

Emerging Opportunities in Diverging Policies

How fixed income opportunities have been created through differing central bank policies



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At a glance

- As inflation soared across the world over the past two years, central banks in many developed market (DM) and emerging market (EM) countries have had to swiftly and decisively raise policy rates.
- While the experience in the global bond market over the past few years conditioned us to expect strong positive correlations in fixed income returns across markets, we are now at an inflection point in the cycle where monetary policy and bond market divergences will occur.
- We expect that going forward, divergences will become more pronounced across all DM and EM bond markets and, against this backdrop, several fixed income investment opportunities will emerge for investors.

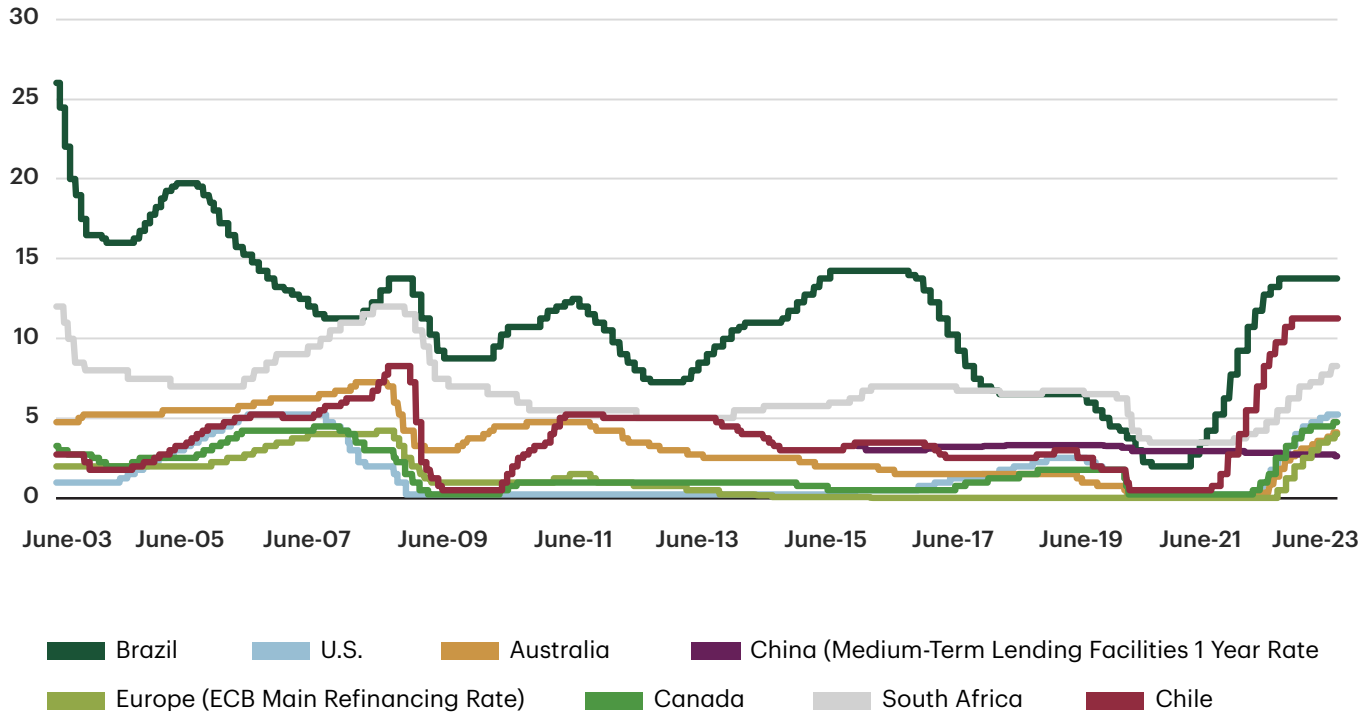
As inflation soared across the world over the past two years, global monetary policy became strikingly coordinated. To slow the growth of price increases on goods and services, central banks across DM and EM countries have had to swiftly and decisively raise policy rates. The outcome has been a significant adjustment higher in interest rates in most bond markets, which has resulted in noticeably negative total returns the world over. Other than a few notable exceptions like China and Japan, investors have had nowhere to hide.

