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Macro Talking Points

Fixed Income Insights

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In brief

- **Big-picture thoughts on fixed income from our CIOs**
- **A deep dive into the fixed income measures of risk**

View from the top: fundamentals, valuations, technicals and the Fed. Alex Mackey and Pilar Gomez-Bravo, our co-CIOs of fixed income, have shared their big-picture thoughts on fixed income. When thinking about the potential drivers of future performance, both duration and credit can contribute. On the duration front, the support comes from central bank signals, including the synchronized policy easing across developed markets. When it comes to the United States, the rates market has priced in a frequent cuts in coming quarters, which is providing some runway for the Fed and is supportive of duration. Meanwhile, on the credit risk side, fundamentals should also benefit from the easing cycle, with high-yield issuers in particular about to see a decline in financial pressures. Additionally, housing and related sectors should experience a pickup in activity as rates decline. Moving on to valuation, spread valuations can be characterized as full, but not stretched. More important, absolute yield levels offer an attractive value proposition to investors, unlike what they have experienced over the past decade or so. Fixed-income technicals are also healthy, reflecting attractive yield levels and anticipation of the imminent easing cycle. Overall, fundamentals, valuation and technicals all align in favor of earning the carry that fixed income currently offers. However, the expected income on cash is set to decline.

Navigating the Fed after Jackson Hole. There is no denying that Fed Chair Jerome Powell's Jackson Hole speech was celebrated by the markets. This is mainly because Powell confirmed that rate cuts are imminent. The other signal received from Wyoming is that the Fed's view on the labor market has fundamentally changed. Specifically, the necessary adjustment has now run its course and any further deterioration in the labor market would be unwelcome. But there are still unanswered questions and the Jackson Hole symposium provided no answers. In particular, we still do not know whether the Fed only intends to normalize its policy rate or whether a bigger move into accommodative territory is in the cards. By the way, we are also unclear on the latest Fed estimate of the neutral rate. With that in mind, an interesting debate emerged at a recent portfolio managers' meeting over what risks and opportunities a 50-basis-point rate cut would present. Would such a cut further boost risk appetite, based on the expectations of a larger stimulus, or would it create fears that the Fed knows something about the economy that investors don't? All of this to say that while rate cuts are generally supportive of fixed income, we continue to listen attentively when the central bank speaks as the devil may potentially be found in the details of its communication strategy. It can be tricky for central bankers to strike the right balance in their messaging. Ultimately, a longer-term anchor for monetary policy would help not only central banks but also investors.

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Fixed income riskiness. You encounter interesting measures of risk when analyzing fixed income. One, which our income portfolio managers often refer to, is the duration times spread indicator. The DTS is the product of the two major sources of fixed income risk, namely duration — which measures the interest rate risk — and spread — which illustrates the credit risk. The higher the DTS, the higher the risk. On that score, it is EMD sovereign hard currency debt that screens as the highest-risk asset class in global fixed income, reflecting the elevated level of spreads and a duration of about 6. EMD sov is followed by global high yield, EM corp and European HY, At the other end of the spectrum, US tax-exempt municipal bonds display the lowest DTS, along with the US agg and Agency MBS.

The volatility of returns can also be seen as a measure of risk. There is first the volatility of total returns, which is mostly relevant for total return investors, and then there is the volatility of excess returns, which excludes the impact of duration and only focuses on the volatility of credit returns.

Analyzing total return volatility first, based on a five-year window, European investment grade displays the lowest volatility across global fixed income, which is surprising given that it involves some corporate credit risk. Notice that European IG volatility is much lower than US IG (6.25% annualized vs. 8.91%).[1] The US agg and tax-exempt munis are less of a surprise and can be described as low-vol asset classes. At the other end of that ranking, EM local currency debt is the most volatile asset class, followed by EMD sov and taxable munis. Taxable muni total return volatility has been elevated over the past five years, reflecting the impact of longer duration. Looking ahead, we anticipate that taxable muni volatility will normalize as we expect rate vol to correct lower. On the excess return volatility front, the hierarchy is as expected, with global agg, European agg, Agency MBS and US agg all exhibiting low credit return volatility. At 4.16%, European IG excess return vol is moderate, especially when compared with the 6.02% volatility produced by the US IG index.[2] EMD sov is the only asset class with a double-digit excess return volatility, with HY (global, US and European) showing high-single-digit numbers.

Overall, the opportunity set in fixed income is broad, both in terms of risks and expected returns, which means there is something for everyone.

Endnotes

[1] Sources: Bloomberg. EUR IG = Bloomberg pan-European IG Corporate index. US IG = Bloomberg US IG Corporate index. Total return index. Volatility is calculated as standard deviation of monthly returns over five years (annualized). Data as of 31 August 2024.

[2] Sources: Bloomberg. EUR IG = Bloomberg pan-European IG Corporate index. US IG = Bloomberg US IG Corporate index. Excess return index. Volatility is calculated as standard deviation of monthly excess returns over five years (annualized). Data as of 31 August 2024.

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