Fixed Income Insights
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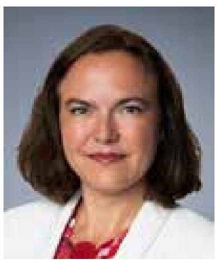
Fixed Income Under the Spotlight

Five Key Questions for Investors

Author



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In brief

- Recession is our base case, and we expect some companies to be hurt by rising funding costs, but the near-term risks are mitigated by the extended maturity profiles of debt held by corporations.
- China faces short-term economic challenges and long-term structural issues, with implications for the global economy.
- With the distortions created when rates rose abruptly after cash earned near zero for more than a decade in the wake of the global financial crisis, the current cash rate of 5%-plus marks a shift that will broadly impact markets and portfolio management.
- We are gradually adding duration in our global fixed income multisector portfolios, largely by finding relative value opportunities in curves and countries as some economies cannot deliver rate cuts priced into the markets.

In meetings with clients and prospects and discussions with colleagues, five questions have frequently arisen in the context of fixed income. Below are the questions and my answers.

What would a recession look like and what follows?

For some time, our base case has been for a recession. Some of the leading indicators have been deteriorating, and money supply has been significantly contracting both in Europe and the United States, and of course financial conditions have tightened in response to elevated real rates. Exhibit 1 shows the New York Federal Reserve Bank's recession indicator, which measures the probability of recession 12 months ahead. The latest reading is elevated, at 71%. We have charted the spreads in high yield alongside this indicator as a proxy for risky assets, and the current level of spreads indicates risky assets are now pricing in a soft landing.

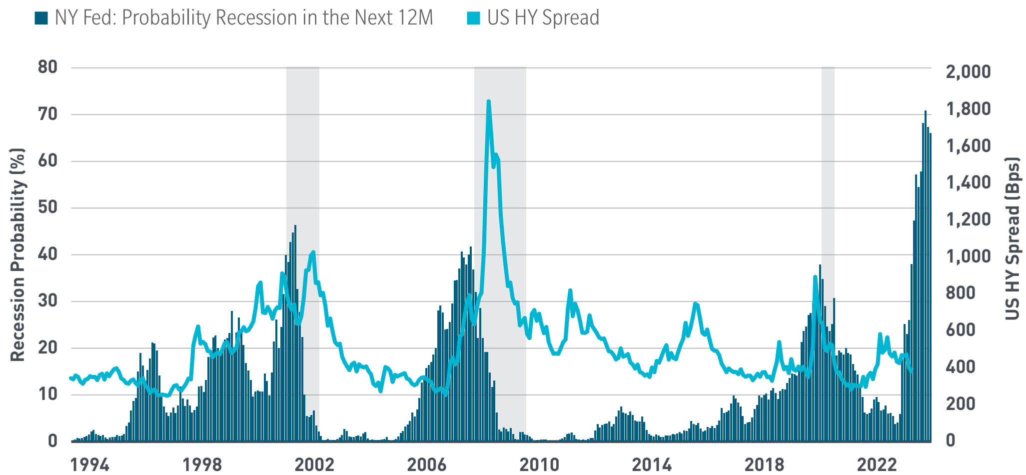
But given the long lags in the impact of funding costs affecting consumer and corporate balance sheets and how anticipated a recession has been by management and consumers alike, a recession, if only a mild one, remains our base case for now.

However, the more the Fed and other central banks press forward with rate hikes without visibly affecting the real economy or inflation, the greater the risk that something breaks and a more severe recession results.

Such a crisis could be triggered by an unexpected systemic-risk event. With rapid moves in rates and levered balance sheets, both public and private, the market has been left fragile, as evidenced by the US regional banking crisis in March and the UBS takeover of Crédit Suisse.

Looking ahead, beyond any recession in the near term, we expect slightly higher growth and slightly higher inflation than prepandemic.

Exhibit 1: Recessions and high-yield spreads



Source: LHS: Bloomberg, NY Federal Reserve. NY Fed: Probability of Recession in the Next 12M = the probability of recession in the next 12 months predicted by treasury spreads series from the New York Federal Reserve Bank. Monthly data from January 1994 through July 2024. US HY Spread = Bloomberg US Corporate High Yield Index Average OAS (Option-Adjusted Spread). Monthly spread data from 31 January 1994 through 31 July 2023. Gray vertically shaded columns represent recessions as defined by the NBER.

Are balance sheets vulnerable?

The private sector benefited from the low funding costs that accompanied the quantitative easing policies of central banks after the GFC. They were also helped by the fiscal splurge during the pandemic. This led to a period in which the private sector engaged in unsustainable capital allocation and operated under unsustainable financing structures. Not much of the liquidity made its way into productive investment in the economy. Instead, it ended up rewarding shareholders through share buybacks or M&A.

