this year have been middling at best, just +2.0% for the Bloomberg Global-Aggregate Bond Index, and +2.4% for the Bloomberg US Aggregate Bond Index, we continue to expect steady performance.

In the U.S., we have dialed back our return expectations somewhat from high single digits to something in the 4% to 6% range as we see bonds as likely to deliver little more than the coupons paid for the year. This is largely a function of the anticipated first rate cuts from the Fed being pushed back to Q1 of 2024 from Q4 of this year previously. At the same time, economic risks have perhaps eased as markets are once again pricing in a soft landing for the U.S. economy.

As the table below shows, RBC Capital Markets projects the 10-year Treasury yield—which is sensitive to economic growth and inflation expectations—to end this year relatively unchanged from current levels at 3.60%. RBC Capital Markets previously forecast a year-end level of just 3.2%, but as recession risks have faded, so too, in our opinion, have the downside potential for longer-term bond yields and chances of a “flight to safety” in bonds were a deep recession to materialize.

Year-end forecasts for key policy rates and sovereign yield levels

	United States			Europe			United Kingdom			Canada		
	Fed policy rate	2Y	10Y	ECB policy rate	2Y	10Y	BoE policy rate	2Y	10Y	BoC policy rate	2Y	10Y
Current	5.25%	4.70%	3.74%	3.50%	3.09%	2.40%	5.00%	4.92%	4.33%	4.75%	4.58%	3.34%
Year-end forecast	5.50%	4.15%	3.60%	4.00%	3.05%	2.55%	5.50%	3.50%	3.65%	5.00%	4.15%	3.00%

Note: Europe sovereign yields reflect German Bund yields and forecasts.

Source - RBC Capital Markets, Bloomberg; data as of 6/23/23

MIDYEAR OUTLOOK FOCUS

The “year of the bond” hasn’t been much of a year at all

Globally it’s a similar story for all major economies except the UK. Inflation there has proved more persistent, which has fueled further rate hike expectations to a peak of 5.50%, with more upside risk to that number, based on RBC Capital Markets’ forecasts. But as the Bank of England is forced to do more with respect to rate hikes, we believe that increases the risks of a policy mistake and the economic jeopardy as a result.

A longer investment window

But for bond investors who don’t often worry about total-return potential but rather the income provided by their capital allocations to bonds—the outlook could hardly be better, in our view.

For much of the past year, the market’s primary concern has been with respect to central bank terminal policy rates—or the peak levels that would be needed to tame inflation. But as the end of rate hike cycles comes further into focus, the debate is shifting to how long policy rates will need to remain at elevated levels to keep inflation from surging back.

The Bloomberg Global-Aggregate Bond Index now yields 3.8%, well above its 20-year average of 2.5% and the highest since 2007 when it peaked at 4.8%. In fact, investors have only been able to invest at yields greater than current levels 15% of the time since 2003.

The Fed recently achieved its goal of convincing markets that rate cuts aren’t on the table this year. In May, markets had priced in nearly five 25 basis point rate cuts this year; following recent Fed decisions and communications, markets no longer expect any.

But the upside for investors of a drawn-out inflation fight by central banks is that the window to put money to work at elevated yields will likely be extended.

While we think central banks will take a more cautious approach going forward after a year of brute force, bond investors are in a unique—and privileged—position. Bond yields have rarely appeared more attractive, in our view, while at the same time they should provide strong capital appreciation potential for portfolios should bond prices rally if and when central banks pivot back toward rate cuts as economic growth and inflation eventually cool.

Research resources

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			Count	Percent
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