“Transitory”

While numerous DM central banks continued to deem inflation “transitory” as late as the fourth quarter of 2021, many EM central banks had already begun monetary policy tightening (chart below). As they had a 6 to 12-month head start in their battle against inflation, it is no surprise then that EM countries saw inflation rates peak sooner than those in DM countries. Fast forward to today and some EM central banks are now on the cusp of cutting policy rates.

“Coordinated” Global Monetary Policy Hikes

Global Policy Rates across Developed and Emerging Markets



Source: Bloomberg Finance L.P., TDAM. Data as of June 30, 2023.

Fixed Income

We are now at an inflection point in the cycle where monetary policy (and bond market) divergences will occur.

This article will highlight the nuanced opportunities in global fixed income today. The first section will review the importance of accounting for currency hedging costs when analyzing DM bond yields. The second section will specifically address one of the aforementioned exceptions to the monetary policy tightening trend: Japan. The third section will highlight opportunities within EM bond markets.

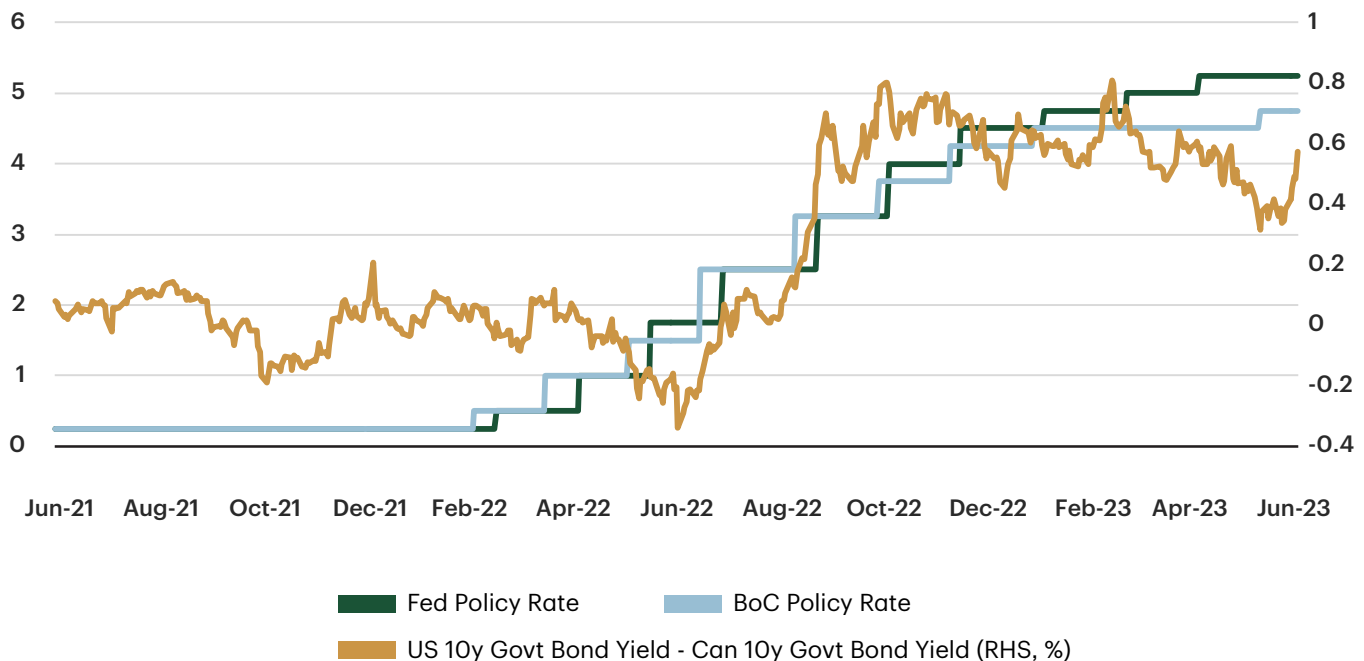


Opportunity 1: DM Bond Markets - mind the FX hedging costs

While the Bank of Canada (BoC) has recently resumed hiking rates, it was among the first of the DM central banks to pause monetary policy tightening while other central banks pressed higher. This means that while some DM countries presently offer higher bond yields, investors need to be aware that the cost of hedging the currency exposure can negate the yield pickups. In particular, investing in shorter U.S. Treasury bonds together with a currency hedge will actually result in negative yield pickups relative to investing in shorter Canadian Government bonds. By the time the BoC stopped raising its policy rate after its January meeting, Canadian interest rates had already lagged well behind those of other DM

