Macro Talking Points

Fixed Income Insights

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In brief

- **The USD may represent an attractive hedge against US election risk**
- **With spread dispersion being so tight, it is time for highly skilled managers to shine**
- **EUR Credit still well supported by technicals and valuation**

Tactically hedging US election risk. The US elections are just two weeks away, and this could trigger a renewed wave of market volatility. One of the best hedges against election risk could be being long the US dollar. Ignoring the election risk, there are many drivers that may weaken the US dollar going forward, including the possibility of more aggressive easing from the US Federal Reserve than currently priced in, a further improvement in the global risk appetite backdrop or an upgrade in global growth expectations, all strong possibilities in the period ahead. But the US election may bring out other factors, which could be dollar supportive. For instance, an increase in tariffs will likely strengthen the dollar, especially as targeted countries will probably engineer some weakness of their own currency to offset the tariff impact. Likewise, an escalation of geopolitical risks may also cause the dollar to appreciate, going forward. On the domestic policy front, the perception that fiscal policy will become even more expansionary may push market rates higher, with positive repercussions for the value of the USD. Similarly, the Fed may be tempted to slow down the pace of its future rate cuts, if they believe that the US economy is at risk of overheating. Overall, our fixed income portfolio managers are likely to face a highly volatile market backdrop in the near term, which will present both risks and opportunities.

Manager skills required. Credit spreads are rather tight these days, especially when looking at US IG credit. Not only that, but spread dispersion, which measures how wide the spread range is within the index, is also back to being well below its historical average. This is when skilled managers have an opportunity to shine, because generating security selection alpha in the face of tight dispersion becomes a higher-skilled business. You see, when spread dispersion is very wide, it means that there are a lot of valuation dislocations, and everybody has a good chance, with security alpha generation being a lower-bar challenge. Not this time, however, as only asset managers with a highly developed global research platform and a strong bottom-up investment process will be able to make an impact. When expectations for credit returns, especially the component of total returns coming from spread compression, are less favorable, alpha, *i.e.* the excess return above the benchmark return, is going to matter a lot more. In a nutshell, this is alpha time for credit. Of course, besides alpha, there is also duration and the attractive carry, which overall make up robust expectations for fixed income total returns in the period ahead.

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Euro credit still supported by strong technicals. In the view of our EUR credit portfolio manager, Andy Li, there are two main drivers that are positive for EUR credit: technicals, and relative valuation. On the technicals side, inflows into the asset class have been robust, and there are good reasons to think that this will remain the case, especially with the ECB easing cycle under way. As for valuation, the backdrop favors EUR Credit relative to the US, where spread valuation appears to be quite stretched. Furthermore, it is worth noting that EUR credit fundamentals remain solid despite the region's challenging growth backdrop. With that in mind, over the medium term, our EUR credit portfolio management team is constructive on the asset class. However, in the near term, there are global risks on the horizon which warrant a more cautious bias from the standpoint of spread dynamics. Andy Li is cautiously constructive for now and stands ready to take advantage of renewed volatility in global markets. From a longer-term perspective, the total yield valuation — or even better, the break-even yield valuation — continue to look favorable.

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