Macro Talking Points

Fixed Income Insights

Week of 8 July 2024

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In brief

- **Worst-case political scenario is averted in France, but long-term challenges persist**
- **A mediocre first six months for total returns in fixed income, but it is probably looking up**
- **The labor market in the US is correcting. The key question is: by how much?**

The anti-"Je ne sais quoi". Investors know what they dislike. They dislike political uncertainty and instability, increasing fiscal risks and shocks to policy credibility. In France, which just completed its parliamentary election, we observe most — if not all — of these risk factors. Yes, the seriously adverse scenario of an extreme party gaining an absolute majority was averted, which may be viewed as a major relief in the near term. But at the same time, it seems obvious to us that France's political problems are far from over. Indeed, they may just be starting. To a large extent, political uncertainty relates to the question on everyone's mind: Who will be the next French President when the election is held in 2027? That may seem far away, but it's unlikely that the political climate will improve until that question is settled. Until then, political uncertainty and even instability may dominate, which is far from ideal for markets. As for the fiscal outlook, France now lacks the political foundation that's necessary to restore fiscal discipline. With that in mind, fiscal risks are skewed to the upside. Finally, it's probably fair to assume that the macro and structural reform agenda — which was never the country's strong suit to start with — has probably come to a halt. Against this challenging backdrop, investors may have to watch for the risk of sovereign rating outlook downgrades in the future, although these may already be priced in. Overall, it's quite possible that France has joined the undesirable list of countries for which investors need to permanently price in a higher political risk premium. So, what does that mean? In terms of country exposure, we would favor corporates over sovereign, especially the French names that are supported by strong fundamentals and can weather the more challenging local environment. This is also because higher fiscal risk is now embedded in sovereign credit. Moving on to rates and currencies, we don't believe that the stability of the eurozone is at risk, which means that a sharp fall in the euro is not our baseline scenario. On the rates front, we are of the view that the French situation is unlikely to derail the ECB policy outlook. Despite France's woes, we believe the macro environment and the valuation backdrop remain supportive of Euro credit, which is currently one of our favorite asset classes in global fixed income.

Taking stock of performance at midyear. It has not been a great first six months of the year for global fixed income, mainly reflecting the adverse impact of rising market rates. Monetary policy has been quite volatile, owing to the volte-face of signals from the US Federal Reserve. Unsurprisingly, the top performers were the segments with the shortest duration or the largest spread cushion. In particular, the best performer was leveraged loans at 4.4%.[1] Emerging market debt also did quite well comparatively, with EM corporate debt producing a return of 3.85% and EMD sovereign gaining 2.34%.[2] High yield also produced returns that were comfortably in positive territory, with global HY outperforming both EUR HY and US HY. At the other end of the spectrum, EM local debt was the worst performer, with a negative return of 2.78%, followed by taxable munis with -1.21%.[3] Looking ahead, with global central banks delivering rate cuts, we expect rate exposure to make a much more positive contribution to expected returns, especially for the long-duration indices. Given the challenging spread valuation landscape, some discrimination will nonetheless be needed, with relative value acting as a major source of potential return for investors with a global mandate.

The soft landing of the US labor market. There are stronger signs that the labor market has entered correction mode. This is a positive development as it may help support the disinflation process. But it's also worth watching as a labor market crash would clearly undermine the resilience of the US consumer. The 3-month average for nonfarm payroll now stands at 177K, its lowest level since early 2021. Meanwhile, the unemployment rate has edged up to 4.1%, the highest since late 2021.[4] Finally, the trend for job openings is firmly pointing down. A growth slowdown should be no surprise given the brutal pace of economic growth registered over the past few quarters. The no-landing scenario has been priced out and no one is talking about more Fed rate hikes at this juncture. Which means that the pendulum is now swinging the other way, and discussions about rising recession risks are likely to surface again. So far, there are no signs of alarm. The Fed GDP nowcast estimates produced by the Atlanta and New York Feds currently range from 1.5% to 2%, which is pretty much lined up with the growth sweet spot. It is true that soft data, including survey indicators such as the ISM services, have taken a turn for the worse lately, but these have been rather volatile. Looking ahead, we remain of the view that the macro backdrop is supportive of fixed income. We believe that the main challenge for fixed income lies with the valuation of spreads, which appear quite tight in a few segments. That means alpha will likely play a bigger role going forward, especially through security selection.

Endnotes

[1] Source: Bloomberg. Morningstar LSTA US Leveraged Loan Index USD, data up to 30 June 2024. Returns are gross and in USD.

[2] Source: Bloomberg, JP Morgan. EMD Sov = JP Morgan EMBI Global Diversified composite. EM Corp = J.P. Morgan Corporate EMBI Broad Diversified Composite Index. Data up to 30 June 2024. Returns are gross and in USD.

[3] Source: Bloomberg. JP Morgan. EM local debt = J.P. Morgan GBI-EM Diversified USD Unhedged. Taxable Munis = Bloomberg Taxable Muni US AGG Eligible Total Return Index Value USD. Data up to 30 June 2024. Returns are gross and in USD.

[4] Source: Bloomberg, Bureau of Labor Statistics. Nonfarm payroll and unemployment rate, as of June 2024.

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