RBC Global Asset Management

Turbulent markets call for more than an Index

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Global economic shifts amid volatile markets mean fixed income investors are going to need more than their traditional benchmarks to achieve meaningful returns.

- The U.S. economy remains strong, but rate cuts are slowing with potential for a rate hike if inflation rises, while Europe faces high energy costs and a need for accelerated monetary easing.
- Renewed spotlight on active management, as "dry powder" needs to be earmarked for market opportunities.

Market volatility and geopolitical shifts have investors reassessing an evolving investment environment. Rising U.S. fiscal deficits and debts levels could lead to long-term sustainability concerns while changes in trade policies amidst new political regimes may force changes in supply chains and operations. These pressures are likely to impact global markets and signal that investors need to reassess their approaches heading into the new year, particularly in fixed income. Significant movements in U.S. government bonds relative to swap rates may reflect positive adjustments in monetary policy on the one hand, or volatility and uncertainty on the other, emphasizing the role key active strategies will have in this shifting landscape.

U.S. Economic Strengths and Looming Bond Supply Issues

The U.S. economy continues to exhibit strength and robust growth, characterized by low unemployment and strong GDP, and despite previous concerns, the anticipated recession following the Federal Reserve's interest rate hikes has not materialized. This resilience is partly attributed to consumer protections against rising rates - like hedged mortgage costs thanks to long-dated fixed rate mortgages - and substantial government spending.

However, the U.S. faces challenges with its rising fiscal deficits and overall debt levels. The fiscal deficit, now more than 4% of GDP, raises concerns about long-term sustainability and bond supply.

"Although U.S. debt levels have reached such heights, I'm not concerned we are going to see the ordeal we witnessed in the UK for example, [which reached its highest debt level since the 1960s in October of this year.] Albeit I do think we're going to be in a world in 2025 where there will be an abundant supply of government bonds," says Mark Dowding, chief Investment Officer with RBC Global Asset Management's BlueBay fixed income team. Markets flooded with bonds might overextend supply, threatening a misalignment with demand and leading to higher interest rates to attract buyers. Excessive bond issuance may also increase inflationary pressures if there is a mismatch between economic growth and the financing of deficits, which typically happens when bond issuance increases during a time of economic stagnation.

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Additionally, there has been significant movement in government bonds which may have implications moving forward. "We've seen a very aggressive move in government bonds relative to swap rates. There has been a big tightening of swap spreads in the U.S. and globally, 30-year swap rates are actually 80 basis points below the level of comparable U.S. Treasury yields," says Dowding.

The tightening of swap spreads signals that the difference between the interest rate on governmentbonds and the interest rate on interest rate swaps is narrowing. This can cause concern for investors as a tightening spread may indicate reduced bond market liquidity and changing perceptions of credit risk, a troublesome possibility as market volatility continues to persist post-U.S. election. Should swap rates fall relative to actual bond yields, it might imply that investors see swaps as a safer bet than government bonds, further requiring a reassessment of fixed income investment strategies moving into 2025.

Dowding says this is a result of "simply too much government paper," which investors will need to keep a keen eye on moving into next year. "Simultaneously, moves in spreads have been very powerful and part of that speaks to country risk, and to different supply differentials in different markets as well," he adds.

The discussion of country risk is re-emerging as geopolitical conflicts and restructurings throughout global economies realign international trade balances.

European Economic Struggles

Europe is currently grappling with economic challenges, particularly due to energy costs. Germany has emerged as a point of concern, where it "imported cheap Russian gas under a blanket of U.S. security protection, which it received free of charge in order to build cheap exports to flock to the Chinese. That model, now, is completely broken," says Dowding.

Germany is facing a considerably difficult period of economic transition on the heels of the added pressures linked to the Russia-Ukraine conflict. Volkswagen plans to shut down as many as three German factories to cut costs amid slumping sales, and the head of Siemens tax service even went as far as to say "there is nothing that would speak in favor of investing" into the country. German MP Gitta Connemann stated Germany's small-to-medium businesses (which make up 99% of its enterprises) simply got hampered by huge energy prices and taxes, among other stressors. Dowding adds "you're paying 3 or 4 times more for energy in Europe than the U.S. and other trading partners, so it's just not competitive."

