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Macro Talking Points

Fixed Income Insights

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In brief

- **It is all about the three dotted cuts for 2024 at this week's FOMC.**
- **In your global fixed income portfolio, consider the attractive benefits of European assets relative to the US.**
- **Disinflation has slowed, but it's too early to panic.**

Connecting the dots. The main item on the watch list at this week's Federal Open Market Committee (FOMC) meeting is going to be the new "dots," namely the US Federal Reserve's internal projection of the future path for the federal funds rate. To be clear, the dots have zero prescriptive policy power as they are simply internal forecasts produced by the FOMC, but they do have signaling power for global markets. Global investors should pay attention to what the median dot is going to tell us about the number of cuts penciled in for 2024. The current median — released in December 2023 — points to three cuts.[1] Any deviation from that magic number would represent a major market development, especially if the number of projected cuts is lowered to two, which would cause some market stress in the near term.

Another area of interest is the long-term federal funds rate projection. It is set at 2.5%, but it could be revised higher. Now, you might think that if that move materialized, it would be perceived negatively by global fixed income investors. After all, it would give further credence to higher for longer as a predominating theme. Fair enough, but there is also a more positive interpretation of an uptick in the policy rate projection. If the long-term federal funds rate is revised higher, it could mean two things: 1) the Fed has given up on its 2% inflation target and is now ready to accept permanently higher inflation — an improbable outcome or 2) the potential for long-term growth is now stronger than it used to be. This would represent a bullish signal for growth assets, in our view, which would make sense in the context of a favorable productivity landscape.

Overall, we're not nervous about this FOMC, mainly because the pricing of Fed policy has already gone through a major correction over the past few weeks. With the federal funds future curve currently pricing only 64 basis points of rate cuts until year-end — or two cuts and 56% of a third one, there is ample room for the Fed to overdeliver.[2] The market pricing of only 64 bps of implied cuts is the smallest number we've seen since October 2023. The Fed will hold seven more FOMC meetings this year. On this basis, it would not be unreasonable to think that the central bank can produce 100 bps of cuts until December, based on a June kickoff. If that scenario materializes, market rates will likely decline, thereby providing a boost to fixed income returns. In other words, the Fed's role still matters a lot, but this time it's playing the white knight instead of Darth Vader.

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USA vs. Europe. This item has nothing to do with fairways and greens, if you're a golf fan, but rather rates and spreads, although as in golf, we believe Europe still comes out on top. Where can you currently find the strongest signals for being long duration? Europe. We believe the European Central Bank should be more aggressive than the Fed when it comes to rate cuts, simply because the local macro backdrop warrants it. Quasi stagnation is probably not the appropriate term to describe the current macro conditions in the United States, but it's very much a reality in the eurozone.

What about fixed income valuation? Again, an advantage for Europe. European fixed income currently screens among the cheapest asset classes relative to both US investment grade and US high yield which appear stretched. Even the total yield picture seemingly favors Europe over the US when looking at total yield valuation scores against their own history. Finally, it's not only about valuation. The asset class fundamental picture seemingly appears stronger in European IG and HY than on the other side of the pond. What's the takeaway? For fixed income investors with a global remit, we believe it makes sense to favor Europe as part of a global allocation.

The disinflation bus: taking the scenic route. Disinflation is still on track — sort of — but it's taking its time. Forget about the highway. It's on the serpentine seacoast. Since the beginning of the year, US data has shown less downward inflation momentum. At this point, that disinflation looks like a bit of a grind. You can blame that on services inflation that looks sticky, especially supercore services (those excluding food, energy and housing). As part of the recent US inflation release for February, supercore services inflation edged up to 4.30% year over year, a number too high for comfort.[3]

Every statistical analysis shows the same thing: Near-term momentum looks far more challenging than a few months ago in terms of supporting the immaculate disinflation story. Take the Atlanta Fed analysis of sticky versus flexible inflation. Both inflation indicators depict more upside risks in the near term. Many other datapoints suggest the same story. The good news is that it hasn't spilled over to the inflation expectations data, which remain well behaved. Why does this matter? Because progress toward lower inflation is the single most important macro driver at this point. It's what could make or break fixed income this year. It's also what's testing the Fed's patience, and what will cause the much-anticipated green light for rate cuts to flash.

But it's too early to panic. The inflation measure that matters, the core personal consumption expenditures price index, currently stands at 2.8%. While core PCE continues to head toward the 2% target, even at a crawling pace, fixed income will remain well positioned. The bad scenario is a disinflation process that stalls, or even worse, hits reverse, with the Fed giving up on rate cuts altogether. If that happens, 2024 could be a mediocre year for fixed income returns. ◢

Endnotes

[1] US Federal Reserve, Summary of Economic Projections, FOMC, December 2023.

[2] Bloomberg, federal funds future curve. Futures for December 2024. Data as of 15 March 2024.

[3] Bloomberg. Bureau of Labor Statistics. Data as of February 2024.

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