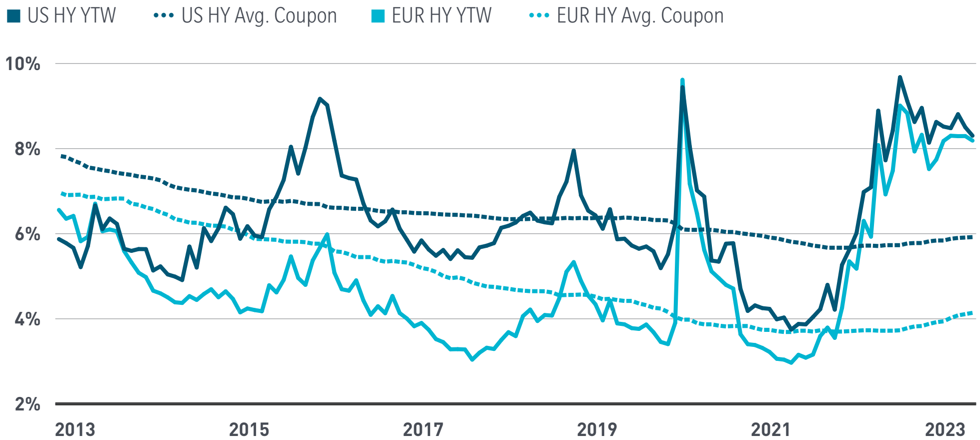
We are concerned about the trajectory of margins at this point in the cycle, particularly in the case of levered companies with weak business models and little pricing power and those with management teams that are unrealistic about the hurdles they face. We rely on the strength of our global research platform to identify the winners and the losers.

One of the factors we are focused on is refinancing risk. Exhibit 2 below shows the increase in yields in euro and US-dollar high-yield markets relative to the average coupon. Exhibit 3 plots the maturity profile of high-yield companies by region. Over the past several years, high-yield and investment-grade companies have done a good job of extending their maturity profile, which is key when they need to refinance and step up their funding costs. As Exhibit 3 indicates, companies face the maturity wall in about twelve to eighteen months, so it will take a little longer for challenged balance sheets to perceptibly impact the market.

Investment-grade, large-cap companies have also extended the maturity profile of their debt. And US consumers have been refinancing mortgages over the past several years, pushing out higher aggregate funding costs.

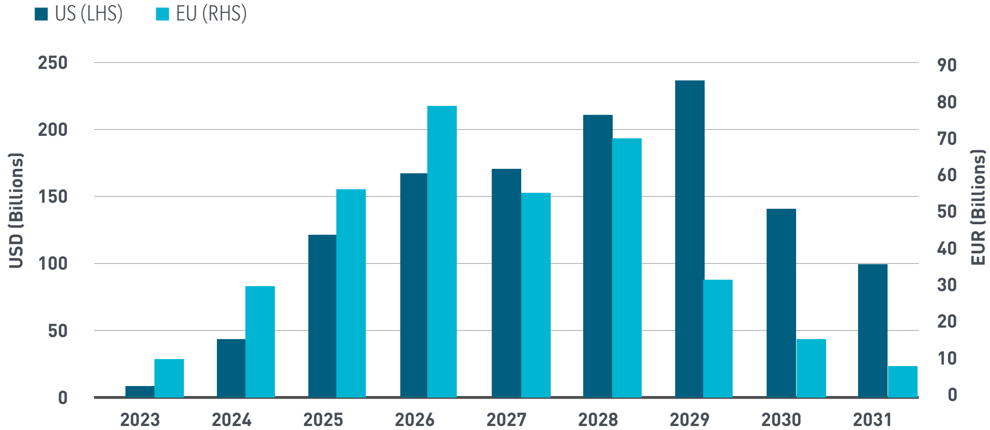
In sum, we expect some companies will be hurt by rising funding costs, but it is hard to argue this is an imminent risk given the maturity profiles of debt owed by corporations.

Exhibit 2: US and euro high-yield average coupon and yield-to-worst



Source: Bloomberg. Monthly data from 31 January 2013 through 31 July 2023. YTW = yield-to-worst. US HY = Bloomberg US Corporate High Yield Index. EUR HY = Bloomberg Pan European Corporate Hight Yield Index.

Exhibit 3: High-yield maturity profile by region



Bloomberg. Data as of 26 June 2023. Maturity profile generated for all non-investment grade corporate bonds domiciled in the US and Eurozone respectively. US results are presented in USD, Eurozone results are presented in EUR, both expressed in billions.

