Macro Talking Points

Fixed Income Insights

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Author

Benoit Anne
Managing Director
Investment Solutions Group

In brief

- **Volatility has risen considerably in the eurozone, which may ultimately pave the way for buying opportunities.**
- **European fixed income valuation has improved.**
- **Disinflation is back on track in US.**

Liberté, Egalité, Volatilité. Volatility has risen substantially in the eurozone over the past week due to escalating political risks in France. While market volatility can be painful at first, it can also be your friend. There are two typical market patterns that can benefit an active asset manager in the event of a risk-aversion shock. The first is overshooting. When risk aversion rises due to an event risk, markets tend to overshoot and move towards pricing in the worst-case scenario. Looking at French 10-year government bonds, the spread against the 10-year German bund now stands at 77 basis points, a level we have not seen since the euro crisis in 2012.[1] The second pattern is contagion as other asset classes or markets come under pressure in tandem with the epicenter of the market crisis. In particular, the European Investment Grade Corporate Bond index has displayed some weakness as a sign of broader contagion. This should be no surprise as, historically, the correlation between IG Corp and European government bond returns is strong. From a country exposure standpoint, France accounts for about 20% of the EUR IG index. Within that 20%, financials represent 10.5%, and is a sector that tends to be vulnerable to higher sovereign credit risk.[2] Given that French parliamentary elections, the main source of political risk, have yet to take place, it may be too early to be thinking about buying opportunities, but buying opportunities may be coming, and an active asset manager who can analyze fair values and assess the relative strength of fundamentals across several single names, sectors or countries may be able to take advantage of them. Finally, it is worth highlighting that EUR duration, unsurprisingly, has done relatively well in the face of the risk aversion shock, with 10-year bund yields compressing by some 30 bps over the past week.[3]

European fixed income assets back to long-term fair value. After the recent French-triggered slide in European fixed income assets, EUR credit is back to its long-term fair value. Our fixed income valuation score for EUR IG, especially when looking at outright spread valuations, has improved substantially. Specifically, EUR IG spreads now stand at 122 bps, which is exactly in line with the 10-year spread average.[4] Likewise, the valuation for EUR HY has also strengthened. This contrasts sharply with the valuation backdrop for US credit, where spread valuations continue to look stretched. The US IG spread z-score, which is how we calculate our valuation score, currently stands at -1.07, pointing to significant richness.[5] Of course, spread valuation is a very important part of the valuation puzzle, but if you are a yield investor, it is important to keep in mind that total yields are going to be the more significant driver of expected returns. And these continue to look attractive across the board to us. Overall, with EUR IG yields at 3.76%, we believe that Euro fixed income is well positioned to deliver robust returns in the period ahead.[6]

The battle of the supercores. Disinflation is still on track, but progress in some places has been rather uneven. In the United States, the beginning of the year was frustrating on that front, although some relief has been provided by the latest round of CPI data. Central bankers as well as global investors have been watching supercore service inflation — core services excluding housing, which is where the main line of resistance to disinflation lies. We got some good inflation news in the US last week, with the supercore service inflation index turning negative on a month-on-month basis in May for the first time since 2021. However, it is still fair to say that, at 4.8% year over year, US supercore service inflation remains elevated. The picture looks considerably better in Europe, where supercore service inflation has slowed to 3.2% from its mid-2023 peak of 7.5%.[7] With price stability such a big part of global central banks' policy mandates, we believe that a wave of policy easing is upon us. We can debate the "when" and the "how much" but overall, we believe the macro environment has turned considerably more supportive of global fixed income.

Endnotes

1 Source: Bloomberg. difference between the 10-year France government bond yield and the 10-year Germany government bond yield. Data as of 14 June 2024.

2 Source: Bloomberg. Bloomberg Pan-European IG Credit index. Broken by country of risk and by sector. Data as of 14 June 2024.

3 Source: Bloomberg. 10-year Germany government bond yield. Data as of 14 June 2024.

4 Source: Bloomberg. Bloomberg Pan-European IG Credit index, option-adjusted spreads. Data as of 14 June 2024.

5 A z-score is a measure of deviation from average, adjusted for volatility. A z-score below minus 1 typically denotes expensive valuation.

6 Source: Bloomberg. Bloomberg Pan-European IG Credit index, yield to worst. Data as of 14 June 2024.

7 Source: Bloomberg. US Bureau of Labor Statistics, Eurostat. Data as of May 2024 for the US and April 2024 for the eurozone.

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