Macro Talking Points

Fixed Income Insights

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In brief

- **No-landing remains a macro risk in the US**
- **There is a place for fixed income Goldilocks**
- **Don't ignore sovereign credit risk**

The eagle has not landed. Some of the recent macro data from the US — hence the eagle reference — may appear on the soft side (like last week's services PMI), but rest assured, the economy is still doing quite well. For instance, the Market Insights' business cycle indicator — which tracks and aggregates a broad set of leading variables for the US — points to the strongest growth outlook we have seen since early 2022. Quite a few growth drivers are currently flashing green, ranging from robust capex expectations to the jump in small business optimism and the resilient labor market. At this point, the only source of growth risk seems to come from fragile consumer sentiment. Overall, this raises the question: Are we in a no-landing scenario? Hopefully not, but that's probably the main macro risk to watch. In a worst-case scenario, the US economy returns to an overheating phase, last observed in 2021/22, which would prompt the US Federal Reserve to revisit its monetary policy strategy. To be clear, we are not there yet, but the risk of no-landing, with its implications for rates and inflationary pressures, seems to be significantly greater than that of a recession at this point. In other words, the US economy is at risk of doing too well. Where does that leave us? The conviction on being long duration now looks to be challenged, with catalysts for pushing rates lower virtually disappearing. Listening to Matthieu Walterspiler from the multi-asset strategy team, the recent macro drivers helping push rates higher have included the widening of the term premium, along with continued momentum in demand pressures. This suggests that this is a macro environment that looks more supportive of credit than duration. Credit spreads may look stretched in many places, but absent some exogenous shock, it's hard to see what could cause a correction in the period ahead. In other words, there is nothing wrong with the extra carry provided by credit under the current macro regime.

Looking for Goldilocks. Goldilocks may have vanished in some places, but there are still two areas that remain Goldilocks' territory from a fixed income standpoint: Canada and the eurozone. In Canada, listening to our global fixed income investment team, it still makes sense to favor a long duration bias. There are only 44 basis points of cuts — or less than two cuts — priced in for the Bank of Canada over the next 12 months, which could easily be exceeded.[1] In addition, Canadian spread valuation looks attractive from a relative value perspective, while the local macro backdrop remains fixed income friendly. Meanwhile in Europe, the current policy pricing may underestimate the amount of easing that the European Central Bank needs to deliver. Our investment team believes that the terminal ECB policy rate will be below 2%. Separately, as highlighted previously, EUR credit remains supported by strong fundamentals and technicals. Overall, for fixed income investors with a global mandate, look to Canada and the eurozone for attractive markets where to allocate both duration and credit risk exposures.

There is such a thing as sovereign credit risk. Nobody understands this better these days than my French compatriots. When I spent a couple of days in Paris a few weeks ago to meet with local clients, their exposure to the French government bonds, the OATs, was a hot topic. It is fair to say that corporate credit risk looks safer in some places than sovereigns. Even in countries that are supported by improving fundamentals, sovereign risk cannot be ignored. Take Italy for instance. Our DM sovereign research team may be a lot more positive about Italy than it used to be, but it doesn't mean that the Buono del Tesoro Poliennale (BTPs) should be perceived of as risk free. In fact, if one looks at BTP credit spreads per unit of credit rating, you only get 9 bps per unit.[2] But if you conducted the same analysis for the EUR credit index, you would instead get 12 bps. In other words, you are poorly compensated for the credit risk you are taking buying BTPs in comparison to investing in EUR Credit. By the way, the same story holds when looking at the yield per unit of duration, another relevant measure of risk. The BTP index, which has a duration of 6.4, produces a yield of 49 bps per unit of duration — i.e., a break-even yield of 49 bps. In contrast, the break-even yield for EUR credit stands at 72 bps, a considerably higher valuation cushion.[3] Put differently, an upward yield move of 49 bps will wipe out any positive return of a BTP index position. For EUR credit, however, it would take a bigger 72 bp yield move to produce a 0% total return. Overall, the total yield for the BTP and the EUR credit indices may be similar, 3.10% and 3.16%, respectively, but don't be fooled, the underlying credit risk looks very different.[4] ◢

Endnotes

[1] Source: Bloomberg. Based on the forward cash curve. Data as of 21 February 2025.

[2] Source: Bloomberg, ICE-BofA, Moody's. BTP Index = ICE-BofA Italy government index. The spreads per unit of credit rating are calculated based on a numerical transformation of the credit rating bands. For instance, Aaa = 1; Aa1 = 2; Aa2 = 3; Baa1 = 8, etc.

[3] Source: Bloomberg. EUR credit = Bloomberg pan-European corporate credit index. Spreads = option-adjusted spreads. Data as of 21 February 2025.

[4] Source: Bloomberg, ICE-BofA. BTP Index = ICE-BofA Italy government index. EUR credit = Bloomberg pan-European corporate credit index. Yields = yields to-worst. Data as of 21 February 2025.

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