Macro Talking Points

Fixed Income Insights

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In brief

- **Questions and answers from our recent Canada client trip**
- **More policy easing priced in, is supportive of fixed income**
- **Political uncertainty likely to escalate further in France**

Reading the maple leaves: Q's. We visited Canada last week to meet with clients. Here were their top questions. The situation in France was top of mind for Canadian investors, including: the impact of French elections; the potential impact on the eurozone; the worst-case scenario; the risk of global contagion; and at what level would French spreads be attractive. Monetary policy was also a major topic, especially the outlook for US Federal Reserve and Bank of Canada policies. One question covered fiscal policy and the risks attached to the elevated level of public debt. Away from policies, China came up as an area of interest. On fixed income, clients asked about the appeal of emerging market debt exposure, the valuation of credit and the issue of elevated cash allocation. In addition, the topic of private credit came up in every single meeting. Finally, one question was about the investment process at MFS®.

Reading the maple leaves: A's. On France, the outcome of the parliamentary election is still unclear, but one thing appears certain: Political uncertainty is going to escalate. A hung parliament — which means political gridlock — would be the best-case scenario. But if one of the two extreme parties gains an absolute majority, the political crisis will likely worsen. If the extreme political parties do not challenge the country's commitment to the European project, the risk of contagion will likely be limited. However, if the stability of the eurozone is undermined, a worst-case scenario may surface, with the risk of a shock to global investor sentiment. The level of French spreads is somewhat irrelevant in the absence of reassurance about the direction of future fiscal policy, among other issues. In other words, spreads may look somewhat attractive from a pure valuation standpoint, but the fundamentals will need to improve before this represents a buying opportunity. On monetary policy, global central banks have now kicked off an easing cycle. While the Fed's dots now point to the possibility of only one rate cut by year-end, a two-cut scenario cannot be ruled out, given recent disinflation progress. Meanwhile in Canada, more cuts are in the pipeline, which is likely to further support the case for Canadian fixed income. On fiscal policy, the key issue is the credibility of the policy framework. Global investors may be spooked by signals that fiscal discipline is being undermined and that public debt is at risk of rising sharply. France falls in that category, but it is not alone. In the US, there are persisting investor concerns about the lack of commitment on the part of the administration to rein in government debt. On China, our bias is long-term bearish, especially from a geopolitical and domestic policy perspective. Moving on to fixed income, EM hard-currency debt makes sense in a broader strategic asset allocation, while EM local debt allocations need to be managed a bit more tactically, given the currency risk component. On fixed income valuation, credit spreads appear quite stretched in many markets, but the total yield valuation backdrop continues to be favorable. This is important, as ultimately it is total yields that will primarily drive subsequent total returns. On cash allocations, our view is that it is now time to switch to fixed income away from cash, given that central banks have started cutting rates (or are about to). Regarding private debt, an allocation to private credit makes sense as part of a broader asset allocation, reflecting diversification benefits and the different time horizon offered by the asset class. However, we would challenge the merit of an overweight allocation at this juncture, mainly owing to liquidity management considerations and the more challenging valuation backdrop. This is also because public fixed income is back to offering a good alternative to alternatives. Finally, on our investment process, our investment team relies heavily on fundamental research produced by the global research team, along with an assessment of valuation and technicals. The top-down signals are analyzed and compared to the signals that emerge from the research team's bottom-up fundamental analysis as part of a confirmation or challenge process.

The Big Easy. Or easing rather, for the global easing cycle is now under way. Let's take stock of where we are with monetary policy pricing around the globe. Interestingly, there is little difference between what is priced in for the Fed, the Bank of Canada, the European Central Bank or the Bank of England one year ahead, with the important nuance that both the ECB and the BoC already have delivered a rate cut. The one-year implied market pricing ranges from -82 basis points for the ECB to -95 bps for the BoC, with both the Fed and BOE broadly in the middle of that range.[1] Of course, the Bank of Japan stands out with 37 bps of rate hikes being priced in over the next 12 months. When looking at how restrictive monetary policy has been around the globe — based on a real policy rate using core inflation — the Fed turns out to be the most restrictive central bank at this juncture, followed by the BoC and the BOE. This is good news for US fixed income, as it indicates that the Fed has a lot of potential room for future easing, especially as progress towards disinflation appears to be clearer again after a frustrating start to the year. Overall, central bank policy moves will continue to be supportive for global fixed income.

I tried to outsmart everyone but that backfired. You would think that this is just a bumper sticker but this has been a recurring theme in European politics on both sides of the English Channel. There are indeed many examples, reflecting either complacency, desperation or plain delusion. Admittedly, politics is hard, but the recent track record of political gambles has been rather poor. The first-round results of the French parliamentary elections appear to fit this description perfectly. The political party of the sitting president suffered heavy losses and it is almost inevitable that political volatility will escalate in France. This does not bode well for core-plus European government bonds in the near term. Looking ahead, investors will remain concerned over the risk of fiscal slippage in France and perhaps other selected countries in the eurozone. Market volatility may present interesting opportunities for an active asset manager, however, as a thorough research process may help identify winners and losers. French government bond spreads over Germany remain elevated, just short of 80 bps.[2] Any sign of broader contagion could open attractive tactical relative-value opportunities, but it is still too early for that. Moving on to European credit — of which French securities are a sizable part of the index — we believe that the asset class remains one of the most interesting segments of global fixed income.

Endnotes

[1] Source: Bloomberg. Based on local forward cash curves. Data of 28 June 2024.

[2] Source: Bloomberg. Difference between the 10-year French government bond yields and the 10-year bund yields. Data as of 1 July 2024.