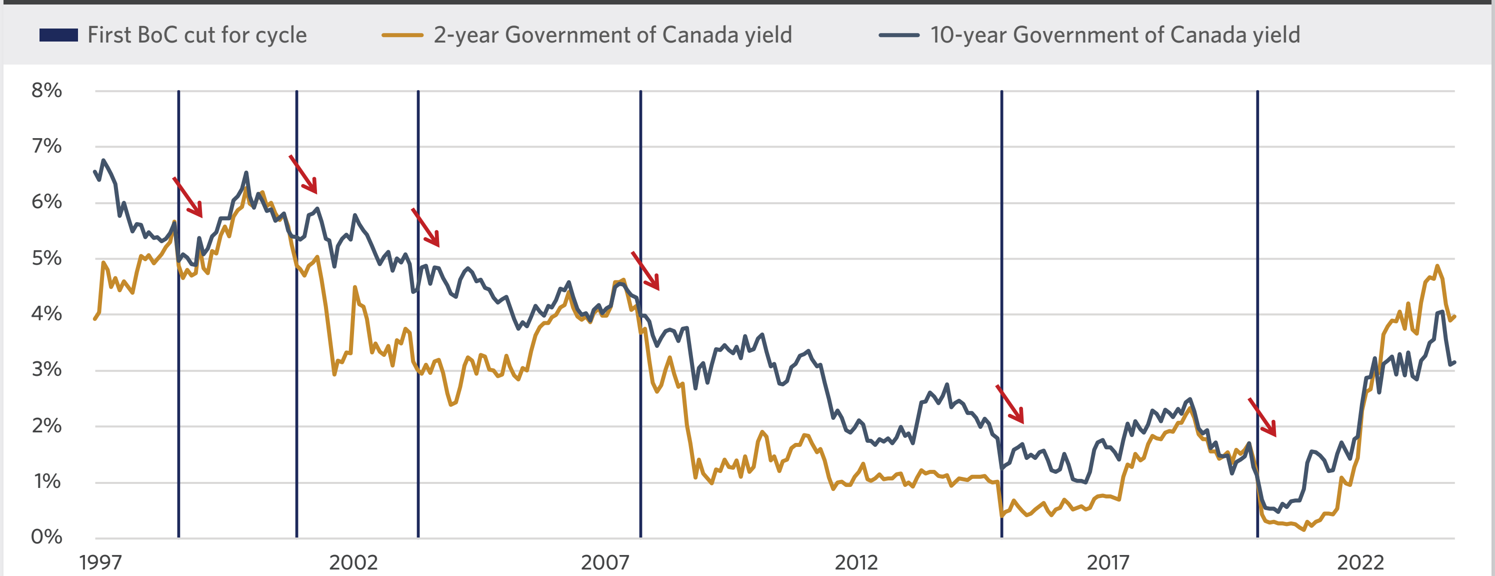
Short- and long-term Government of Canada yields tend to decline when the BoC starts cutting rates



Source: Bank of Canada

Fixed-income outlook

Yields have risen in recent months, driven in part by the slowing pace that inflation is declining. While higher yields have impacted bonds prices - weighing on Canadian and U.S. bonds – Canadian government bond and U.S. Treasury yields generally remain well below highs for the cycle. We expect the Bank of Canada and Federal Reserve to start cutting rates soon, which should drive short-term rates lower, steepening both yield curves.

Bank of Canada (BoC) maintains policy rate at 5% - CPI eased to 2.9% in March, still above the BoC's 2% target, but continuing a slower trend lower. The central bank noted that employment continues to grow more slowly than the population, and wage pressures may be easing. Our expectation is for rate cuts to start in June, provided that inflation continues its downward trend.

The Federal Reserve signals three rate cuts this year – At its March meeting, the Fed updated its economic projections, maintaining expectations for three rate cuts this year. If inflation continues to moderate, as is expected, the Fed should be able to pivot to less restrictive monetary policy soon. We expect Fed rate cuts to start in the second half of the year if inflation continues to ease.

The yield curve could steepen – As the timing of BoC and Fed rate cuts becomes clearer, short-term yields could decline. We expect short-term rates to fall more than long-term rates, steepening both the Canadian and U.S. yield curves, which have been inverted for nearly two years. This could increase reinvestment risk for short-term bonds and GICs as investors might have to reinvest maturing principal at lower rates. Maturing bonds and GICs could be a source of funds to reallocate to underrepresented asset classes of a well-diversified portfolio.

▶ Action for investors

We recommend underweighting fixed income relative to your long-term strategic asset allocations, as we expect U.S. stocks to outperform over the near term, particularly relative to International bonds. Within Canadian investment-grade bonds, extending duration by adding to intermediate- and long-term bonds and bond funds can help reduce reinvestment risk by locking in rates for longer.

Before investing in bonds, you should understand the risks involved, including credit risk and market risk. Bond investments are also subject to interest rate risk such that when interest rates rise, the prices of bonds can decrease, and the investor can lose principal value if the investment is sold prior to maturity.

