Macro Talking Points

Fixed Income Insights

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In brief

- **The week after the Fed rate cut**
- **The outlook for the USD**
- **The structural headwinds facing China**

Words are as loud as actions. The US Federal Reserve rate cut last week was significant, not only because of the size of the adjustment but because of the words that accompanied it. Essentially, the Fed argued that a soft-landing scenario remains its baseline. In other words, if we believe the central bank, it is Goldilocks time. The Fed forecast lower inflation, solid economic growth and only a modest uptick in unemployment. The announcement of the rate decision was well managed, and there was no mishap at the press conference. So what's next? On the policy side, the Fed appears to have expressed a preference for a faster convergence toward a neutral policy stance, though the pace of rate cutting from here remains uncertain. Aside from monetary policy, we believe that the macro backdrop remains supportive for both fixed income and risky assets. US financial conditions — as illustrated by the Goldman Sachs index — are now as loose as they have been since early March 2022, a positive sign for global investor sentiment. Looking at the market response following the Fed cut, the most important signal we observed is that credit spreads tightened further both in the United States and Europe, an indication that the macro credit fundamentals remain constructive. Finally, the aggressive policy easing in the US may put downward pressure on the US dollar, with positive implications for other developed markets and emerging market assets.

The bull–bear discussion about the US dollar. Making currency calls is always a tricky business, simply because there are so many — often unpredictable — factors that come into play. In currency markets, there are always two sides of the trade: You buy a currency or you sell it against another currency. There are also often two sides of the same coin, meaning there are arguments that support a strong dollar and others that don't. On the bull-case side, the main narrative that boosts the value of the US dollar is so-called US economic exceptionalism. With the United States set to continue to outperform the rest of the world on the macro front, the demand for the US dollar remains strong. This the same argument used to justify the lofty US equity valuations. From a macro standpoint, there are several scenarios that could benefit the dollar. The first is that the Fed may decide to ease policy at a much slower pace than is currently priced in. Separately, while a US recession isn't our baseline scenario, a surprising turn for the worse would whet the appetite of investors for the US dollar again given its status as a safe haven. Likewise, renewed geopolitical tensions could lead to the dollar benefiting from its defensive characteristics. Turning to the bear case under current market assumptions, the interest rate differential (US rate vs. other markets' rate) is set to erode, thereby undermining the interest rate support for the USD. On the valuation side, looking at real USD indices, we can see that the USD is almost 15% richer than its long-term fair value, whether measured by the Fed real broad index or the BIS data.[1] Meanwhile, the global risk appetite backdrop appears robust, and that typically tends to be associated with a weaker dollar. Given all these risk factors, our investment team is on the fence, albeit leaning toward a weaker dollar in the period ahead.

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The bear in the China shop. When thinking about the long-term outlook for China, our in-house China analyst, Aimee Kaye, believes there are more structural headwinds than tailwinds. In other words, we are not constructive on China over the long term because the country's challenges are numerous and significant. On policymaking, it seems that the focus has shifted away from implementing market-friendly policies. On growth, the challenge has to do with structural headwinds facing domestic demand and private consumption. The emergence of a strong middle class and solid social safety net was meant to be the key to China's growth model transitioning to a more sustainable, consumption-driven regime. However, progress has been mixed on this front. Weak inflation has become increasingly entrenched, weighing on household and corporate balance sheets. On financial stability, the local economy is still trying to digest the unwinding of the property bubble. In addition, the debt picture remains unappealing and fiscal policy is struggling to be effective given that local governments are constrained by already high debt burdens and are less able or willing to implement top-down infrastructure mandates. Against this backdrop, our emerging market team is cautiously biased toward China exposure. This does not mean, however, that there are no interesting investable opportunities in China. For instance, it is fair to say that there are sectors that are vibrant, such as tech or green transition sectors, although Chinese corporates themselves are looking for growth opportunities abroad.

Endnotes

[1] Sources: Bloomberg, US Federal Reserve, Bank for International Settlements. Fed = US Fed Trade Weighted Real Broad Dollar Index. Data up to Aug. 2024. BIS = Real effective exchange rate, monthly. Data up to Aug. 2024.

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