Macro Talking Points

Fixed Income Insights

Week of 24 June 2024

Author

Benoit Anne
Managing Director
Investment Solutions Group

In brief

- **Alpha is a major source of return in global fixed income.**
- **C'est la vie: We are back to watching fiscal risks.**
- **Investor sentiment seems robust, helped by favorable financial conditions.**

Greek to me. Alpha and beta, the first two letters of the Greek alphabet, are the two fundamental components of portfolio performance. While beta — how the benchmark/index performs — is always key, alpha — the excess return over that benchmark—can also be a significant source of return. This is particularly relevant to the Global Agg. Over the past 20 years, the Global Agg has returned an annualized 2.27%.[1] During the same period, the broad community of asset managers that has used the Global Agg as their benchmark has generated an annualized alpha of 0.83% per year.[2] In other words, a passive investor who has sought exposure to the Global Agg has collected a 2.27% long-term annual return, but an active investor has produced a total return of 3.1% during the same period, a performance enhancement of 36.5%. To reframe it, $100,000 invested passively 20 years ago would have grown to $156,663 while it would have produced $184,151 when invested actively — beta + alpha. In global fixed income, the potential sources of alpha are numerous and diverse, including regional diversification, currency exposures, asset and sector allocation, duration differentiation and security selection.

French fries, French dressing and French deficits. Does government debt matter? We have talked a lot about monetary policy over the past couple of years, which is understandable. But does the other side of the government policy equation — fiscal policy — matter as well? It does, but in spurts. In other words, global investors pay attention only when trouble is brewing, which is happening in right now in France, where there are growing concerns that fiscal discipline will be relaxed further after the parliamentary elections in a country already well known for its government spending largesse. However, it's not necessarily the level of public debt that scares investors. Rather, it's the risk that the level of debt will rise sharply that tends to trigger a shock to investor confidence. The worst-case scenario is when the starting point is already characterized by an elevated ratio of government debt to GDP combined with concern that the debt dynamics will deteriorate further. France is in that category, but it isn't alone. In the case of the United States, there is persistent concern that the government isn't committed to reining in debt. The big difference, however, is that US Treasuries remain the ultimate safe-haven assets in global markets. As a result, the bar is considerably higher for UST demand to dissipate because of US fiscal policy woes. Meanwhile in France, the 10-year spreads over bunds remain at extreme levels, but without fiscal policy reassurance, it's unlikely they will normalize to their pre-European election levels. In markets, fundamental analysis matters, and the ability to distinguish between strong sovereign credits and weaker ones, including when it comes to the credibility of the fiscal policy framework, is essential when investing in global fixed income.

Financial condition tailwinds. Investors may have stopped watching financial conditions closely because central banks are no longer in tightening mode, but there tends to be a strong relationship between financial conditions and global risk appetite. A lot of indicators are flashing green on that front, which is ultimately supportive of risky assets. Regarding financial conditions, both the Goldman Sachs and the Fed indicators currently point to a favorable backdrop. Risk appetite signals also look healthy across the board, be it the American Association of Individual investors' readings, macro volatility indicators or the signals extracted from currency markets. In other words, investor sentiment appears to be in a good place, although volatility hasn't disappeared and the sources of global risks — from elections to geopolitics — bear watching.

Endnotes

[1] Source: Bloomberg, Bloomberg Global Aggregate index. Monthly data from April 2004 to April 2024. Gross returns in USD.

[2] Source: eVestment Alliance, LLC. The eVestment All Global Fixed Income universe was screened for active managers using an unhedged approach and benchmarked to the Bloomberg Global Agg. The returns are gross of fee and in USD. Quarterly data from May 2004 to April 2024. Past performance is no guarantee of future results.

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.