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THE FINAL STAGE OF GRIEF FOR RATES MARKETS: ACCEPTANCE

October 2023

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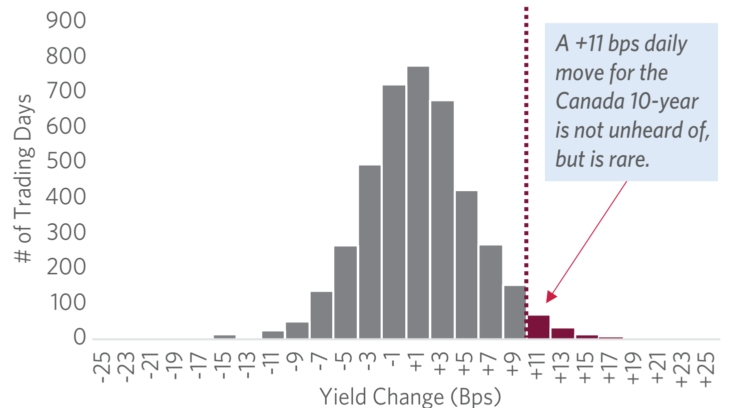
Approximate reading time: 15 minutes

Where do bond yields currently stand?

It seems as though rates markets have reached the final stage of grief, accepting that rates are likely to stay higher for longer with no return to the easy monetary policy days of the past decades. US and Canadian government bond yields continued their march higher with recent volatile moves catching the attention of investors. In the first days of trading in October, we've seen meaningful increases in US and Canadian yields, especially in mid-term and longer-dated bonds. For context, the US and Canadian 10-year bond yield jumped 22 basis points (bps) from September's month-end levels. Although not unheard of, two consecutive daily moves of 11 bps or higher definitely caught the attention of market participants.

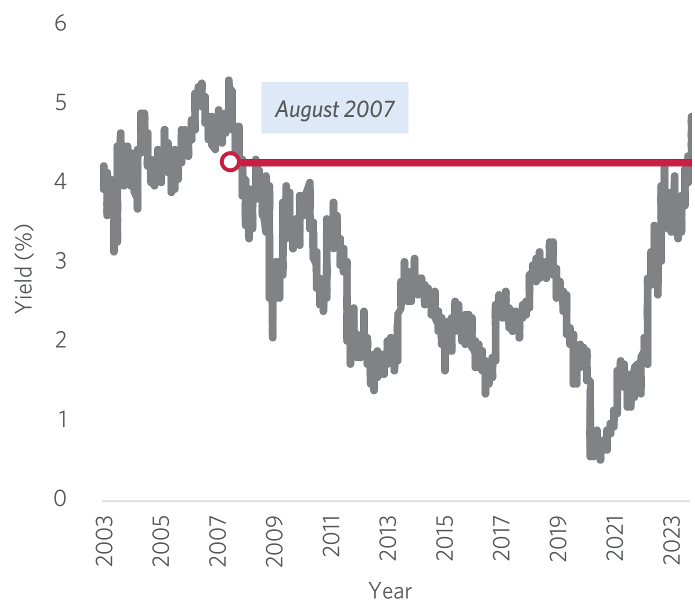


Source: Bloomberg, as at October 6, 2023.
Based on daily yield changes of on the run Canada 10-year from 2007 through to October 6, 2023

With the yield on the 10-year Canada ending the week at 4.14% and the 10-year US Treasury at 4.80%, we now stand at levels last seen in 2007.

Canada and US 10-Year Yields Highest Since 2007

Source: Bloomberg, as at October 6, 2023



Source: Bloomberg, as at October 6, 2023

This sudden spike in yields comes as the bond market seemed intent on pricing in lower rates. As recently as this spring, Canadian markets were pricing in cuts by the Bank of Canada (BoC) by the end of 2023. However, sentiment clearly shifted and market participants continue to realize that central bankers may be more steadfast in maintaining a higher-for-longer stance.

