Macro Talking Points

Fixed Income Insights

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In brief

- **The comeback of higher for longer**
- **The eurozone sovereign risk: not what it used to be**
- **Exposure to EM local debt makes total sense. At least in some parts of the world**

Higher for longer, for longer. We were tempted to think a few months ago that the days of "higher for longer" as a major market theme were over. Not so fast. Market rates are back up and are not far from their recent highs. US 10-year rates are above 4.3%, something that has only happened 24% of the time since early 2000.[1] So, what has changed? For a start, expectations for the US Federal Reserve's monetary policy easing look very different from just a few weeks ago. Specifically, there are only 60 basis points of rate cuts priced over the next year.[2] That seems too conservative, but let's ignore that for now. Besides monetary policy, the risk of recession has been virtually priced out, with the US economy displaying resilience, as again illustrated by the latest round of strong PMI numbers. Not only that but there seems to be some sort of animal spirit effect (decisions made through optimism rather than math) playing out in anticipation of Trump 2.0, which has contributed to pushing market rates higher. Finally, nobody can claim victory over inflation just yet, and that includes the Fed. To be fair, the inflation outlook is much better than it was but the core PCE inflation measure — which the Fed pays close attention to — has been stuck above 2.5% for a while.[3] The question ahead is whether this is just a mini-plateau on a disinflation trajectory or whether we're now facing an inflection point, with inflation risks back to being skewed to the upside. So, what does higher for longer, for longer mean? On the macro side, we get a second chance answering the question of whether higher market rates are ever going to bite the consumer and the corporate sector. As for fixed income, the restoration of higher for longer suggests that there is no yield erosion, which is great news as an attractive de-risking asset class. In principle, higher rates should also play an adverse role in equity market valuations, but nobody seems to care about that these days.

The eurozone turned on its head. Back in the day, a two-tier hierarchy within the eurozone was well established. We had the core countries, characterized by economic strength, credible macro policies and political stability. And then we had the periphery countries, which on occasion were marred by fears of financial instability, macro risks or political disruption. Somehow, pecking order no longer seems to apply. It is the core that is feeling the heat these days, while the countries on the periphery are thriving for the most part. This was painfully evident when looking at the latest round of PMI numbers across the region, with manufacturing prints for Austria, France or Germany all standing in the low 40s against about 55 for Spain.[4] But it's not just about growth performance. The credibility of macro policies as well as the political environment also support the view that the eurozone core is not what it used to be. Looking into European sovereign exposure, European sovereign portfolio manager Annalisa Piazza has turned a lot more constructive on periphery countries, including Italy. The problems facing the core countries are probably not great news for the euro, with the European Central Bank incentivized to go ahead with its policy easing plans. Away from sovereign risks, the good news is that corporate credit investors should not be too nervous overall. Euro corporate fundamentals continue to show strength despite the challenging macro environment in the region and ongoing ECB easing should help maintain a fixed income–friendly market backdrop.

Trump didn't trump EM debt. Not necessarily, especially if you are based in Europe. The main headwind to emerging market local debt has been the strength of the US dollar, but of course that risk factor is avoided when one looks at the asset class from the perspective of a non-US investor. In fact, since November 1, the euro has weakened by some 3.2% against the dollar, which means that it has underperformed most EM currencies.[5] For instance, the well-followed JP Morgan EM Currency index has lost only 1.7% of its value and some specific EM currencies, such as the Brazilian real or the Colombian peso, have appreciated against the dollar during the same period.[6] EM local debt offers attractive yields, especially by standards of European markets. The yield for the EM local debt index currently stands at 6.3%, or higher than what you get if you invested in EUR HY.[7] With EM inflation having declined to about 3.7%, the real yield story is also quite compelling, especially compared with eurozone real yields, which are barely positive.[8] Of course, there is significant currency risk involved, but with the EUR as the starting denomination, we would argue that the currency risk profile of EM local debt looks quite different from its USD-based counterpart. There are a lot of headwinds for the EUR in the period ahead, according to our DM sovereign research team. Meanwhile, EM local debt fundamentals are moving in the right direction, with most central banks still in easing mode and disinflation well entrenched. To be clear, as a higher-volatility asset class, EM local debt is probably best suited for the investor with a high appetite for risk, but we don't think there is anything wrong with a 3% return registered since the beginning of the month in EUR terms.[9]

Endnotes

[1] Sources: Bloomberg. 10-year generic UST yields. Data as of 22 November 2024.

[2] Source: Bloomberg. Based on the federal funds futures curve. Data as of 22 November 2024.

[3] Sources: Bloomberg, the Bureau of Economic Analysis. Most recent data point was for September 2024: 2.65%.

[4] Sources: Bloomberg, S&P. Global manufacturing PMIs for October 2024.

[5] Sources: Bloomberg. EUR-USD as of 25 November 2024.

[6] Sources: Bloomberg, JP Morgan. EM currency index = JP Morgan Emerging Market Currency Index (EMCI). Data as of 22 November 2024.

[7] Sources: Bloomberg, JP Morgan. EM local debt = JP Morgan GBI-EM diversified. data as of 22 November 2024.

[8] Sources: Bloomberg. EM inflation is estimated using a country basket based on GBI-EM weights. Data as of October 2024.

[9] Sources: Bloomberg, JP Morgan. EM local debt = JP Morgan GBI-EM diversified, unhedged in EUR. Data as of 22 November 2024.

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