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Global interest rates

From “lower for longer” to “higher for longer” and (eventually) back again?

At a glance

- Investors today face a significant amount of uncertainty over whether now is a good time to buy bonds given the risk of further central bank rate hikes.
- Some data shows that actual economic performance remains strong, while other data shows that economic activity should contract at some point in the future. This divergence in data creates a very challenging forecasting environment.
- Long government bond yields are highly influenced by how low central banks will cut rates once they begin monetary policy easing.
- Against this backdrop, TD Asset Management Inc. (TDAM) expects a positive tilt in returns for interest rates over the next 12 months, which creates a compelling opportunity to invest in government bonds.



It wasn't supposed to be this way.

Two years ago, the prevailing narrative was that inflation was transitory and that central banks would have years to gradually raise rates to bring the economic dynamics back into equilibrium. Even policymakers projected that inflation would remain at or below their 2% targets for 2022 and beyond. At that time, it was thought that pandemic-related inflationary disruptions would soon be overwhelmed by the slow moving, disinflationary structural forces that dominated the “lower for longer” rates world for much of the 2010s. Fast forward to today and that all seems like a pipe dream.

After delivering one of the fastest global monetary policy tightening cycles on record, many global economies and, more importantly, labour markets, appear extremely resilient. Financial markets continue to march to the beat of their own drum as financial conditions are broadly looser today than they were in October 2022 when interest rates were at similar levels. As a result, most central banks

continue to fret that inflation risks remain skewed to the upside. Even central banks that have reached peak policy rate, which is the highest policy rate in a tightening cycle, have said that monetary policy easing is a long way away and that a pause could, in fact, be followed by more rate hikes. Not what you wanted to hear? Don't worry, you are not alone.

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Will we ever get back to target inflation?

Until this year, the bond market expected the U.S. Federal Reserve (Fed) to cut two times to a 4.5% policy rate by December 2023 after reaching a peak rate above 5% in June 2023. The Fed has consistently insisted that it would not cut rates this year, but the bond market ignored the message. However, after stellar jobs numbers in early 2023, investors had to concede that rate cuts may not happen until 2024. And after several inflation releases that showed “sticky inflation”, investors began to worry that central banks may never again hit their 2% inflation targets and that we should brace for “higher for longer” rates. If you are equally bewildered by this paradigm shift around inflation and rates, just remember: “There is nothing either good or bad but thinking makes it so.” Now replace “good or bad” with “lower or higher” and somehow, it all makes sense.

Once U.S. regional bank concerns emerged in March, we went back to pricing in rate cuts for the second half of 2023. However, this time, investors expected

four cuts. Then, after some swift, policy assisted regional bank takeovers, concerns over broader financial contagion dissipated and investors, once again, turned their attention to inflation that has defied expectations by normalizing at a “slower than expected” pace. So, today, investors are moving back to pricing out 2023 rate cuts as central banks continue to tighten monetary policy, albeit at a slower pace.

Although the global financial system concerns that have emerged since March certainly add another layer of uncertainty around the future path of inflation, the continued tightening in global monetary policy may seem intuitive based on prevailing inflation levels. However, even before banking stresses came to the forefront, continued rate hikes were surprising when we consider that leading economic indicators having been signaling that a recession is coming. But is it?



The divergence between hard and soft data

Hard data, which shows that actual economic performance to date remains strong, continues to defy the gravity of the soft data, which shows that economic activity *should* contract at some point in the future. Today's divergence between the hard data, which includes metrics around employment or retail spending, and the soft data, which includes financial market variables and survey-based business and consumer metrics, is at extreme levels. So, which sets of data are right? Will we finally realize the most anticipated recession ever? Or will we see financial markets and sentiment indicators rebound off low levels? The answers to these questions will have massive implications for returns of all financial assets this year. However, none more so than interest rates because of the profoundly different monetary policy reactions we should expect depending on how the economy evolves from here.

Unfortunately, the extreme global disruptions we have repeatedly faced since 2020 have made amateurs of

even the most professional of forecasters: a massive build-up of excess savings for households and businesses thanks to war-like government stimulus packages, wildly oscillating demographic trends from rolling global lockdowns, substantial labour retirements and resignations, and global supply chain disruptions. To this, we add overwhelming global challenges due to Russia-Ukraine, US-China, and climate change. These (brewing) conflicts are no longer abstract thought exercises. They already have meaningful socioeconomic and policy implications today. Now any of these socioeconomic or geopolitical issues alone could break the most robust of economic models. However, when all of them occur simultaneously and we add financial system stresses, uncertainty is so high that models are less reliable. Instead, we rely on narratives to create a plausible distribution of expected returns for interest rates (government bonds).

