Fixed Income Insights
January 2024

Fixed Income Under the Spotlight

The Three Key Themes for 2024

Author

Pilar Gomez-Bravo, CFA
Co-CIO Fixed Income

In Brief

- Inflation, growth and central bank policy will continue to keep fixed income investors on their toes in 2024.
- Despite remaining resilient in 2023, corporates and US consumers face a tougher test in 2024.
- Markets remain fragile to a fast unwind of leverage by forced sellers like insurers, pension funds and hedge funds.

Looking back on 2023, two things stand out for me: the continued importance of security selection and the elevated level of interest rate volatility. The latter, theoretically, should have declined given lower inflation outcomes, but instead those outcomes have hampered the ability to get consistent returns from fixed income, overall. However, high rate volatility has created large dislocations which allow active mangers to be nimble in portfolio construction and risk management.

Below, I share my thoughts on key themes for 2024 and how we are positioning portfolios based on our market views.

Theme 1 – Macro dynamics

Inflation, growth and central bank policy will keep fixed income investors on their toes in 2024. Will inflation fall back to target? Is growth heading for a soft, hard or no landing? How accurate is the market in pricing the size and timing of central bank rate cuts?

While inflation around the globe continues to decrease, we still need to monitor three elements that could hinder it from reaching the 2% target set by central banks. The first of these is the price of energy, which helped to lower inflation in 2023 due to base effects and by reducing inflation expectations. Second, unit labor costs as seen in wage growth are still higher than central banks would like, but this is really impeded by poor productivity, especially in Europe and the United Kingdom (UK). We could see corporates trying to pass on further increases in prices to consumers to protect profit margins. Third, fiscal policies — given the number of elections happening around the world. It's unlikely we will see material changes in the fiscal path until after the elections, so this may be a much larger driver as we look through the end of this economic cycle and head into the next cycle.

The major dynamic around growth surrounds which type of landing we will get — soft, hard or none. We have argued that even if we get a soft landing, much of that is already priced into markets, particularly risky assets such as equity and credit. We think a soft landing would require proactive cuts from central banks and would result in the front end of the curve outperforming as further cuts are priced in. A hard landing, involving a recessionary outcome with higher defaults and unemployment rates, is certainly not priced in and would lead to significantly lower yields across the curve as well as a steeper curve. If we have no landing in 2024, we see increased chances of a very hard landing further down the line. Therefore, tail risks appear weighted towards having an adverse recessionary outcome.

In terms of central banks, it's important to understand the path of monetary policy and not just the final outcome. Markets are focused on the pause and potential of peak rates, but it's unclear how quickly central banks will cut. Wage growth, particularly in the service sector, will continue to be a focus for central banks. While it has come down, it's still too high for policymakers to become comfortable that inflation will reach its target. In terms of size and timing of rate cuts, we do not disagree with the magnitude of cuts priced in, but we do think markets are anticipating cuts too soon.

Theme 2 – Resilience of corporates and consumers will face a tougher test than during 2023

How will corporates and US consumers fare this year? Corporate balance sheets are still robust, but we are starting to see a deterioration in credit metrics. Corporates were surprisingly resilient in 2023. Key in 2024 will be how profit margins hold up in the face of increased pressure on revenues. We are starting to see some consumer-facing corporates commenting on lower volumes, which for now are partially offset by higher prices. We worry that a decline in real revenue growth could lead to job losses and a more recessionary outcome. It's a race against time to achieve a soft-landing scenario.

We need to see proactive rate cuts before higher refinancing rates hit corporate balance sheets, both in high yield and investment grade. If this happens, credit will continue to perform well. If the US Federal Reserve (Fed) or European Central Bank (ECB) opt for a longer, higher rate cycle moving into the second half of 2024, I worry a lot more about the resilience of corporate balance sheets.

In this environment, security selection and fundamental research are paramount. Fixed income investors should focus on the robustness of cash flow generation at corporates, their liquidity needs, access to and diversification of funding sources, the asset base in case of a need to sell assets and also their operating leverage.

With regards to the resilience of US consumers, they still have dwindling excess savings, but they appear happy to fund their spending through credit cards. Continued spending will be determined by holding on to jobs, especially in lower-income cohorts. We will attentively watch continuing claims numbers as well as the rate of delinquencies in asset-backed securities.

Theme 3 – Fragility (risks that we're monitoring)

When it comes to fragility in fixed income markets, the biggest risk is, as always, a fast unwinding of leverage when forced sellers need to find liquidity. The liability-driven investing crisis in the UK was the most recent example of what happens when you have forced sellers in an illiquid market. When monitoring for the unwind of leverage, it's inherently difficult to predict where the leverage lies.

My concerns are with holders of fixed income that would have to crystallize losses, should there be higher capital losses through the end of the cycle due to increasing defaults. This could be the case for insurance companies and pension funds that have asset/liability mismatches. Investors with business models relying on high leverage and low rates are also a source of fragility. Hedge funds with very high funding costs whose business models no longer appear viable may be at risk of redemptions. Private credit does not seem to pose a systemic risk but could trigger capital losses.

