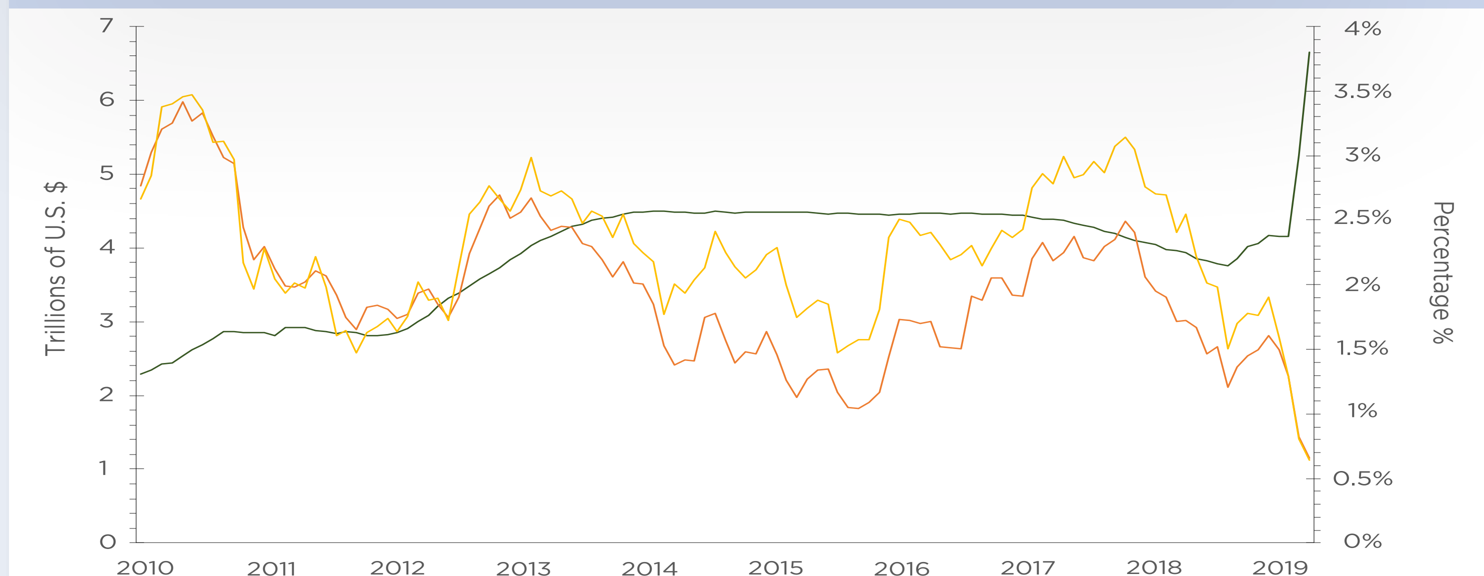

Source: Federal Reserve Bank of St. Louis, Statistics Canada

QUARTERLY MARKET OUTLOOK: **THIRD QUARTER 2020**

Fixed-income Outlook

Interest rates have fallen to historic lows amid the economic downturn and ramped up central bank stimulus. The rebound in GDP should offer modest support, but we expect rates to remain relatively low for an extended period, with low bond yields persisting well beyond this year. At the same time, our expectation for ongoing equity market volatility means a diversified allocation to fixed-income investments offers valuable downside protection for portfolios, in our view.

- **Low rates linger on** – 10-year interest rates are near 0.50%, slightly above the record low touched earlier this year. We think two primary influences will keep interest rates relatively low for an extended period: sizable central bank stimulus programs and subdued inflation. The Bank of Canada (BoC) has slashed its policy rate and injected liquidity while the U.S. Fed has expanded its balance sheet above $7 trillion to support the respective economies and credit markets through the pandemic. In addition, Canadian housing market and household debt excesses coming into the recession will, in our view, partially stunt the pace of the domestic recovery.

- **Credit stress warrants diversification within bond portfolios** – There are two competing forces at play in the bond market: a likely rise in defaults and unprecedented credit market support from central banks. In Canada, we think the mortgage market will experience some challenges given record consumer indebtedness, high unemployment and falling real estate prices, though we do not expect a housing or mortgage crisis. In the U.S., corporate debt levels were already at their highest levels since the late 1980s coming into this crisis and the economic shutdown is likely to result in an uptick in defaults this year. At the same time, the Fed has pledged extraordinary support to provide a financial bridge to the other side of this crisis. We expect the BoC, and the Fed, to remain committed to credit market support, which we think should support investors' confidence in maintaining appropriate – but diversified— bond allocations.

- **Policy responses have longer-term implications** – The dramatic destruction of demand during the pandemic required unprecedented responses from monetary and fiscal policymakers. Domestically, with BoC playing a smaller role than the Fed and with the federal debt burden (as a % of GDP) being among the lowest in the G7, we think collateral risks will be more muted relative to more aggressive responses across other developed nations. In the U.S. a bloated Fed balance sheet and rising federal budget deficits/debt do pose potential longer-term implications for inflation and tougher budget decisions.

▶ *Action for Investors*

During the recent selloff when the stock market fell more than 30%, bonds provided a modest positive return, stabilizing portfolios. We recommend a neutral fixed-income allocation in line with your long-term target, and we favour the stability of higher-quality investment-grade bonds. An increased allocation to high-yield bonds can help add yield while benefitting from a sustained economic recovery.

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.

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