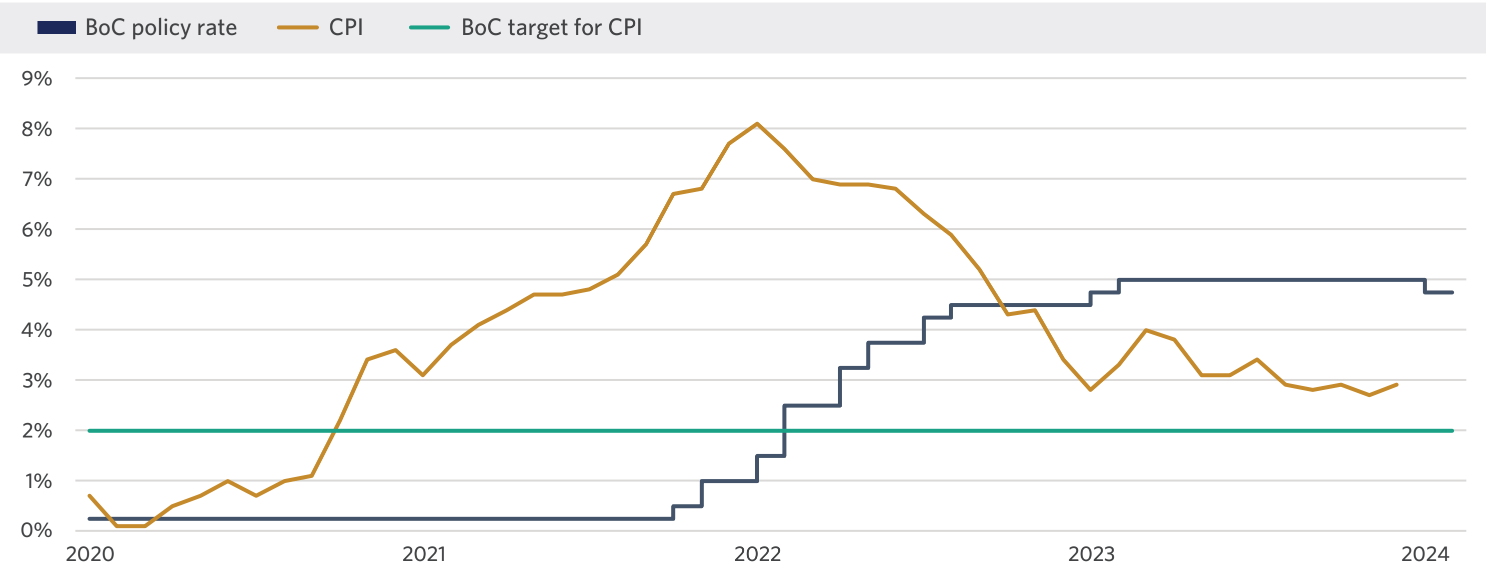
Moderating inflation should allow Bank of Canada to continue rate cuts gradually



Source: Bank of Canada

Fixed-income outlook

Bond yields have dropped from the recent peak in late April as markets price in the recent Bank of Canada rate cut and expectations for additional cuts, benefiting bond prices, and driving stronger returns. We expect slowing U.S. economic growth and moderating inflation to allow the Federal Reserve (Fed) to follow with rate cuts soon, which should push short-term rates lower, steepening the yield curve.

Bank of Canada (BoC) cuts policy rate - BoC cut its policy rate to 4.75% - from 5.0% in June citing further evidence showing that underlying inflation is easing on a more sustained path toward its 2% target. The central bank noted that additional cuts would likely be gradual given that inflation is forecast to slow gradually. While CPI ticked up to 2.9% in May, we expect inflation to resume its path lower over the coming months, allowing for additional rate cuts toward the end of this year. As the timing of additional BoC easing becomes clearer, short-term yields should decline, likely steepening the yield curve and leading to higher reinvestment risk for short-term bonds and GICs. We see value in intermediate- and long-term bonds, which allow investors to lock in higher rates for longer. Maturing or called bonds and GICs could be a source of funds to extend duration or to reallocate to underrepresented asset classes.

The Fed signals one rate cut this year – At its June meeting, the Fed updated its economic projections, trimming expectations to one rate cut for this year, down from three cuts at its March meeting. While the Fed's preferred inflation measure - core Personal Consumption Expenditures (PCE) - remains above the Fed's target of 2%, we expect inflation to continue to moderate in the back half of the year, driven in part by lower shelter inflation and slower wage growth. U.S. government measures of shelter inflation, including the Consumer Price Index (CPI) and PCE, have been lagging market-based measures, such as Zillow's Observed Rent Index, which show housing costs rising at a slower pace. Labour markets have also started to cool, reflected in fewer job openings and slowly rising unemployment. We expect moderating inflation to allow the Fed to pivot to rate cuts, likely in September or December of this year, potentially both, steepening the U.S. yield curve.

International bonds could underperform U.S. small- and mid-cap stocks over the near term - U.S. economic growth moderated in the first quarter of 2024 from the above-trend pace of late 2023. A likely Fed pivot to interest rate cuts later this year should support U.S. economic activity over time. While bonds typically perform well during Fed rate-cutting cycles as their prices rise, we expect this backdrop to also be supportive for U.S. stocks. We believe U.S. small- and mid-cap stocks can outperform international investment-grade bonds over the near term by offering a balance of quality and cyclicality to potentially benefit from the ongoing U.S. economic expansion.

▶ Action for investors

We recommend underweighting fixed income relative to your long-term strategic asset allocations, as we expect U.S. stocks, and more specifically, U.S. small- and mid-cap stocks to outperform international investment-grade bonds over the near term. 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.

Investing in equities involves risks. The value of your shares will fluctuated and you may lose principal. Mid-and Small-cap stocks tend to be more volatile than large company stocks.

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.