The significance of the new rate floor

Last year, when outlining the stages of the Fed's tightening cycle, Chairman Powell suggested there were three pivotal questions: **how fast rate hikes would be delivered, where the Fed rate would peak and how long it would remain at the peak**. Not surprisingly then, investors continue to debate those latter two questions today. However, we believe that they should, instead, debate the question of **how low the policy rate will go** once the cycle turns. And this was true even before we knew of U.S. regional banking stresses, which potentially indicate that the cycle is, in fact, already turning. Answering this fourth question will matter a whole lot more in determining the attractiveness of interest rates at this point in time. Although, to be clear, this can only be said if we assume that we are closer to the end (or peak rate) of the hiking cycle than we are to the start or middle of it. In other words, a Fed peak policy rate of 6% or 7% should not deter people from investing in government bonds, although a 10% peak rate probably should.

Will we finally realize the **most anticipated recession ever?**

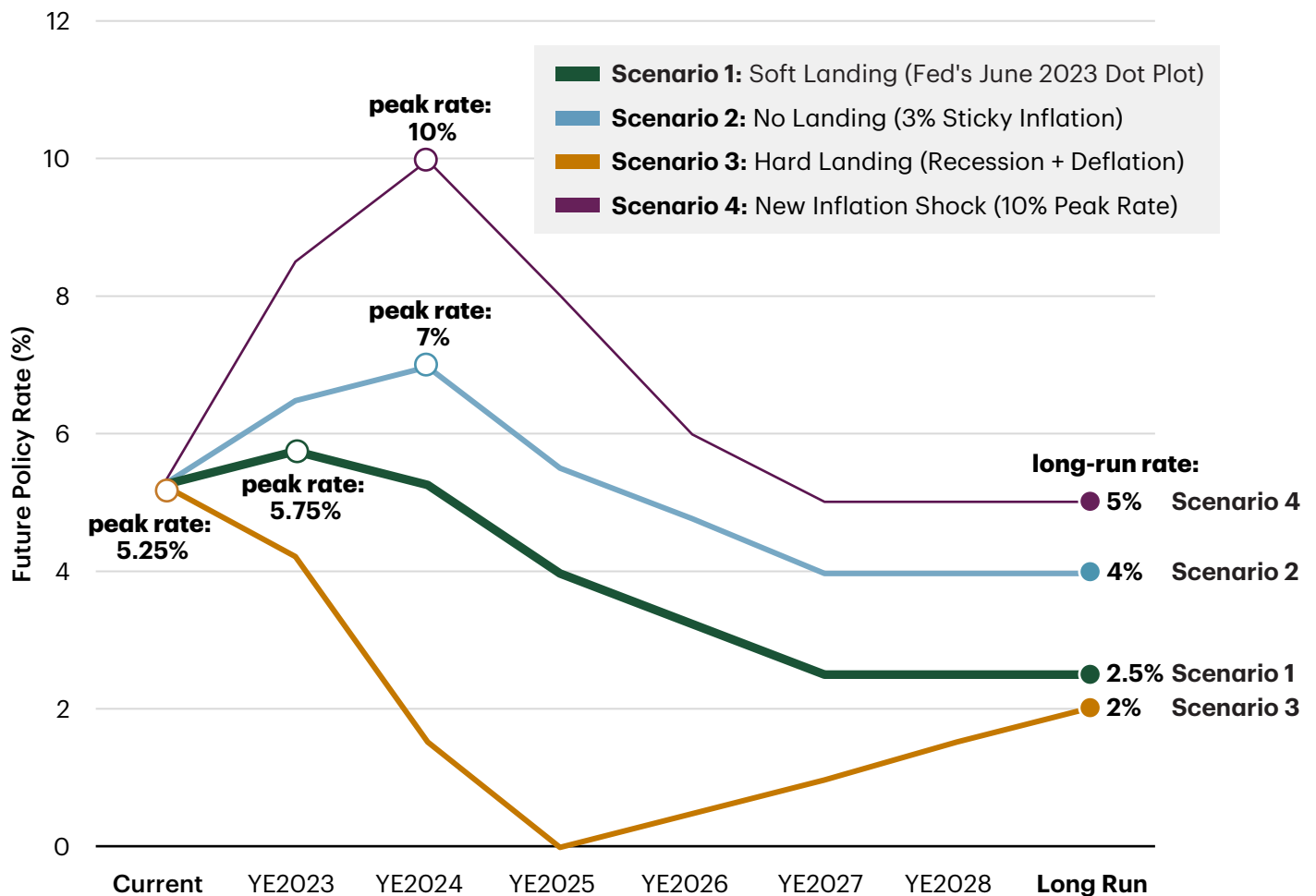
Fed policy rate scenarios

Interest rates have a number of complex risk factors that influence their returns, however, analyzing this asset class can be reduced to thinking of longer-term rates as a compounding of a stream of short-term rates. In other words, if you build a timeseries of where you believe the central bank policy rate will be in the future, you can calculate where interest

