Macro Talking Points

Fixed Income Insights

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In brief

- **A soft landing remains the central scenario**
- **It's important to pay attention to labor market dynamics in the US**
- **Is the Fed behind the curve?**

We are softies. With recession fears having reignited, at least temporarily, it's worth flagging that we are still firmly in the soft-landing camp. In fact, in our internal fixed income strategy meeting last week, chief economist Erik Weisman described the central scenario as a "soft soft landing," or a very moderate growth slowdown. This is positive for global markets as it signals that the macro environment remains in goldilocks mode. There are of course two-sided risks, with recession coming back to the fore as the fattest tail. To be clear, we would need to see considerable deterioration in macro data to be concerned about the risk of recession, both in the United States and in the eurozone. On the US inflation front, disinflation is well on track, which is the most important factor for the US Federal Reserve to decide to pull the trigger on rate cuts. Overall, fixed income is not going to get much push-back from the macro backdrop, in fact quite the contrary. The combination of rate cuts and attractive yields continues to be supportive of the asset class.

This time may be different. Looking back, the market turmoil in early August appears to have been caused by the perception that the US labor market was in considerably worse shape than anticipated, especially after the poor nonfarm payroll number for July. The so-called Sahm rule, which historically has signaled a forthcoming recession, was triggered. The rule is that when the three-month moving average of the unemployment rate rises by a half-percentage point or more relative to its low during the previous 12 months, a recession follows. But today's labor market is far from typical. In the view of our Co-CIO of Fixed Income, Pilar Gomez-Bravo, US labor market dynamics is one of the top-of-mind macro issues at this juncture. Analyzing the jobs market is challenging as there are still lingering impacts from COVID, along with the significant impact of a surge in larger immigration. The deterioration of the labor market may potentially reflect higher labor supply rather than weaker demand, which if confirmed, would be great news as it does not necessarily send a powerful signal in terms of recession risks. One further headline risk to flag is that the Bureau of Labor Statistics is due to release its 2024 preliminary benchmark revision to Establishment Survey data this week, which may result in major downward revisions to past job creation numbers. Given the current volatility and the uncertainty, our fixed income team will continue to monitor the macro backdrop closely and go through a thorough investment process for appropriately sizing duration and credit exposures.

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The other BTC. BTC may be the ticker symbol for Bitcoin, but what we are talking about here is the ultimate insult for a central bank, to be tagged as being "behind the curve." That is essentially what happened to the Fed earlier this month. What if the Fed fell asleep at the wheel and failed to react soon enough, which made the recession inevitable? To be clear, this risk is not negligible and cannot be ignored. By design, the Fed has opted to become more data-dependent, which implies acting in a reactive way rather than in an anticipatory fashion. The problem is further compounded by the reality that the inflation data — which has been the Fed's focus — tends to be lagging, as opposed to leading. But there is no cause for panic, in our view. First, we do not see a recession coming, as highlighted above. Furthermore, Fed cuts are on the table, with a first move likely next month. Before that, Fed Chair Jerome Powell will probably work hard at the Economic Policy Symposium in Jackson Hole this week to dismiss the idea that the Fed is "BTC." One risk in the near term is that current market pricing of future cuts tends to err on the side of overshooting, according to internal discussions that the fixed income strategy group held recently. The implication is that the front-end rate move may have gone too far, and that the room for further curve steepening may perhaps be limited. This is also because, in the view of our fixed income team, 10-year rates, currently just short of 4%, may be fairly close to where they should land going forward.[1] Nonetheless, the general bias remains in favor of being long duration, mainly reflecting the supportive macro backdrop.

Endnotes

[1] Source: Bloomberg, US 10-year generic rates. Data as of 16 August 2024.

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