Liquidity withdrawal by central banks is also a potential fragility issue as a plummeting money supply frequently contributes to recession. As lending conditions tighten, we are starting to see banks increase their loan loss reserves due to concerns about asset quality. As well as higher rates, quantitative tightening and changes in the Fed's reverse repo operations are also impacting liquidity.

Finally, crowded trades also present fragility risks and are worth monitoring and avoiding where possible. There are currently a lot of crowded trades as investors position for the end of the cycle and a soft-landing scenario, which is why we are closely monitoring those parts of the markets we invest in.

Portfolio positioning and market views

Transitioning from long duration to curve steepeners. We have been taking some profits on our long-duration position and, mostly in the US, we are positioning for steeper curves. This is a negative carry trade, so we are trying to do this in more innovative ways. We still like to be long some duration; however, our base case is that yields are heading lower regardless of the landing. In terms of regions, we prefer Europe and to a lesser extent the UK because they are more exposed to recessionary outcomes than the US.

Overweight to investment grade but reduced high yield allocation. We have taken profit on credit exposure after strong performance but remain overweight investment-grade credit. We believe this will still be the sweet spot as there is little supply in 2024 and investors will seek to lock in the attractive yields. While we continue to have exposure to high yield, we have reduced the allocation as we think this market is more fragile and spreads are relatively tight compared to their history.

Looking to build higher-quality spread exposures. We would particularly like to add to supranationals and mortgage-backed securities, where we continue to slowly build positions in the higher-quality credit space.

Significant reduction in overweight US dollar position. We have been overweight the US dollar (USD) into the higher yield environment but have shifted to a neutral position. We prefer to keep our options open to go long USD again in the case of US exceptionalism, where growth continues to be high, or a risk-off environment where the currency will be seen as a safe haven asset.

Potential for lower yields wherever the economy lands. In the very near term, US 10-year yields seem fairly priced, but we see potential for lower yields as the cutting cycle begins, in a soft landing and certainly in a hard landing. In the case of a soft landing, I can see 100 basis points to 200 bps of Fed cuts. A hard landing could see the Fed cut by 200 bps to 300 bps, with the entire yield curve shifting lower. This is why we continue to advocate for some long-duration positions, while being cognizant of rate volatility and the need to be nimble in positioning and duration.

Preference for inflation-linked versus nominal bonds depends on the landing. Real yields are likely to move with expectations for central bank paths. Currently, the breakeven inflation levels of linkers are fairly priced or even a bit cheap. I think a soft or no landing scenario would see breakevens widen, which would benefit linkers relative to nominals. In a hard landing, breakeven inflation would decline significantly, and linkers would underperform. The worst scenario for linkers is a high-volatility and a very-hard-landing scenario, as linkers would quickly get crushed and a lot of fast money and leveraged accounts would exit the asset class. However, this would be a short-term dislocation that active managers could take advantage of, so we are monitoring the participants are in the overall inflation-linked market.

Mortgage-backed securities are attractive in the medium and long term. Recently, there has been a lot more attention on mortgage-backed securities (MBS) and spreads have tightened considerably. Even with these valuations, we continue to like MBS as an alternative to corporate credit and think it’s still attractive over the medium and long term. We find MBS offers a cheap way to express a short view on volatility and effectively also expresses a steeper curve. We prefer to be underweight the lower coupon part of the asset class, and like exposure to Ginnie Mae as they receive a 9% risk weigh and are favored by banks. Fortunately, we have an experienced team of MBS investors that can help us find idiosyncratic collaterals we like within the wider pool of assets.

Preference for high yield over leverage loans. We prefer high yield to leveraged loans for a few reasons. The weighted average credit quality in high yields is higher than in the loan market. A lot of loans are in the single-loan capital structure, so we do not see the same recovery expectations as in previous cycles where there was a mix of bond and loan capital structures. The higher-for-longer thesis is negative for loans. Interest costs in loan-only structures are high, so will weigh on free cash flow generation for those companies. Additionally, the soft-landing argument favors owning duration in high yield, and demand tends to be more from longer-term investors, rather than from technically driven shorter-term investors.

Low implied credit volatility makes it cheap to utilize derivatives for exposure. An unusual feature of fixed income over the last 18 months or so has been the sustained high volatility in rates markets, while there has been a lack of volatility in credit and equity markets. We think rates volatility should fall as inflationary outcomes narrow, but this is strongly driven by central bank policy and messaging. My mantra of “You have to be early not to be late” applies here, as it is prudent to position the portfolio ahead of market dislocations and pick-up in volatility so you can provide liquidity when the market lacks it. Right now, implied volatility in credit markets is the lowest it has been in around five years, and we are using this opportunity to create better profiles of risk exposures by utilizing credit derivatives thoughtfully versus cash markets. If you anticipate increasing volatility in credit markets, using these instruments provides a cheaper way to protect portfolios and are a more efficient construction of risk.

Fixed Income Insights

January 2024