Rate cuts are coming

What it means for your bond portfolio

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Inflation and monetary policy have been two of the hottest topics in the past couple of years, putting smiles on the faces of savers and causing some concern for borrowers. After raising policy rates to roughly 5% over the past number of months in a bid to quell inflation, both the Bank of Canada (BoC) and the U.S. Federal Reserve (Fed) appear poised to commence with rate cuts at some point in 2024, marking a shift in monetary conditions back towards an accommodative posture.

As a result, we believe that ample opportunities remain for bond investors in the coming months, especially once North American central banks begin to cut policy rates and the yield curve steepens further. In the sections below, we suggest ways in which investors can position their bond portfolios to benefit from this market context, such as purchasing government bonds with longer maturities and shorter-term high-quality corporate bonds, which provide the potential for higher income and price appreciation. Before we explore these opportunities, however, we believe it is instructive to provide a synopsis of the typical impact monetary policy exerts throughout the business cycle so we can obtain a better understanding of the path forward for North American central banks. We will then examine the current state of monetary policy and consider the implications for fixed income investors, particularly in the context of a steepening bond yield curve.

First off, what is a yield curve and what do we mean by “steepening”?

The yield curve illustrates the difference in interest rates (yields) for bonds of equal credit quality, but with different maturities. Typically, longer-maturity bonds (which are on the long part of the yield curve) offer a higher yield than shorter-maturity bonds (which are on the short part of the yield curve) because they require more time for repayment and are thus seen as riskier, producing an upward-sloping yield curve. However, the shape of the yield curve can change based on economic expectations. Currently, the yield curve is inverted, meaning short-term interest rates are higher than long-term rates, which suggests a pessimistic long-term outlook as investors anticipate an impending recession.

When the term "yield curve steepening" is used, it means the gap between short-term and long-term interest rates is increasing and implies a favourable long-term economic outlook. For instance, if the central bank lowers rates to boost the economy, and the decrease in short-term rates exceeds that of long-term rates (widening the gap), the shape of the yield curve is said to be steepening. This phenomenon serves as a signal that investors anticipate improving market conditions and strong economic growth.

Understanding monetary policy and the business cycle

The cyclical relationship between economic growth and inflation, and the role of monetary policy is summarized below:

- **Strong growth – weak inflation**: In this first phase of the business cycle, economic growth usually increases amid low inflation. But because robust growth triggers inflation, an overheated economy eventually causes a resurgence of inflation.
- **Strong growth – strong inflation**: As the economy thrives, inflation comes to life. Central banks respond to high inflation by raising rates, eventually moving the clock to the next phase.
- **Weak growth – strong inflation**: We have been in this context since mid-2022, although U.S. growth has started catching on in the last few months. Rate hikes are designed to control inflation by first cooling economic growth. Central banks then continue hiking or keep rates at elevated levels until inflation falls convincingly to desired levels. At this point, the economy often slides into a recession.

- **Weak growth – weak inflation**: The rate hikes finally catch up with inflation and, in this final phase, economic growth and inflation are both low. This combination usually happens while the economy is in a recession or is emerging from one; demand is slow and inflation is under control. This direction is where we are headed over the next few months.

Business cycles are a natural part of any normally functioning economy and the goal of monetary policymakers is to ensure they do not exacerbate any of the peaks and troughs in that cycle; otherwise recession or, conversely, hyperinflation may ensue.

Monetary policy: Where do we currently stand?

As inflation picked up while the pandemic lingered, central banks were not proactive in hiking policy rates, but rather reactionary. That conservative posturing allowed inflation to reach levels of over 8%, making it harder to tame than in previous periods over the past several decades. Despite the slow start, albeit with fairly rapid implementation once things got going, the weight of rate hikes is working its way through the economy, and the six to eight quarters of lagging effect suggest that 2024 will be the point of maximum impact.

Although leading indicators suggest that the fight against inflation is showing positive signs, central bankers are being careful not to cut rates too soon and fail at the ultimate task of bringing price growth to target in a sustainable manner. In other words, they might over adjust for the lateness of their initial reaction.

We believe both the BoC and the U.S. Fed are likely to start cutting rates before the end of 2024 and Canada may begin as early as the middle of this summer. The central banks may pause after the first cut to gauge the reactions of the markets and the economy. Meanwhile, we note a growing divergence between Canada and the U.S. in terms of the pace of inflation and economic growth, with Canada exhibiting more noticeable deceleration on both fronts. Thus, the Fed will need to closely monitor economic data releases and its decision to cut rates will depend on the strength of the economy and the sticky nature of inflation.

Regardless of whether the U.S. starts to cut rates this summer or towards the end of the year, we believe the key takeaway is that we are shifting from a restrictive stance (high-rate environment meant to slow down the economy) to an accommodative stance (phase in which rates are lowered to help stimulate the economy). As policy rates move towards neutral while supporting the 2% inflation targets set by both the U.S. Fed and BoC, we anticipate that longer-term bond yields will increase and thus, the yield curve will steepen more aggressively.

Positioning your bond portfolio

We believe short-term instruments, such as money market funds, no longer provide a strong value proposition given that yields will likely head lower in the coming months and will gradually provide less profit over time. As such, we suggest investors shift their focus towards acquiring longer-term bonds, beginning in the 5 to 10-year range. Bonds beyond the 10-year threshold may not offer significant value at the moment due to the 10-year to 30-year yield curve inversion in Canada and 20-year to 30-year inversion in the U.S.

It is worth noting that large institutional investors, such as pension funds and insurance companies, are demonstrating this behaviour already, strategically acquiring longer-dated bonds whenever there is a rise in yields (and thus a drop in bond prices). Although extending bond maturities, particularly beyond the 10-year segment, poses near-term risks if inflation persists, we anticipate that the longer end of the bond curve will eventually stabilize as inflation approaches the 2% policy target in both Canada and the U.S. We expect yields to decline gradually rather than consistently in line with data releases over time.

In addition, we believe that high-quality corporate bonds in the very short part of the yield curve present a decent opportunity to benefit from higher profit potential versus sovereign and sub-sovereign bonds, with the added potential for price appreciation as yields for shorter-dated corporate bonds fall and the curve steepens. Even so, we remain cautious on corporate bonds beyond a couple of years as we move out of the curve.

These developments present a compelling opportunity for investors to assess their fixed income investment strategy, focus on potential market shifts, and explore dynamic investment opportunities across different maturities and levels of credit quality.

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