

Macro Talking Points

Fixed Income Insights

Week of 8 July 2024

Author



Benoit Anne
Managing Director
Investment Solutions Group

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.

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.

GLOBAL DISCLOSURE

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.