Macro Talking Points

Fixed Income Insights

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In brief

- **Central bank easing is coming, which is supportive of fixed income.**
- **The probability of the no landing scenario occurring is going down.**
- **Credit spread valuation looks stretched in some markets, but there's no cause for panic.**

March madness in global monetary policy. Last week, we witnessed some unusual activity among major central banks. Indeed, one — the Swiss National Bank — delivered a rate cut while another — the Bank of Japan — announced a rate hike. Sightings of unsynchronized monetary policy actions at the major central bank level are less frequent than bigfoot sightings. Not only that, but we are starting to sense central bank agitation, including on the part of the US Federal Reserve, which delivered dovish policy signals at last week's Federal Open Market Committee meeting. In other words, central bank activity is about to bubble up, with the Fed and the European Central Bank likely leading the way. The US rates market is back to implicitly pricing in three cuts for this year.[1] This is consistent with the Fed's own forecasts, after it downplayed the prospect of aggressive rate cuts for a while. What does that forthcoming central bank activity mean for the long-term fixed income investor? The main impact is on the duration view. We believe it makes a lot more sense to be long-duration if you are an investor with a long time horizon. But that's not all. Easing cycles also tend to be supportive for investor sentiment. Therefore, we anticipate that the appetite for risky assets — including credit — is likely to pick up further in the period ahead. This is important for fixed income given the growing concern over spread valuation. If the macro data remain benign, we may struggle to find a catalyst that would trigger a spread correction. That would be good news for fixed income expected returns.

The no landing scenario is not landing well. The outlook for the no landing scenario is not so bright after all. And that's good news. The realization of that scenario would likely spell trouble for global markets, as it would probably signify dimmed hopes for central bank rate cuts and a possible return to higher inflation. But there are signs that the US economy has entered an orderly slowdown phase, which is exactly what we want to see. US real GDP growth stood at 3.1% in Q4 of 2023 on a year over year basis. But that pace isn't sustainable. The latest leading indicators published by the Atlanta Fed and the New York Fed point to a growth slowdown towards 2% for Q1 of 2024, which would be welcome.[2] In macro land these days, it's much less about growth than it is about inflation. We're in the last mile of the disinflation story, and we need to cross that finish line. Goldilocks's porridge is still too pricey, but we'll get there. Overall, the macro fundamentals are not going to be a detractor from performance, in our view. Quite the opposite. If all the investment process components were color-coded, macro fundamentals would be flashing green. In fixed income, they are the most important factor, so that's positive.

What about credit spread valuation? It's been a race to the bottom for credit spreads, and for some markets, we're now approaching the lows reached in 2021 during the post-COVID rally. By some measures, spread valuations look stretched, and, using color-codes again, would be flashing red. With that in mind, let's look at the distance to the 2021 lows for the broad spectrum of fixed income sub-asset classes. For US investment grade, with credit spreads currently at 88 basis point, we're only 10% away from the level reached in June 2021.[3] Likewise, US high-yield spreads are 10.4% away. In Europe, there's a lot more distance to the lows, with European IG spreads still 37% above their 2021 lows. For European HY, we are looking at a 24% distance to the bottom. In emerging markets, the valuation picture looks challenging, especially for EM corporate debt, for which spreads now trade well through their previous lows. Overall, while the valuation backdrop is less supportive than it used to be, there's no cause for panic. As it turns out, spreads can stay in stretched territory for a long time. At least this is what history is telling us. In addition, besides valuation, fixed income can rely on the support of other drivers, including the strong macro backdrop and robust asset class fundamentals.

Endnotes

[1] Source: Bloomberg. Federal funds future curve. Data as of 25 March 2024.

[2] Sources: Bloomberg, US Federal Reserve. Atlanta Fed GDP nowcast. As of 19 March. 2024. New York Fed GDP nowcast, Federal Reserve Bank of New York Nowcast GDP Growth for Current Period. As of 22 March 2024.

[3] Source: Bloomberg. US IG = Bloomberg IG Corporate credit index. Option-Adjusted Spreads, data as of 22 March 2024.