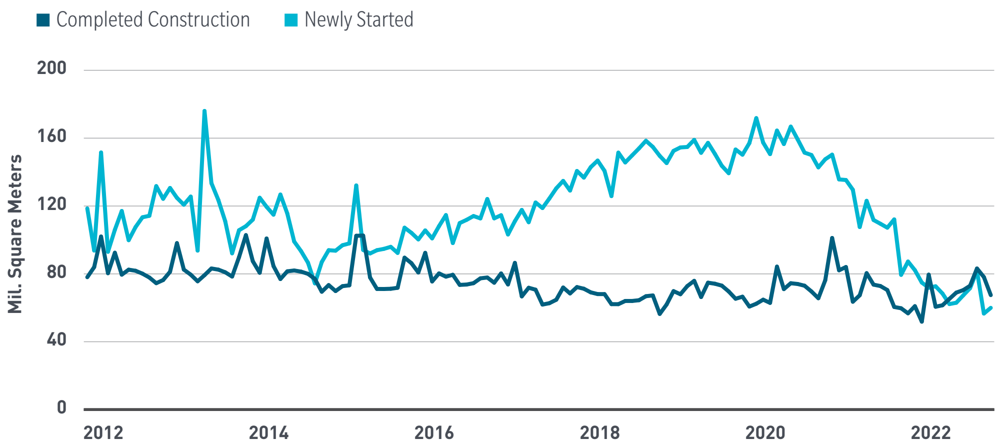
How do macro developments in China impact the rest of the world?

China's activity data remain in the doldrums, and structural issues compound the picture, with a crisis of confidence in much of the private sector. The default risk of local government financing vehicles remains elevated. Exhibit 4 examines residential construction, showing the duration of the property sector concerns. More problematic for the Chinese government is the significant increase in youth unemployment and the resulting social issues that may lie ahead (Exhibit 5).

Global markets have been waiting for easing and stimulus, but for now the initiatives have been underwhelming, to say the least. We would like to see measures that meaningfully restore confidence in the economy. We expect further easing measures, such as those recently enacted, that extend loans to the property sector by a year so they can refinance their short-term debt. However, there is limited fiscal room and there are significant policy constraints at play as well. These small steps in support of the stressed property market are likely to continue, as well as measures to shore up local government debt vehicles.

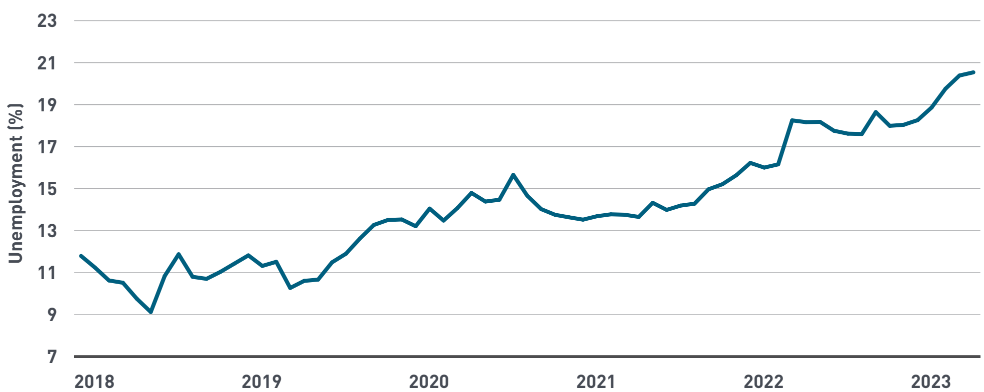
The biggest impact for the Chinese economy and markets will likely come from currency management. Despite trying to keep the renminbi slightly higher to avoid a rapid depreciation, it suits the Chinese government to have a slightly weaker currency. The depreciation trend is expected to continue, which also increases the chances that with increased deflationary pressures at home China will start exporting deflation to the rest of the world. We will be monitoring this aspect of Chinese policy in the coming quarters.

Exhibit 4: China residential construction



Source: Haver Analytics, National Bureau of Statistics. Monthly data from 31 January 2018 through 31 May 2023.

Exhibit 5: Youth unemployment (ages 16 to 24)



Source: Haver Analytics, National Bureau of Statistics. Monthly data from 30 June 2012 through 31 May 2023.