rates should be today or in a year from now. When uncertainty is as high as it is today, this exercise helps bring into focus what matters for the asset class and highlights potential returns even if we cannot confidently assign probabilities to the scenarios.

In **Figure 1** below, we go through this exercise for four scenarios:

Figure 1: Four Scenarios for Fed Policy Rate Paths



Source: TD Asset Management Inc, Bloomberg Finance L.P. Data as of May 31, 2023. For illustrative purposes only.

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1

Scenario 1: We assume the Fed's June 2023 economic projections are realized such that they hike to a peak rate of 5.75% this year, which gradually begins to fall next year until it reaches a long-run rate of 2.5% (their median longer-term dot.) This is the soft-landing scenario.

2

Scenario 2: We assume that the Fed's inflation forecast for the end of 2023, which is 3.2%, becomes sticky. That is, the bulk of the easy disinflation gains occur through 2023, but due to the overwhelming macroeconomic challenges in a geopolitically fragmented world, inflation cannot fall below 3%. This is the no landing scenario. Here, we assume the Fed hikes the policy rate to 7% over the next 12 months, but, in time, accepts 3% as its new inflation target and normalizes the policy rate to 4% (above the new inflation target.)

3

Scenario 3: Something breaks in the economy, in a big way. This is the hard landing scenario. The Fed pauses at its current rate of 5.25% because unemployment begins to rise very quickly in the summer of 2023. As the economic contraction gains momentum and inflation falls off a cliff, the Fed begins to cut the policy rate in the fourth quarter of 2023 and ultimately cuts to 0% by 2025. Eventually, the policy rate gradually moves back up to 2%.

4

Scenario 4: We assume a new shock takes headline inflation back above 8% and the Fed hikes to a peak rate of 10% by early next year and keeps it there until the end of 2024. In time, the policy rate is lowered to 5%, which is the highest long run policy rate in all scenarios.

For each scenario, we calculate the expected yields in 12 months from now for different interest rate maturities (in **Figure 2**) and calculate 12 months returns for all interest rates if the yields change as expected (in **Figure 3**.)

Drawing some conclusions

From **Figures 2 and 3** below, we can draw several conclusions.

First, significantly tighter monetary policy over several years, as per Scenario 4, can generate negative total returns for interest rates this year. However, interest rates now have sufficient income to largely offset capital losses (negative price returns due to interest rate increases). Even in Scenario 2 where the policy rate peaks at 7% and falls over time to 4%, 5-year and 10-year interest rates would generate only small negative returns over the next 12 months of -0.2% and -2.1%, respectively. Meanwhile, 30-year interest rates would be expected to generate positive total returns over the next 12 months in Scenario 2 despite higher interest rates because the negative price return is more than offset by the positive income return over the next 12 months. In other words, the distribution of government bond returns over the next year is most likely positively skewed.

Second, shorter 2-year and 5-year interest rates, are greatly influenced by the peak policy rate

whereas longer 10-year and 30-year interest rates, are anchored by the long-run policy rate. This is extremely important because interest rate sensitivity, which is known as duration, of most fixed income markets is very close to that of 10-year interest rates. So, to assess the opportunity in fixed income at this point in the cycle, we mostly need to focus on where we think the policy rate will be in the long run. More specifically, we need to focus on how low we think the Fed will cut rates once the monetary policy easing cycle begins.

Third, and this is an extension of the second observation, any additional Fed policy rate hikes will simply further invert yield curves. Figure 2 shows that 2-year rates currently yield 0.75% more than 10-year rates. But, in Scenario 2, where the peak policy rate is 7%, 2-year rates should yield 2.2% more than 10-year rates, and in Scenario 4, where the peak policy rate is 10%, 2-year rates should yield 3.3% more than 10-year rates.

