

Macro Talking Points

Fixed Income Insights

Week of 29 April 2024

Author



Benoit Anne
Managing Director
Investment Solutions Group

In brief

- **Stagflation trying to stage a comeback**
- **Q&A from last week's Asian client trip**

Too early to fret over stagflation. Let's not panic about the prospect of stagflation in the United States just yet. Yes, US real GDP growth slowed in the first quarter while inflation surprised to the upside, reigniting stagnation fears. The statistical fine print matters, however. The composition of GDP growth was indeed robust, and overall the signals were reassuring, especially when it came to the health of the US consumer and the outlook for private investment. Deep down in the GDP report, the two line items that caught our attention were the growth in residential investment (housing), which recovered to 13.9% quarter over quarter, and the private fixed investment in information-processing equipment and software, which grew by a double-digit rate for the second quarter in a row.¹ That smells like an IT-driven positive productivity shock to us. Another potential source of comfort is that this first-release GDP number, officially known as the advance release, is prone to substantial revision. For quarterly GDP data, there are three different releases — one month apart, the advance, the second release and the final release. Guess what? Over the past ten years, the standard deviation of the revision between the advance and final releases for the same quarter was a staggering 1.4%. In other words, the latest GDP growth release of 1.6% for the first quarter could end up being revised up to as high as 3.0% or all the way down to 0.2%), based on historical patterns. It's therefore too early to draw any major conclusions. Yes, 1.6% quarter over quarter performance was disappointing, but we aren't too far off the GDP growth sweet spot, which we estimate to be in the low twos.

Moving on to the inflation side of the stagflation equation, there's no need to panic here either. The highly significant core PCE deflator number for March, which was also released last week, stood at 2.8%, stable from a month earlier.² This means that progress toward the US Federal Reserve's 2% inflation target is rather slow but at the same time there is little evidence of a big inflation flare-up. Overall, we believe the macro backdrop is still supportive for fixed income, despite the increased uncertainty over the timing and magnitude of future rate cuts.

You asked. I spent last week meeting with institutional investors in Southeast Asia. Many important topics were discussed. Here's a quick rundown of the issues on Asian investors' minds.

On the macro front, monetary policy was a major item of discussion, especially the outlook for Fed and European Central Bank policies. Fiscal policy was covered, with one investor asking whether fiscal dominance was a tangible policy risk. The no-landing scenario came up as well, including the upside risk to inflation. Turning from the US, investors wanted to know our view on Japan. Besides macro, there were a lot of questions related to our market views, starting with the appropriate stance on duration and curve positioning. Higher-for-longer was also raised, with the question being whether it was still a relevant theme. Fixed income valuation was a hot topic, including where we still saw attractive opportunities. Other market view questions included our view on the US

dollar and why gold was rallying. Market risks were understandably a major topic, in particular which risks were the most serious and how we should position for rising geopolitical risks, including election risks, especially what will happen if Donald Trump wins the US presidential election. Other interesting themes came up, including passive vs. active management in fixed income, the appetite for green bonds in the context of sustainable investing, and the appeal of private credit.

We answered. On monetary policy, we still believe the Fed will deliver rate cuts, but the uncertainty over the timing and the magnitude of cuts has risen. It's still possible the Fed will deliver two or even three cuts this year alone. The good news is that the current market pricing backdrop is favorable, with the market potentially underpricing the magnitude of future rate cuts (in fact, the federal funds future curve only prices in 35 basis points of rate cuts by year-end right now).³ Moving on to the ECB, it's likely to be more aggressive with rate cuts than the Fed, simply because the macro backdrop in the eurozone supports that outcome. We expect ECB rate cuts to begin in June, with several more following before year-end. Still on the topic of monetary policy, in Japan, we expect a gradual move to the exit. With that in mind, we aren't necessarily looking to be mega short duration there. Moving on to fiscal policy, yes, the lack of fiscal discipline in the US is an important issue, but not in the short term. Also, with the Fed's independence entrenched, we don't find fiscal dominance a tangible risk. Another issue is the inconsistent policy mix currently facing the US, with fiscal policy getting in the way of the monetary policy objectives.

In terms of the macro scenarios, the no-landing scenario is more likely to play out than the recession one, but our baseline is still a soft landing, simply because we're observing signs of a moderate growth slowdown in the US, as we discuss in our introduction above. For the strategic long-term investor, we still like being long duration given where we're in the rate cycle and the attractiveness of market rate valuation. Admittedly, the case for being long-duration is stronger in the eurozone than in the US. As for curve positioning, it makes sense to extend the position down the curve especially when the curve re-steepening process gathers momentum again. Higher-for-longer is a matter of definition, in our view. Rate cuts are coming soon but policy rates as well as market rates will stay higher than during the post-GFC era. That's a good thing, and we should celebrate the return to the "old normal." Meanwhile, spread valuations now look stretched in many markets, but the yield valuation story is still compelling. In addition, European fixed income looks more attractive than its US peer. On the USD, the macro backdrop should in principle lead to USD weakening in the period ahead, but there is more uncertainty around the macro drivers. With respect to the gold rally, the metal tends to be perceived as an inflation hedge, and the latest move aligns with recent fears about stickier inflation in the US.