German interest rates have room for cuts, potentially more than the U.S., which may provide some economic relief. There is a push for accelerated monetary easing to counteract trade tariffs as pressure mounts. "We're seeing European bond yields at the front-end rallying in anticipation that Europe actually tries to counter the threat of tariffs, while in part weakening the Euro by slashing interest rates more quickly than the Fed does," adds Dowding. Cutting interest rates may weaken the Euro, making European exports more competitive via reduced costs in foreign markets – a strategy that can be used to counteract tariffs placed on European economies.

The issue of tariffs was a significant area of contention during the recent election cycle, and changing policies throughout the world are likely to restructure international trade balances.

Global Trade and Country Risk

The potential for renewed trade disputes under a new Trump administration looms large. Regions like Mexico and China are particularly vulnerable to policy shifts. Trump has threatened to withdraw from the United States-Mexico-Canada Agreement (USMCA) which replaced NAFTA, to leverage better deals. The president-elect has already threatened big tariffs on Canada, Mexico, and China – the U.S.'s three largest trading partners - with a pledge to incur tariffs on Chinese imports in excess of 60%.

Trade policies under the new Trump administration could significantly affect multinational corporations, influencing global supply chains and economic strategies. China faces internal challenges with consumer demand and export strategies, and the country may experience slower growth struggling to balance internal and external pressures. Japan's economy is showing signs of strength, with rising wages and interest rates, presenting opportunities for investors. This points to a shifting balance of power in Asia, with Japan potentially emerging as a more stable player.

Looking ahead, several long-term trends are anticipated. The yield curve is expected to steepen in the U.S., as "there needs to be more term premium as there'll be too much debt, and fiscal policy is not going to change," says Dowding. Europe's struggles will likely conclude with more fiscal expansion, more debt issuance and "will likely also result in steeper yield curves in a number of countries. It doesn't sound exciting, but you can make a lot of money investing that theme If you do it right," he adds.

Investment Strategies and Market Volatility

Several factors will allow investors to get it right in the short-term as volatility continues to question the status quo. President-elect Trump's contributions to the global scene surprisingly present investors with opportunity. "With Trump, we know there are going to be episodes of volatility. Wave after wave of volatility will hit us because we're going to end up with hordes of comments hitting us constantly. When they do, there will be occasions where markets overreact; there'll be other times where markets underreact. It will be in those moments you have the opportunity," Dowding offers.

"Donald Trump is giving us, as active investors, an opportunity to really deliver active returns," Dowding adds, implying that investors that actively invest based on the highs and lows will be able to exploit those market movements.

To capitalize on these opportunities, investors will need to reassess their holdings amid a shifting and dynamic investment landscape. "I believe one of the seminal things in a Trump administration is that holding bonds or stocks passively in an environment like this is not as good of an option as it was in years past, so active management counts and is quite important at this point," says Dowding.

"If you know what you're doing as fixed income investor, you should be able to make money on a routine basis. You've got this shocking product – core fixed income – and people tend to be benchmark huggers. It's easy to consistently churn out good returns if you know what you're doing," he adds stressing the importance of reconsidering passive index investing.

"I want people to get off their hands. I want people to get excited about active management because there is an ability to generate returns if you've got skill."

Indeed, the argument for active fixed income deserves its merits – a recent Morningstar[1] report found that roughly two out of every three active bond managers beat their passive counterpart over the trailing twelve months as of June 30, 2024, led by a 72% success rate in the intermediate bond category.

The bond category included funds invested primarily in investment-grade U.S. fixed-income debt with 2–10-year durations, with active portfolios in the category tending to sport shorter duration and take higher risks than their indexed peers. This proved successful amid high interest rates and shrinking credit spreads that characterized the 12-month period ending June 2024.

Dowding adds, "I want people to get off their hands. I want people to get excited about active management because there is an ability to generate returns if you've got skill. I'm speaking passionately because I care about this. We are investing people's savings. We're investing people's futures. So being passive in this environment - I simply don't believe it's good enough."

While passive strategies offer simplicity and lower costs, the potential of active management to outperform benchmarks cannot be ignored, especially in turbulent markets. As fixed investors consider their 2025 approach, they would be wise to weigh the opportunity cost of devoting too much to passive strategies in a global landscape where volatility and shifting power balances are expected to define the new year.

[1] Morningstar, "Active vs. Passive Investing," accessed [Nov 25,2024], https://www.morningstar.com/business/insights/blog/funds/active-vs-passive-investing.

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