Figure 2: Expected Level of Interest Rates in 12 Months

Interest Rates	Current Yields	Expected Yields in 12 Months			
		Scenario 1	Scenario 2	Scenario 3	Scenario 4
Peak Rate		5.75%	7%	5.25%	10%
Long-Run Rate		2.5%	4%	2%	5%
2-year	4.40%	4.6%	6.6%	0.7%	9.0%
5-year	3.75%	3.2%	4.7%	0.9%	6.3%
10-year	3.65%	2.9%	4.4%	1.5%	5.7%
30-year	3.85%	2.5%	4.0%	1.9%	5.1%

Source: TD Asset Management Inc, Bloomberg Finance L.P. Data as of May 31, 2023.

Figure 3: Hypothetical Returns for the Next 12 Months Given Expected Yields in 12 Months

		Expected Returns for the Next 12 Months			
		Scenario 1	Scenario 2	Scenario 3	Scenario 4
2-year	Return Due to Price Changes	-0.4%	-3.5%	6.9%	-8.7%
	Return Due to Income	4.5%	5.3%	2.6%	6.7%
	Total Return	4.1%	1.8%	9.5%	-2.0%
5-year	Return Due to Price Changes	2.4%	-4.5%	12.6%	-11.4%
	Return Due to Income	3.5%	4.2%	2.3%	5.0%
	Total Return	5.9%	-0.2%	15.0%	-6.4%
10-year	Return Due to Price Changes	6.4%	-6.2%	18.2%	-16.8%
	Return Due to Income	3.3%	4.0%	2.6%	4.7%
	Total Return	9.6%	-2.1%	20.7%	-12.2%
30-year	Return Due to Price Changes	23.5%	-3.1%	34.7%	-21.2%
	Return Due to Income	3.2%	3.9%	2.9%	4.5%
	Total Return	26.7%	0.9%	37.5%	-16.8%

Source: TD Asset Management Inc, Bloomberg Finance L.P. Data as of May 31, 2023.

As debt levels have grown over the years, even a 5.25% policy rate will seriously challenge debt sustainability in time.

Comfort in the math

The math gives us comfort when so much uncertainty prevails.

Scenarios 2, 3 and 4 were purposely designed to warrant noticeable changes in the Fed's monetary policy stance, but we should note that the market response may deviate from where rates should be in these scenarios. In Scenario 4, if the Fed needs to hike the policy rate to 10%, it is highly likely that investors will react by inverting the yield curve a lot more than seen in Exhibit 2. This means that 10-year and 30-year interest rates may not rise above 5%. In fact, they could even fall from current levels. Why? Because investors will likely expect a very deep recession at some point in the future. A crash landing. This might also be investors' reaction in Scenario 2. As debt levels have grown over the years, even the current 5.25% Fed rate will seriously challenge debt sustainability in time, notwithstanding a 10% policy rate.

This would also be true for consumers, households, businesses and governments, alike. So, investors will likely respond to a significantly higher peak rate by pricing a lower long-run rate than the 4% or 5% that we have assumed in Scenarios 2 and 4. As the scenarios have shown, a lower long-run rate should translate into lower 10-year and 30-year interest rates, and therefore higher total returns, than what we have calculated for Scenario 4. Furthermore, in Scenario 3, we do not expect the Fed will cut the policy rate back to zero so soon after the biggest inflationary episode in decades. They have repeatedly stated that history has taught them not to cut rates too soon or too low, as inflation can come in waves. We believe this stance is justified as we expect a greater level of volatility around inflation in the coming years than what we have been accustomed to in the years preceding the pandemic.



Opportunity in the face of uncertainty

Inflation is never a straight line up and disinflation is never a straight line down. Patience and persistence are required. However, should the Fed ignore history and slash the policy rate back to zero in the next 12 to 24 months, we would worry that market-based inflation expectations will rise, which would put a floor under interest rates. In other words, we expect that interest rates would fall less than what we have calculated in Scenario 3 so the total returns would be lower than what we see in **Figure 3**.

While we acknowledge that inflation is proving to be stickier than we previously expected, in large part because the economy has demonstrated greater resilience to higher interest rates, we do believe that the current level of rates is restrictive for the real economy. We can see that economic growth is decelerating, which suggests that soft data has been a reliable predictor of the direction of travel for the economy. Worse still, soft data continues to point to weak or weaker growth in the coming months and quarters. Therefore, even if inflation remains sticky above 3%, we don't anticipate that the Fed will respond by hiking the policy rate to 7% as we assumed in Scenario 2.

Overall, this thought exercise highlights the fact that regardless of how we assign probabilities across the four scenarios, we expect a positive skew in total returns for interest rates (government bonds) over the next 12 months. In the face of so much uncertainty, this opportunity in government bonds is as compelling as it possibly can be. ■

Investing



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