countries. For example, at the end of January the 10-year US Treasury bond yields were more than 0.6% higher than 10-year Canadian government bond yields despite the fact that both the BoC's policy rate and the U.S. Federal Reserve's (Fed) policy rate were at the same levels, around 4.5% (chart below). Canadian bond investors had largely anticipated the BoC's pause and perhaps even an end to the hiking cycle. The yield differential between the two government bonds remained broadly consistent at 0.6% until the middle of May, although the notable difference was that the Fed continued to raise its policy rate while the BoC remained at 4.5%.

Fed and BoC Policy Rates versus 10-year Government Bond Yield Differential Between U.S. and Canada



Source: Bloomberg Finance L.P., TDAM. Data as of June 30, 2023.

As the policy rate difference between the Fed and BoC grew from 0% in January to +0.75% in May, Canadian investors' currency hedging costs associated with U.S. dollar (USD) denominated assets grew accordingly.

Over the last two months, Canadian economic data on housing, consumption, and inflation has surpassed the BoC's expectations, giving the BoC cover to resume rate hikes. This has helped to reduce Canadian investors' foreign currency hedging costs. However, since May, in anticipation of a resumption in monetary policy tightening, Canadian government bond yields have also risen such that U.S. government bond yields still do not offer a yield pickup after accounting for currency hedging costs.

Nevertheless, the speed with which the BoC raised its policy rate over the past 18 months has meant that there are numerous DM bond markets, including lower yielding markets than Canada, that currently provide higher yields than Canada as it is still relatively cheaper to hedge foreign currency exposures. Among them are U.K., Europe, and Australia. Of course, at this stage in the global monetary cycle, we expect noticeable divergences in the speeds and end points in monetary policy tightening paths as each central bank must now contend with idiosyncratic economic factors. **This means that Canadian investors must increasingly tread carefully when venturing abroad with their fixed income investments and understand the full extent of the costs and risks they assume.**

