# Macro Talking Points

Fixed Income Insights

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## In brief

- **The great bifurcation: Market regime**
- **The great bifurcation: Fixed income return drivers**
- **The great bifurcation: Growth dynamics**

**The great bifurcation 1.** Goldilocks used to be a global market regime phenomenon, but not anymore. It's gone more local. This means potential dislocations and relative value opportunities may rise, creating a favorable global market backdrop for an active asset manager. Essentially, the Goldilocks playground can be found where central banks are still aggressively easing policy. That includes Canada, where the central bank should deliver another cut of at least 25 basis points this week, and the eurozone, where the European Central Bank is likely to cut rates as well, along with providing some dovish language to signal that the easing show must go on. Also, there is a new joiner at the central bank policy circus: the People's Bank of China. Its actions have been modest to date, but the latest government communication suggests that policy signals are getting stronger. And don't be fooled by the Chinese authorities' official language. The new guidance is indeed that monetary policy is about to turn "moderately loose," but in practical terms, that may mean that they are prepping to pull out the policy bazooka. By way of reference, China's policy response to the global financial crisis of 2008 and 2009 was also officially tagged as moderately loose. While these headlines are positive, let's see what happens in the country, bearing in mind that the structural headwinds remain considerable. Meanwhile, it's obvious that Goldilocks is still on American soil, especially with the US Federal Reserve sounding a lot more cautious. It's true that the environment for risky assets remains constructive in the United States, but the backdrop for fixed income has become more challenging. The macro regime bifurcation is a major driver of global investment opportunities.

**The great bifurcation 2.** There are many differences between the US and the eurozone these days. One of them is the key drivers of fixed income returns. At this juncture, the US has become a pure carry play and probably not much else. Can we count on aggressive Fed rate cuts? Current market pricing seems to suggest otherwise. Can we rely on further spread compression? It's hard to argue that, at 78 basis points for US IG spreads, there is a lot of juice left to squeeze.[1] It's a reasonable assumption to think that spreads will remain supported by the favorable macro environment, but spread stability —not compression — is the investment team's baseline scenario. Carry sometimes is just good enough, so let's not complain too much, especially with the total yield valuation seeming attractive. Incidentally, this has become an alpha environment, given the limited spread dispersion backdrop. In other words, alpha is expected to play a significant role in total returns, but actual results may vary based on market dynamics. Looking at duration alone, our fixed income team has a neutral bias towards US rate exposure. In Europe, however, the situation looks different. For a start, European investment-grade spreads, currently at 100 basis points, look more attractive.[2] More important, European fixed income still stands ready to possibly reap the benefits of a central bank in full easing mode, so we have the carry, but we also have the impact of rate cuts, together with some potential spread compression, albeit minimal. All that combined continues to support the strong case for exposure to European fixed income, both from a duration standpoint and a credit risk exposure one.

**The great bifurcation 3.** Looking at growth dynamics, the US also appears different. The idea of US growth exceptionalism makes sense, with the important caveat that the US is experiencing all the growth that money can buy. Fiscal stimulus has played a big part of keeping US exceptionalism alive. In any case, the Market Insights' Business Cycle Indicator — which is based on an aggregation of selected leading indicators — indicates there is little sign of economic weakness at this juncture as recession risks have virtually disappeared. Looking into the BCI details, there's some residual weakness in manufacturing, in small firm business sentiment and in housing, but nothing alarming. Meanwhile, corporate profits appear robust, with positive implications for profit margins. Likewise, the labor market remains healthy. The picture in Europe, however, is different. The latest data suggest that consumer and business sentiment isn't doing well, and as we all know, the region is going through political troubles in a few major countries. This all explains why our investment team will be adopting a differentiated view when they talk about the US and Europe.

## Endnotes

[1] Sources: Bloomberg. US IG = Bloomberg US IG credit index, option-adjusted spreads, data as of December 6, 2024.

[2] Sources: Bloomberg. European IG = Bloomberg pan-European IG credit index, option-adjusted spreads. Data as of December 6, 2024.

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