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Macro Talking Points

Fixed Income Insights

Week of 18 November 2024

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In brief

- **Looking into the recent US rates correction**
- **The rate divergence between US and Europe**
- **The surprising resilience of EM sovereign debt**

US rate rebound: good or bad? As usual, it depends — both on what we're looking at and on what the primary driver of the correction is. For long-duration positions, the past few weeks have been tough, with 10-year UST yields moving 70 basis points higher since the beginning of October.[1] However, thinking more strategically, the rate correction has contributed to a significant improvement in the total yield valuation picture, which we believe is an important consideration for the long-term investor. For instance, the total yield on US investment-grade credit now stands at 5.25%, its highest level since July, and this despite spread levels that remain tight.[2] Why does this matter? Because the level of total yield has greatly influenced fixed income long-term total return expectations. This is what the Market Insights team calls the strategic power of entry points. Separately, it makes sense to look under the hood of that rate correction and analyze what has driven the market move. Any change in nominal rates can be decomposed into a real rates move and an inflation pricing move. Here lies the good news: The nominal rate move has reflected the real rate move (to the tune of 80%) as opposed to an inflation pricing move (which has accounted for only 20%). In other words, market rates have moved up for a good reason, an upgrade in growth expectations. This is better from a macro standpoint than it would be if the recent move higher only reflected renewed inflation fears. Given recent market momentum, it's too early to call the top for nominal market rates in the US, but at least from a strategic perspective, fixed income is back as a relevant asset class that has the potential to provide not only valuable de-risking benefits but also an attractive level of income.

Mind the gap! The difference between US front-end rates and front-end bunds is back to its recent high. The two-year rate differential stands at over 2.25%, an illustration of strong monetary policy divergence.[3] This divergence is also reflected in current policy-rate pricing, with the rates market implying twice as much easing for the European Central Bank than for the US Federal Reserve over the next year. Our head of developed market rates research, Peter Goves, still believes the ECB will deliver another rate cut in December, followed by steady easing next year. Our investment team estimates that the ECB terminal rate will settle below 2%. In contrast, the tone coming from the Fed has turned more cautious lately, mainly reflecting stickier-than-anticipated inflation. Looking ahead, there's also a risk in the United States due to the challenging policy mix, with fiscal policy objectives potentially clashing with the Fed's objectives. The recent strength of the US dollar should come as no surprise given that the interest rate differential acts as a major driver of currency markets. In other words, risks for the euro are skewed to the downside. As for duration, the picture is clear: Our fixed income investment team favors long-duration in Europe against the US, owing to diverging growth dynamics and monetary policy expectations. With monetary policy desynchronizing, this is a great macro environment for active asset managers.

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Trump didn't trump EM debt. We thought that the election of Donald Trump would trigger a significant risk aversion shock for emerging market debt. But that didn't materialize. In fact, EM sovereign spreads have behaved well, tightening by 20 basis points over the past month, mostly driven by the high-yield sovereign bucket.[4] It seems that EM fixed income benefited from the risk-on market response to the US election, with risky assets enjoying quite a run. Talking to our Fixed Income EM team, it also transpires that this time around, EM as an asset class was prepared to weather the US election risks. Not only was the Trump win less of a surprise in 2024 than it was in 2016, but EM fundamentals appear to be stronger than they were a few years ago. Yes, many EM countries have a fiscal discipline problem, but so do advanced economies, so it has become harder to single out EM for its fiscal largesse. One sore point has been the strength of the US dollar and the weakness of EM currencies. The well-followed JPMorgan EM Currency index has lost 4.7% of its value since late September, a major challenge for EM local currency debt.[5] In fact, EM local currency debt has been the worst performer in global fixed income year to date. One important consideration is that beyond the asset class beta discussion, there are many attractive potential alpha opportunities in EM, chiefly reflecting country and region selection. For instance, geopolitical risk is likely to weigh more on the performance of Middle East credits than elsewhere, so it, makes sense to manage country exposures carefully. Likewise, the potential impact of tariffs is likely to target some countries, such as China, more than others. Overall, we believe EM is proving to be a much more resilient asset class than feared, but that doesn't mean we should downplay global macro risks. A more cautious Fed, higher market rates and a stronger US dollar are all headwinds to consider in the period ahead.

Endnotes

[1] Source: Bloomberg. UST 10-year generic yields, data as of 15 Nov. 2024

[2] Source: Bloomberg. US IG Corp index, yield to worst, data as of 15 Nov. 2024

[3] Source: Bloomberg. Difference between the 2yr UST yield and the 2yr Bund yield, data as of 15 Nov. 2024

[4] Source: Bloomberg, JP Morgan. EM debt = JP Morgan EMBIG diversified. data as of 15 Nov. 2024

[5] Source: Bloomberg, JP Morgan. EM currency index = JP Morgan Emerging Market Currency Index (EMCI). Data as of 15 Nov. 2024.

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