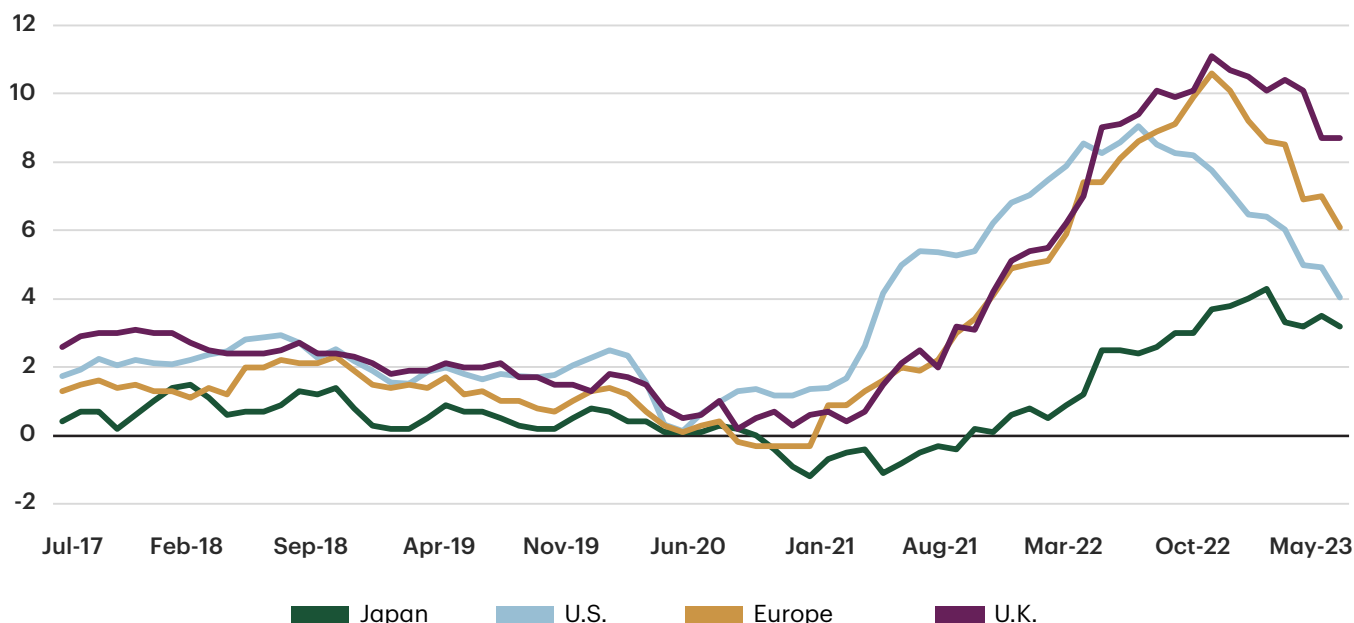
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Opportunity 2: Japan – there is no such thing as a free lunch

As inflation in Japan has been slower to materialize and appears to have peaked at a noticeably lower level than all other DM countries (chart below), the Japanese currency has borne the brunt of the ultra-easy monetary policy stance that the Bank of Japan (BoJ) has maintained since 2020.

Inflation Rates in Select Developed Market (DM) Countries

Year-over-Year Inflation Rates for Select DM Countries (%)



Source: Bloomberg Finance L.P., TDAM. Data as of June 30, 2023.

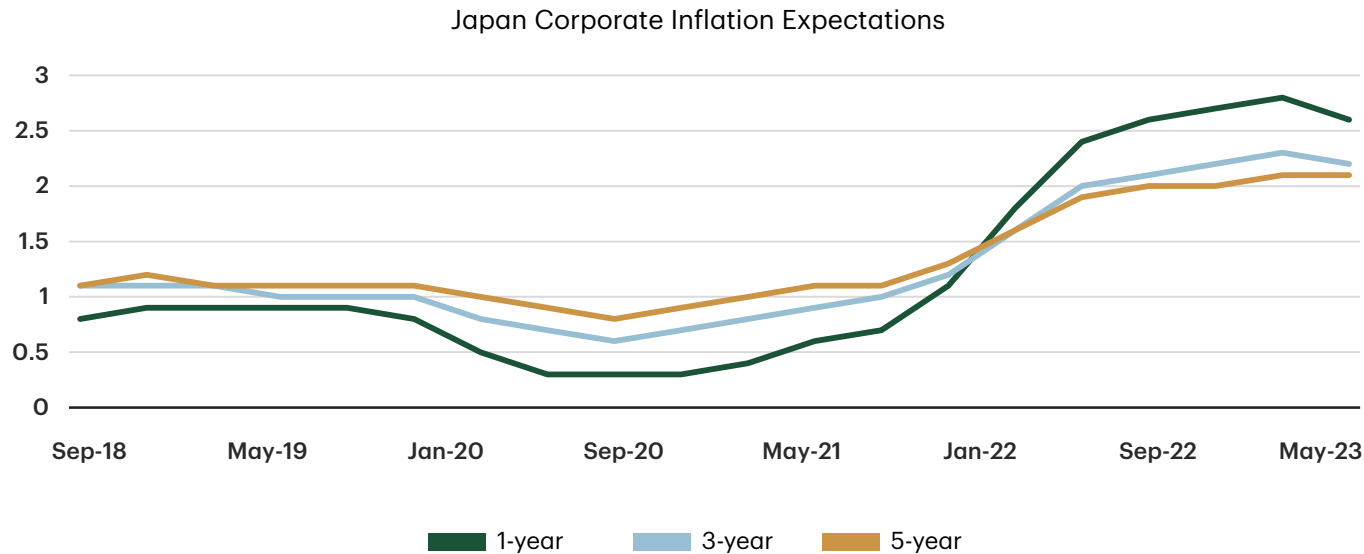
In contrast to modest growth rates in other major DM countries in recent quarters, Japan had experienced relatively stellar economic growth and is likely to see economic growth remain above potential in the coming quarters. Indeed, the BoJ has maintained the ultra-accommodative monetary policy stance since 2020, which continues to support consumption recovery and investment activity. The Japanese Yen (JPY) has also depreciated meaningfully due to monetary policy divergence as DM central banks raised rates quickly over the past 18 months while the BoJ has remained at rock bottom. This has contributed to higher inflation in Japan but also stronger export earnings in some economic sectors.