On risks, it's virtually impossible and probably not even desirable to position for geopolitical risks. As a first line of defense, we advocate a diversified portfolio across regions, currency exposures and asset classes, including fixed income and commodities. As we say above, a Trump win is a major market risk, simply because it remains unclear what a second term would look like. Consensus errs on the side of Trump-II being less market-friendly than Trump-I, with a greater risk of tariff wars and protectionist policies. To be clear, the US election is still too close to call, and a lot can change before November. On the debate about passive vs. active management, we recognize that there is room for passive management in a broad portfolio. At the same time, the higher the macro volatility, the greater the value that can be extracted from an active approach to portfolio management. That's why we believe using an active manager still makes sense. On green bonds, Asian investors expressed great interest in them. We explained our approach to sustainability, which relies on the full integration of the consideration of sustainability factors into the investment process. Finally, on the appeal of private credit, an allocation to private credit is justifiable as part of a broader asset allocation. However, we believe caution is warranted, and given the restored attractiveness of public fixed income, we suggest not being overweight private credit at this juncture, especially as the asset class has become a lot more crowded. ▲

Endnotes

¹ Sources: Bloomberg, Bureau of Economic Analysis. GDP chained dollars QoQ for Q1 2024.

² Sources: Bloomberg, Bureau of Economic Analysis. Core PCE price index for March 2024.

³ Sources: Bloomberg, federal funds future curve. Data as of 26 April 2024.

Source: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Bloomberg neither approves or endorses this material or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

The views expressed herein are those of the MFS Investment Solutions Group within the MFS distribution unit and may differ from those of MFS portfolio managers and research analysts. These views are subject to change at any time and should not be construed as the Advisor's investment advice, as securities recommendations, or as an indication of trading intent on behalf of MFS.

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by: **U.S.** – MFS Institutional Advisors, Inc. ("MFSI"), MFS Investment Management and MFS Fund Distributors, Inc., Member SIPC; **Latin America** – MFS International Ltd.; **Canada** – MFS Investment Management Canada Limited. **Note to UK and Switzerland readers:** Issued in the UK and Switzerland by MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorised and regulated in the conduct of investment business by the UK Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS®, has its registered office at One Carter Lane, London, EC4V 5ER. **Note to Europe (ex UK and Switzerland) readers:** Issued in Europe by MFS Investment Management (Lux) S.à r.l. (MFS Lux) – authorized under Luxembourg law as a management company for Funds domiciled in Luxembourg and which both provide products and investment services to institutional investors and is registered office is at S.a r.l. 4 Rue Albert Borschette, Luxembourg L-1246. Tel: 352 2826 12800. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore** – MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand** - MFS International Australia Pty Ltd ("MFS Australia") (ABN 68 607 579 537) holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong** - MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO"); **For Professional Investors in China** – MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company registered to provide financial management consulting services.; **Japan** - MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments; **Bahrain** - This document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally. The Central Bank of Bahrain assumes no responsibility for the accuracy and completeness of the statements and information contained in this document and expressly disclaims any liability whatsoever for any loss howsoever arising from reliance upon the whole or any part of the contents of this document. The Board of Directors and the management of the issuer accepts responsibility for the information contained in this document. To the best of the knowledge and belief of the board of directors and the management, who have all taken all reasonable care to ensure that such is the case, the information contained in this document is in accordance with the facts and does not omit anything likely to affect the reliability of such information.; **Kuwait** - This document is not for general circulation to the public in Kuwait. The information has not been licensed for offering in Kuwait by the Kuwait Capital Markets Authority or any other relevant Kuwaiti government agency. No private or public offering of the information is being made in Kuwait, and no agreement relating to the information will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the information in Kuwait.; **Oman** - For Residents of the Sultanate of Oman: The information contained in this document does not constitute a public offer of securities in the Sultanate of Oman as contemplated by the Commercial Companies Law of Oman (Royal Decree 4/74) or the Capital Market Law of Oman (Royal Decree 80/98). This information is being circulated on a limited basis only to corporate entities that fall within the description of sophisticated investors (Article 139 of the Executive Regulations of the Capital Market Law). The recipient acknowledges that they are a sophisticated investor who has experience in business and financial matters and is capable of evaluating the merits and risks on an investment.; **South Africa** - This document has not been approved by the Financial Services Board and neither MFS International (U.K.) Limited nor its funds are registered for public sale in South Africa.; **UAE** - This document, and the information contained herein, does not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The information is only being offered to a limited number of exempt investors in the UAE who fall under one of the following categories of non-natural Qualified Investors: (1) an investor which is able to manage its investments on its own, namely: (a) the federal government, local governments, government entities and authorities or companies wholly-owned by any such entities; (b) international entities and organisations; or (c) a person licensed to carry out a commercial activity in the UAE, provided that investment is one of the objects of such person; or (2) an investor who is represented by an investment manager licensed by the SCA, (each a "non-natural Qualified Investor"). The information and data have not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority, the Dubai Financial Services Authority, the Financial Services Regulatory Authority or any other relevant licensing authorities or governmental agencies in the UAE (the "Authorities"). The Authorities assume no liability for any investment that the named addressee makes as a non-natural Qualified Investor diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document you should consult an authorised financial adviser.; **Saudi Arabia** - This document may not be distributed in the Kingdom except to such persons as are permitted under the Investment Funds Regulations issued by the Capital Market Authority. The Capital Market Authority does not make any representation as to the accuracy or completeness of this document, and expressly disclaims any liability whatsoever for any loss arising from, or incurred in reliance upon, any part of this document. Prospective purchasers of the securities offered hereby should conduct their own due diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document, you should consult an authorised financial adviser.; **Qatar** - This material/fund is only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such material/fund. The material does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). The fund has not been and will not be registered with the Qatar Central Bank or under any laws of the State of Qatar. No transaction will be concluded in your jurisdiction and any inquiries regarding the material/fund should be made to your contact outside Qatar.