RBC Global Asset Management

RBC Canadian Government Bond Index Fund

Commentary as at December 31, 2023

Canadian bonds posted gains in 2023, breaking a two-year losing streak, on optimism that central banks would begin rolling back policy rates from the highest levels in more than two decades. Fixed-income returns were supported, particularly in the fourth quarter, by signs that slowdowns in inflation and economic growth, especially in Canada and Europe, would give central banks the cover they needed to bring down their benchmark rates. The lack of a recession made the job of policymakers more difficult, as fears persisted that lower rates would rekindle inflation.

The slowing inflation and a pullback in economic growth allowed the Bank of Canada (the “BOC”) to decrease the speed at which it had been raising rates. The BOC increased interest rates three times during the period, compared with seven times in 2022, resulting in a benchmark rate of 5.0%. Canada’s 10-year yield ended the year slightly lower at 3.11% but traded in a range between 2.72% and 4.24% - the highest since July 2007.

The Fund holds Government of Canada bonds and federally backed mortgage bonds. The Fund's relative performance benefited from exposure to mortgage bonds, which outperformed Government of Canada securities. The Fund’s overweight allocation to longer-maturity bonds had a positive impact on returns.

The portfolio manager believes the BOC has finished the current round of rate hikes and will start lowering rates in 2024 as the Canadian economy slows under the impact of tighter financial conditions. Given record high levels of debt and high interest rates, Canadian households are cutting back their spending, and businesses are borrowing and investing less. The portfolio manager’s view is that bond yields will continue to fall as the economy slows through the first half of 2024.

Over the longer term, bond yields may stay higher than investors would like as the Canadian government will have to increase bond issuance to fund expanded social spending. Also supporting yields would be a situation in which inflation persists, forcing the BOC to hold policy rates at levels that could limit economic growth.

In November 2023, the federal government suspended plans to stop issuing mortgage bonds after concluding that such a move would hinder efforts to boost construction of new housing. Instead, the government said it will purchase up to $30 billion worth of mortgage bonds per year, which is 50% of the annual issuance, starting as early as February 2024.

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