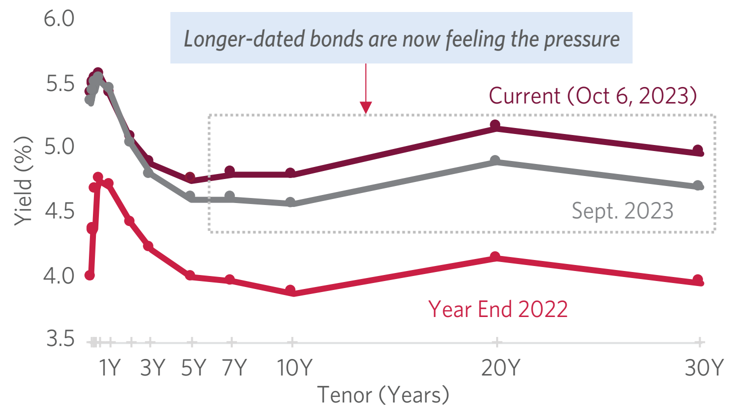
Why are bond yields expected to stay volatile?

The push behind higher yields has been driven by a combination of continued positive economic data out of the US, specifically on a robust labour market that continues to defy the odds and threatens any progress on further decreasing or maintaining lower inflation levels. Market participants are also facing continued supply as quantitative tightening continues. Unexpected actions by the Bank of Japan also caught markets by surprise with buying programs initiated to help stem increases in yields on Japanese government bonds and the flow-through impact on the Yen. These factors, set against the month-end technical, led to some of the more aggressive moves seen recently.

What should investors expect from the bond market going forward?

Although recent moves are catching headlines, the underlying dynamics remain the same for bond markets as we price in higher-for-longer outlook and discount the probability of returning to the old rate-cut reaction function from central banks. This is simply a continuation of the trend.

The move we've seen in longer-term bonds is noteworthy. While most of the previous volatility in rates had the largest impact on the short-end of the yield curve, we're now seeing more pronounced repricing in longer tenors (ie. 5yrs, 10yrs and 30yrs). For example, 5-year rates in Canada are a key barometer of 5-year fixed mortgage rates and similar for the US long bond and US mortgages that can carry a 30-year term. As rates volatility spreads further out the yield curve, this is a trend worth watching.



Source: Bloomberg, As at October 6, 2023

We remain conservatively positioned across fixed income portfolios, given our view of continued rates volatility as markets come to terms with a higher-for-longer outlook. Our overall duration remains neutral to our benchmarks, and we continue to position for a steepening of the curve. In those mandates where we have the ability to go outside the benchmark, we're also taking advantage of increased volatility to capture relative value between Canadian government bonds and US treasuries. From a credit perspective, short-term, high-quality bonds is our area of focus.

Further stress on consumers will continue to flow through to corporations that are likely facing higher financing costs and slowing demand. This will surely impact earnings. From a credit perspective, many of these issuers have positioned well for the inevitable slowdown. They have extended maturities, raised cash on the balance sheet and reduced leverage. However, we remain intensely focused on stress-testing our holdings against a range of scenarios and avoiding lower-quality credits, given the attractive all-in yields we can find in some of our top-conviction issuers.

Our Outlook

Looking forward, we believe it'll prove increasingly difficult for central banks to keep long-term inflation expectations anchored.

While recognizing it's taken longer to unfold than we had expected, our baseline scenario still calls for a mild global recession (55% probability). In this scenario, we see Canadian 10-year bond yields lower over the next 12 months. A less likely scenario of financial instability (10% probability) would also lead to lower yields. A soft-landing scenario with sticky inflation (35% probability) would mean marginally higher yields over the same period.

The range we're working with is 3.25% to 4.25%. 3.25% would be in a world of financial crisis. 4.25% would be consistent with a Canadian economy that continued to look like it's experiencing a soft landing, although still with elevated inflation. Our base case of a mild recession would pull yields down to perhaps 3.75%.

About the author

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