Since 2022, Japan's headline and core inflation has increased sharply, albeit significantly less than other DM countries; a development that has been welcomed by the fiscal and monetary authorities. While headline inflation appears to have peaked and could moderate further as cost-push factors

normalize further, core inflation remains very strong. Nonetheless, the BoJ still expects inflation to moderate over the coming months and is not yet confident that inflation will remain sustainably above 2% over the medium term.

This explains why the BoJ remains the outlier among DM central banks by maintaining its policy rate at the historical low rate of -0.1%. In fact, any steps in normalizing monetary policy will necessitate further inflation outlook upgrade from the BoJ. The magnitude of policy divergence with other DM central banks has been stark and is the key contributor to the sustained weakening of the JPY. Nonetheless, the medium-term inflation outlook has brightened as evidenced by the strong Shunto wage negotiation results as well as the pickup in corporate inflation expectations (chart below). Over the coming months, we may see the BoJ finally embark on the path of policy tightening, possibly starting with an adjustment to its yield curve control policy.

Inflation Expectations Among Japanese Companies



Source: Bloomberg Finance L.P, TDAM. Data as of June 30,2023.

Development

This would result in upside risk to Japanese government bond yields but, more importantly, it would also be a supportive factor for JPY. Considering that JPY's valuation is at historical lows and that potential currency intervention by Japanese authorities could limit further downside risks, there exists an interesting opportunity to capture the eventual rebound in the JPY. However, given how much the BoJ has lagged other DM central banks in their rate hike cycles, the JPY currently exhibits highly negative carrying costs. Therefore, investors should consider expressing JPY upside views through currency options to ensure there is a known, and limited, cost to gaining exposure to the Yen.

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Opportunity 3: EM Bond Markets - the early bird gets the worm

As previously mentioned, some EM central banks began raising policy rates 6 to 12 months before the Fed, BoC, and other DM markets. This was especially true for many countries in Latin America (LatAm) and Central and Eastern Europe (CEE). The more prudent central banks were also aggressive on the magnitude of those rate hikes. For example, the central banks in Brazil and Chile initially raised policy rates in less than 1% increments when their monetary policy tightening cycles began at the start and middle of 2021, respectively. However, within 6 to 9 months, they were raising rates in 1.5% increments. This is how, in the span of 18 months, they were able to raise policy rates some 11% to 12%.

