

Macro Talking Points

Fixed Income Insights

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In brief

- **Policy mix, macro regimes and inflation risks**
- **The bond-equity correlation has corrected lower**
- **TIPS are attractive again**

David vs. Goliath. There's a contest emerging between the chair of a major central bank and the winner of an election in a major country, but it's really more a clash of macro policies than of individual contenders. Monetary policy versus fiscal policy, to be exact. Ideally, the policy mix should be consistent. Challenges arise when the two sides of the policy coin work against one another. In this instance, the central bank needs to see further progress on the inflation front to continue lowering its policy rate. But what if fiscal policy becomes so expansionary that it fuels domestic demand and reignites inflationary pressures? Time will tell, but this is a risk on our radar. With that in mind, the outlook for market rates has become muddled, especially in the face of the policy push-pull. That means that the case for being long duration has weakened, even though at face value the valuation looks more compelling than it did a few weeks ago.

Beyond the rate view, there are broader implications for the prevailing macro regime. There's substantial risk that Goldilocks comes under attack because of that David versus Goliath confrontation. The question would then become, if we were to transition from Goldilocks, which new macro regime would prevail? Here, there is a bullish case and a bearish case. The difference between the two is determined by what happens to economic growth. In the bullish scenario, we would stabilize in the growth momentum regime, which would continue to be supportive of spreads but challenging for long duration. The bearish case is a familiar one: a return to the dreaded "fear of the Fed" regime, which we want to avoid at all costs. For that to happen, the Fed would have to change gears and start tightening again. After what we heard from the FOMC last week, that's unlikely, at least for now. On balance, the macro policy environment remains supportive of risky assets but the call on duration may get tougher, at least until we get more clarity on policy.

Goldilocks and the bond-equity correlation. There has been no sighting of Goldilocks over the past couple of weeks, especially with rates correcting sharply higher. In fact, something remarkable has happened: a major downward correction in the bond-equity correlation. Until recently, the bond-equity correlation had been high because Goldilocks is supposed to be a high-correlation regime in which both risky assets and fixed income tend to perform strongly. This isn't what we have experienced recently, however. A fast-moving correlation estimate indicates that the move has been dramatic. Based on a 60-day window of daily returns, (a short-term correlation measure), the bond-equity correlation has now swung into negative territory, reaching its lowest level since August 2020. It will take more time for the longer-term measures of correlation — which, by definition, are slow moving — to show persistent signs of correction, but this is a major development and may be indicative of a transition to a new macro regime. Why does that matter? Because under this new regime, fixed income, along with the benefit of providing high carry, could regain its status as a portfolio diversifier.

TIPS are back. There are times when exposure to nominal duration makes a lot more sense than exposure to real duration. And then there are times when the pendulum swings the other way like it seems to be doing now. What's changed? The presidential election and its widespread impact on both the macro and market outlook. Against this backdrop, our global multisector fixed income portfolio managers believe exposure to US TIPS is attractive, especially when nominal rates are wobbling. Not long ago, inflation risks were skewed to the downside, the Fed was in full dovish mode and the economy was showing signs of moderate slowdown. Now all that has changed. The Fed is still cutting rates, but more cautiously. Inflation is back as a major macro risk, and the US economy is on fire, hence the rationale for exposure to inflation-linked bonds. US 10-year breakeven inflation, currently at 2.36%, has already moved higher over the past few weeks, and there may be more upside, which means that TIPS may offer certain benefits under current economic conditions.¹ ▲

Endnotes

¹ Source: Bloomberg. 10-year break-even inflation, data as of 8 Nov. 2024.

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