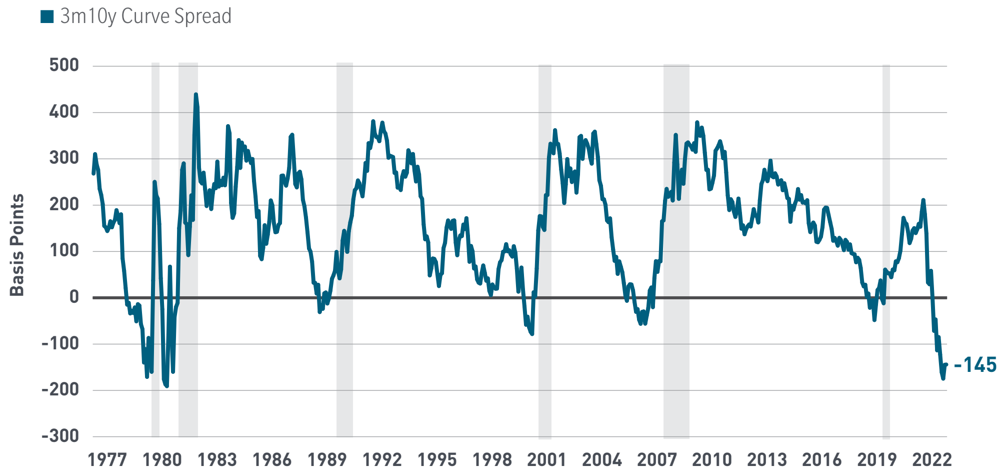
What is the impact of the market distortion related to the strong curve inversion at the front end in the US?

This question requires a multifaceted answer. We think, after cash earned near zero for more than a decade, that blind spots may have been created. The shift to a cash rate of more than 5% is going to have a broad impact on the markets and portfolio management. Several elements that go into portfolio management have suddenly changed.

The larger inversion of the front end of the yield curve could lead to distortions in funding markets and funding costs for portfolios that will impact the carry across different rates futures; it will affect carry basis trades, cash management, margin management and MBS funding. At some point, it could have a greater impact on banks' profitability and the financial plumbing of the US system.

A clear effect of distortion, in our view, is going to be on the cross–currency hedging and the relative attractiveness of US assets for foreign investors. In this context, we closely monitor the expectations for the Bank of Japan around yield curve control and monetary policy given the large Japanese participation in US credit markets and US markets in general. The potential for domestic Japanese investments to suddenly outyield traditional dollar-denominated investments could hamper the performance of traditional asset classes such as CLOs in the US.

Exhibit 6: Inverted yield curve



Source: Bloomberg. Monthly data from 31 January 1977 through 31 July 2023. Gray vertically shaded columns represent recessions as defined by the NBER.

What are the opportunities in fixed income as we position our global fixed income portfolios?

With recession viewed as the base case and the recent rate moves, we are looking for cross-country opportunities to gradually add duration in our global fixed income multisector portfolios. We see a stronger case for duration as the year progresses and macro data provides higher conviction. We are focused on finding relative value opportunities in curves and countries as it is unlikely every economy will deliver the rate cuts that are priced into the markets. We have diversified the overweight position and duration in different markets including the US but also in parts of Europe, such as Sweden, and other markets, such as Canada and New Zealand. We are lukewarm regarding duration in China, Australia and parts of Europe.

Idiosyncratic local emerging market currency bond markets are becoming increasingly attractive given the high number of past rate hikes and prospective rate cuts. We are proceeding gradually and selectively because of the tight global financial conditions. We have gained exposure mostly in Latin countries where the real rates have led to an inclination to buy locally, such as Uruguay, Brazil, Mexico and Peru. One of our favorite markets for building duration exposure continues to be Korea. We expect the Bank of Korea to be one of the first banks to start cutting rates.

With regards to FX, we are slightly underweight exposure to the US dollar given that we expect the dollar will weaken on the back of the Fed soon ending its hiking cycle. The-US-versus-rest-of-the-world growth expectations and interest rate differentials will determine the path of the US dollar. The potential for US-dollar outperformance in a severely risk-off environment is also a consideration. A serious global recession could make the dollar a more attractive “safe haven”.

In securitized and structured, recent widening in areas such as nonagency mortgages and ABS provides new issue opportunities. Secondary CLOs provide opportunities too. We have been closing a large underweight in mortgage pass-throughs, though valuations are less appealing now than they were in the last quarter of 2022. We have been more inclined to add risk in these traditional mortgage-backed securities. We continue to think that there is value there. It is a high-quality asset class still suffering from the consequences of the regional banking crisis and commercial real estate concerns.

In credit broadly, we continue to favor investment-grade. Some attractive opportunities have emerged in recent weeks. We watch for potential dislocations in the face of likely volatility and new issue market concessions. We favor securities issued in euros and Canadian dollars over US dollars.

In emerging markets, with a strong fundamental and technical backdrop, compressed valuations mean selectivity will be key. Investment-grade sovereigns and EM corporate debt is less attractive.

Finally, in high yield, we have reduced exposure, but continue to look for ways to add yield within our allocation. We are identifying opportunities among B-rated securities where we can find good quality names that offer more yield. There is little relative risk-adjusted value outside of specific idiosyncratic research–led ideas.

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