The heavy lifting by these central banks, which have decades of experience in fighting inflation, has been that ex-ante real policy rates (current nominal policy rates less consensus CPI forecasts to the end of 2023) are elevated in many EM countries relative to DM countries. This is especially true for LatAm countries as well as China, Indonesia, and South Africa (table below). These positive ex-ante real policy rates have broadly enabled foreign capital inflows to remain stable, preventing any balance of payments crises in higher-rated EMs, despite elevated inflation levels relative to pre-pandemic levels.



Ex-ante real rates across EMs (Nominal Rates Less Forecasted 2023 Year-End CPI Rates)

Latin America	Policy Rate	2Yr	5Yr	10Yr
Brazil	8.8	5.6	6.8	5.6
Chile	3.3	-1.2	-0.8	-2.8
Colombia	1.6	-1.8	-1.9	-1.4
Mexico	5.6	4.5	3.1	3.0
Peru	1.2		-0.6	0.3
Asia	Policy Rate	2Yr	5Yr	10Yr
China	2.4	0.9	1.2	1.4
India	-0.1	0.4	0.5	0.5
Indonesia	1.8	1.9	1.9	2.3
South Korea	0.2	0.4	0.4	0.4
Malaysia	0.0	0.5	0.6	0.9
Philippines	0.6	-0.4	0.1	0.9
Singapore	-1.2	-1.4	-1.8	-1.9
Thailand	-0.5	-0.4	-0.2	0.0
Central and Eastern Europe	Policy Rate	2Yr	5Yr	10Yr
Czech Republic	-3.8	-5.1	-5.9	-6.4
Hungary	-5.3	-9.6	-10.6	-11.3
Poland	-5.8	-6.7	-6.9	-6.7
Romania	-3.4	-4.1	-3.7	-3.8
Turkey	-30.0	-31.7	-29.2	-28.7
South Africa	2.3		2.9	5.8

Source: Bloomberg Finance L.P, TDAM. Data as of June 30,2023.

With inflation retreating quickly, several EM central banks have not only been able to pause rate hikes for many months now, but some of them are expected to pivot towards easing this summer. For example, investors think Chile's central bank will begin to cut policy rates at the end of July, followed by Brazil's central bank at the beginning of August. That said,

these rate cuts are already anticipated and priced in local bond markets. Furthermore, expectations for policy rate cuts across EM bond markets in 2024 are already very elevated (table below), although that is not unlike the U.S. and Canada where investors expect the Fed and BoC to deliver at least 100bps of rate cuts before the end of 2024.

Expected Start and Magnitude of Monetary Policy Easing Across EMs

Country	Current Policy Rate (%)	First Cut Market Pricing	2-year Ahead Market Pricing for Policy Rates
Brazil	13.75%	Aug-2023	-4.13%
Chile	11.25%	Jul-2023	-6.86%
Colombia	13.25%	Oct-2023	-5.64%
Mexico	11.25%	Feb-2024	-3.85%
Czech Republic	7%	Nov-2023	-3.19%
Hungary	16%	May-2023	-9.84%
Poland	6.75%	Oct-2023	-2.14%
South Africa	8.25%	Sep-2024	-0.09%
India	6.50%	Apr-2024	-0.73%
South Korea	3.50%	Q2 2024	-0.38%
Malaysia	3%	No cuts priced	0.09%
Thailand	2%	No cuts priced	0.39%

Source: Bloomberg Finance L.P, TDAM. Data as of June 30,2023.

Year to date, some local EM bond markets have already appreciated substantially as disinflation themes have become more credible. However, given the magnitude of real rates in some EM countries and regions, particularly LatAm and Asia, local currency investments in those EM currencies and government bonds still present attractive opportunities to earn incremental yields compared to DM governments and even DM corporate bonds.

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Taking advantage of investment opportunities

The increasing divergences between central banks' policy paths at this stage in the global monetary cycle will likely see bouts of volatility, particularly with respect to currency fluctuations. Therefore, tactical risk management of currency exposures is critical to protect capital deployed abroad as the central bank divergence theme gains traction. This is true as Canadian investors take advantage of investment opportunities in DM and EM countries, alike. ■

Opportunity



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