

Fixed Income Under the Spotlight

Trick or Treat? Rate Cuts Amidst Election Risks

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In brief

- US election outcome and geopolitical risks continue to pose uncertainty and present tail risks
- Macro outlook appears supportive due to central bank easing and robust fundamentals
- Portfolios are defensively positioned, but are nimble to take advantage of idiosyncratic opportunities

As the United States (US) election and Halloween draw near, it seems the only certainty is uncertainty. While the election outcome has not yet been a key driver for markets, there are clear differences in market implications based on the winning candidate. However, until the outcome is known, we can only speculate as to the impact on fiscal and monetary policy and, in turn, on markets and the macro outlook.

In general, we expect that Kamala Harris would likely be a continuation candidate relative to Biden, while Donald Trump 2.0 is the more unknown. Even when the result is in, uncertainty will continue if the outcome is contested. The biggest challenge for investors, in our view, would come from Republicans sweeping the House and Senate as this puts the independence of the US Federal Reserve at risk.

Given the potential for increased volatility going into and following the election, there's a strong case for portfolios to be defensively positioned. Once the outcome is known, we believe that there will be opportunities for investors that are prepared to position appropriately, particularly in emerging markets, the US dollar, duration and yield curve as well as with equity exposure.

Geopolitics continue to present tail risks

Geopolitics are always a risk, but the risk is generally underappreciated by investors until escalation takes place. Looking around the world, we see three major points of potential geopolitical escalation. First, Russia-Ukraine appears to be a prolonged war as it is difficult to see any immediate outcome. Unfortunately, this will continue to be a drag on Europe and countries that are closer to the conflict. Second, the tragic events in the Middle East are the biggest geopolitical risk at the moment. This is mainly due to concerns around Israel and the potential escalation with Iran, particularly related to Iran's oil and nuclear facilities. Third, although it is currently muted, geopolitical risk still stems from China and its policy stance regarding Taiwan. These ongoing geopolitical risks present large tail risks, particularly around inflation shocks, so we feel that it may be worth considering hedges like US Treasury Inflation-Protected Securities (TIPS) or covering any underweight to the US dollar.



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Macro outlook for 2025 appears supportive

As we draw closer to the end of 2024, our thoughts turn towards the outlook for 2025. In terms of the macro landscape, we think about four things: the evolution of inflation, the evolution of growth, monetary policy and fiscal policy. Looking across these four, we see a macro picture that is supportive of a soft landing. However, given where valuations currently are, we are more attracted to higher quality and more defensive exposures.

Inflation has come down significantly from its highs but risks remain. While we do not see structural reasons for inflation to go much higher, idiosyncratic risks such as oil supply chain shocks, tariffs, trade wars and natural disasters could lead to a sudden spike in prices.

The outlook for growth now comes with an increased focus on the labor market. The Fed has been clear that it's monitoring the labor market, so we will be closely watching labor data and leaning on the analysts in our global research platform to understand what is happening at the individual company level that can provide a read-across to macro data to come.

Monetary policy across the world has become more coordinated, with developed market central banks and some emerging market central banks gradually easing policy. In our view, they will not start an aggressive easing cycle as economies are still growing and we have disinflation rather than deflation. So we see a slow normalization of policy rates for most countries, with Japan being an exception with its tightening policy.

The fiscal situation presents a bigger question. If fiscal deficits result in higher productivity, then inflation should remain in check and there is less concern about rates rising. On the other hand, if fiscal spending is not productive, we face risks of higher inflation, which will put central bankers on high alert. Coming back to the US election, it appears neither candidate is keen on reducing the fiscal deficit and the differences are more about what makes up the deficit.

Portfolio positioning

There is good news from this uncertain outlook for fixed income investors, especially those with a very broad universe: Increased market dislocations can present more opportunities for active managers to generate alpha. Bottom-up security selection becomes even more valuable in times of higher price dispersion and higher volatility. There will be winners and losers after the US election and as economies slow down. From a top-down perspective, we are defensively positioned in general. Our overall allocation to credit markets is driven by the slowdown stage of the credit cycle we believe we are in. We expect increased volatility and dispersion and therefore retain significant exposure to liquid bonds to take advantage of market opportunities that arise.

Investment grade

We are still overweight credit markets and feel that investment grade (IG) is the sweet spot in a low-growth and low-inflation environment. Corporate balance sheets remain robust even in the face of higher rates, and credit fundamentals of most investment-grade companies are relatively solid. IG spreads are at their tightest levels in many years, but high rates mean the asset class still provides a relatively attractive yield, so money continues to pour into the market. Even though valuations appear rich, IG spreads may stay tight for a continued period unless we see a change in the fundamental macro picture, for example, due to concerns of moving from a slowdown into a recession rather than moving between slowdown and recovery or expansion. We don't see a catalyst right now that would drive spreads materially wider.



We remain focused on being nimble to take advantage of asset allocation opportunities across global fixed income markets. ▲

Within investment grade, we are being careful with our regional exposures. We see opportunity in European real estate if the rate cut cycle continues. This sector was hurt from the hiking cycle but should see support from the European Central Bank as it lowers rates. We have reduced our exposure to financials because of the compression in valuations and an increased risk of spread widening. We are underweight cyclicals such as the auto sector. In the US, we have stayed away from the long end of credit curves as they are flat and don't present much potential upside to us. Our preference is for capital goods companies with real assets and those that generate inflation-linked cashflows.

High yield

High yield investors have crowded into short duration trades due to the good visibility of short-term cashflows to repay the debt. The yields available in this market are attractive and fundamentals are in better shape than the last cycle, so it's an area we are focused on. BB-rated credit is expensive in our view, but we are still finding idiosyncratic research-led opportunities in short-duration higher yielding credits. Given the low level of spreads, our allocation to high yield is reduced but we are looking to add more risk when opportunities arise.

Emerging market debt

Emerging markets are providing opportunities in crossover credits in hard currency countries that have positive balance of payments, good external profiles and stand to benefit from core improvement regardless of the US election outcome. Until we know the election result, it's difficult to have conviction in allocating more to the asset class given the potential for increased volatility due to tariffs under a Trump administration.

Duration

With central banks seemingly committed to cutting rates, the biggest opportunity we see is being strategically long duration. We believe investors should look to allocate away from cash and short duration into longer duration as easing cycles start. Historically, given the high level of starting yields in fixed income markets, we would expect higher total returns than from cash, if central banks continue to cut rates, as well as providing investors with the traditional benefits of income and diversification. This is particularly the case for investors with a global universe who can invest in more than one yield curve. It is important to note that our duration and government debt exposure is globally diversified and not just US. We are still overweight duration in the US but have reduced it and have shifted our duration exposure towards markets where we expect rate cuts that are not priced in, including Europe, Korea and Canada.

Conclusion

We remain focused on being nimble to take advantage of asset allocation opportunities across global fixed income markets in a period of potentially higher volatility and dispersion ahead. We are also focused on the compounding value and opportunities that active security selection and idiosyncratic risk provide, as identified by our global and deep research platform. Given the continued geopolitical tail risks, we have taken advantage of low credit spreads and low volatility to invest in cheap tail risk hedges. We believe that a prudent diversified asset allocation approach could be appropriate given the material potential impact of such developments on energy and commodity markets, global trade and supply chains. ▲



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