# Macro Talking Points

Fixed Income Insights

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## In brief

- **Risky assets don't like strong macro data.**
- **When it comes to curve steepening, it's all about fiscal.**
- **On an FX-hedged basis, the US IG market has grown more attractive.**

**Good data are bad.** More precisely, bad news for risky assets. This has become evident after the market response to the strong US employment report last week, which has triggered a sharp risk-off move. To be clear, this is not an unusual phenomenon, but it does tell us that investors remain addicted to expectations of central bank cuts, at least for now. In other words, central banks, especially the US Federal Reserve, continue to hold outsized market-moving power. But it won't stay that way for ever. At some point, the Fed will play second fiddle, but not until the market has grown comfortable with the idea that the central bank's easing cycle is almost over and that the US economy can deal with the level of interest rates where the Fed pauses. Until then, investors are bound to be subject to sharp swings in market rates and elevated levels of macro volatility. Where is the silver lining in all this? Markets do what they have always done: overshoot. At this juncture, Chief Economist Erik Weisman is of the view that future rate cuts may have become underpriced. Indeed, the market has gone too far pricing out the Fed policy moves. A stingy 17 basis points or not even a full rate cut is penciled in for the rest of the year, which looks rather harsh to us.[1] This is the good news — potentially. At some point, investors may come to the realization that the risk to market rates has become heavily skewed to the downside.

**Curve steepening comes in all shapes and sizes.** Often, curve steepening is a positive market development, as it typically signals that macro conditions are strengthening and recession risks fading, unless of course the steepening reflects more concerning risk factors. In principle, a more adverse curve steepening pattern can either be the cause of rising inflation risks in the face of a central bank of dubious credibility or rising fiscal risks in the face of fiscal authorities of dubious credibility. In the view of our head of DM debt sovereign research, Peter Goves, the latest market moves mainly reflect vulnerability in sovereigns with limited fiscal room, including in the United Kingdom. 10-year gilt yields have skyrocketed by over 60 bps over the past six weeks, triggering a sharp steepening of the curve in the process.[2] But the UK is not alone. In France, the 2s10s on the OAT curve is now trading near 100 bps, mainly reflecting investor concerns over rising fiscal risks there as well.[3] Meanwhile, in the United States, the UST curve may also have steepened, but right now the move is probably less about fiscal worries and more about strong growth, together with sticky inflation. When looking at the decomposition of the market moves that have underpinned the US 10-year rates upward trajectory since early December, one can indeed see that it has been largely driven by two-thirds higher real rates — which tend to be associated with stronger growth expectations — and one-third higher breakeven inflation — which signals the pricing of higher inflation risks. Overall, all the market excitement appears to occur in the rates and curve space these days, while it is worth noting that credit spreads remain relatively well behaved, both in the US and in the eurozone. Despite elevated rate volatility, investors seem to be sticking to the reasonable view that credit fundamentals remain robust, which we see as good news for fixed income.

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**The US is open for business.** One of the key impacts of the ongoing easing cycle around the globe is that hedging costs have changed dramatically over the past few months. In particular, the US credit market used to be relatively unattractive for the EUR-based investor who wanted to hedge the currency risk. Not anymore. In IG, the EUR investor can enjoy a yield of about 3.40% when gaining exposure to EUR credit, or a yield of 3.85% when seeking to buy US IG credit after hedging the USD risk.[4] This is because the cost of hedging the USD has declined to 1.66%, well below what it was in 2022 or 2023. The same story applies to the Japanese investor who may now find more attractive yields in US IG after having hedged the cost of USD exposure. Specifically, a JPY-based investor can currently expect to collect a yield of 1.36% in US IG, net of hedging cost, which is a bit higher than the 1.23% yield offered by the Japanese IG market.[5] Overall, it seems that the normalization of hedging costs is helping expand the size of the investable universe for the non-US credit investor, with access to US IG becoming relatively more attractive from a FX-hedged yield perspective. Also relevant here, of course, is the decision on whether to currency-hedge the exposure to US assets. The dollar has been on a tear, so for the global investor who has the flexibility to do so, embracing some currency risk along may make sense. ◢

## Endnotes

[1] Source: Bloomberg. Based on the US forward cash curve, data as of 13 January 2025.

[2] Source: Bloomberg, UK generic 10-year rates, data as of 13 January 2025.

[3] Source: Bloomberg, French OAT generic two-year and 10-year rates, data as of 13 January 2025.

[4] Source: Bloomberg. European IG yield = Bloomberg pan-European IG index. Data as of 13 January 2025. Cost of USD hedging is based on three-month FX forwards. The ticker shows the three-month USD hedge cost for EUR-based investors on an annualized basis. This assumes that investors sell EUR to buy USD in the spot market and simultaneously sell USD in the forward market to buy back EUR.

[5] Source: Bloomberg. Japan IG yield = Bloomberg Asian-Pacific Japanese Corporate Index. Data as of 13 January 2025. Cost of USD hedging is based on three-month FX forwards. The ticker shows the three-month USD hedge cost for JPY-based investors on an annualized basis. This assumes that investors sell JPY to buy USD in the spot market and simultaneously sell USD in the forward market to buy back JPY.

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