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Macro Talking Points

Fixed Income Insights

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In brief

- **Retail investor bearishness has reached an extreme level, but that may ultimately be good news**
- **Surprise, surprise: the divergence between European and US data**
- **The valuation gap is closing fast between Europe and the US**
- **MBS remains well positioned**

Some more calm after the storm? There has been significant anxiety among investors over the past few weeks. Understandably so, given high levels of uncertainty and market volatility. Several risk appetite indicators are now flashing red, suggesting that risk aversion has surfaced in some places. If you look at the copper/gold price ratio in commodity markets, it suggests deteriorating risk appetite, with the demand for gold (typically viewed as a defensive asset) outpacing that of copper (more of a growth asset) by a wide margin. In currency markets, the pairing of the Australian dollar versus Japanese yen, often a useful risk barometer, also points to flagging enthusiasm for risk-taking. But none of these indicators are more dramatic at this juncture than the sentiment reading produced by the American Association of Individual investors (AAII), which tracks sentiment among the US retail investor community. The AAII net bearish score currently stands at -41.2, the worst level since September 2022 and the second worst in the history of the data series, which starts in 1987.[1] In other words, the retail investor bearishness towards the US equity market has reached an extreme level. However, Market Insights is prepared to make the bold assertion that this may ultimately be good news. Indeed, our observation is that in the past, extreme bearishness has operated as a contrarian signal. Following some data analysis, we found that since 1987, when the AAII net bearishness score reached an extreme level, on average the subsequent 12-month S&P return stood at 12.8%, and that result even captures the global financial crisis of 2008, which caused a prolonged period of market stress.[2] Excluding the GFC, the 12-month subsequent S&P return following an extreme bearishness signal stood at 21.1%, a remarkably superior return than normal equity market expectations. Of course, past performance is no guarantee of future results, but as we have seen before, episodes of severe risk aversion typically tend to be relatively short lived. So, while there are reasonable causes for investor anxiety, it is important not to overreact to the ebbs and flows of sentiment.

Nobody likes surprises. Unless you are from Europe. In the US, we got used to remarkable macro performance over the past few months, and as a result, what we have seen more recently is that macro data have started to disappoint against these lofty expectations. This is particularly well illustrated by the Citi Economic Surprise Index, which turned negative for the US ten days ago.[3] In contrast, against a gloomy prognosis, European data have surprised to the upside, with the Citi's indicator now comfortably in positive territory. To be clear, it doesn't mean that the outlook for Europe has fundamentally improved, but it's probably not as miserable as feared. It's all about expectations. It's true that in the US, consumer confidence numbers

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have deteriorated sharply, but there is a cause to argue that these data may somewhat miss the bigger macro picture. As underscored by Chief Economist Erik Weisman, business sentiment remains robust, and it remains a stretch to flag elevated recession risks. Overall, the macro backdrop in the US continues to be supportive despite the negative signals coming from some of the recent sentiment survey data.

Is the valuation gap between Europe and the US closing? This is a hot topic in equity land, where European markets have outperformed their US peers over the past few months. But this is also very much a theme in global fixed income. It was easy to claim that European fixed income was much cheaper than its US peers a few months ago. But this has all changed and Europe has been a victim of its own success. To be clear, the market backdrop remains a lot more supportive of fixed income in Europe than it does in the US. In terms of credit spreads, the EUR IG index has tightened in a major way since the beginning of the year, now standing at 91 basis points against 102bps at the end of December 2024.[4] This contrasts with US IG spreads widening by 7bps during the same period.[5] If we use our quant investment team's favored spread valuation measure, which looks at spreads per unit of excess return volatility, the EUR IG index now looks more expensive than the US index, something we have not observed for some time. Likewise, comparing the outright EUR IG yield with the currency-hedged US IG yield, now comes out in favor of the US market. The only saving grace of the European IG index valuation is that the index duration is much shorter than its US counterpart. In other words, when looking at valuation in break-even terms, per unit of duration, the European market continues to stand out as markedly more attractive than US IG, with a break-even yield of 70bps in Europe against just 46bps in the US.[6] Overall, we believe EUR IG credit remains well positioned to potentially perform well in the period ahead, especially if the ECB delivers all these rate cuts, but the valuation argument has weakened.

MBS standing out. MBS stands out in the global fixed income universe these days. Not so much because it continues to be supported by fairly strong fundamentals. After all, that feature also applies to corporate credit, high yield and even emerging market debt. No, where MBS stands out is on the valuation front. While everything else in fixed income looks stretched from a spread valuation standpoint, MBS spreads, in contrast, look more attractive. To be clear, the valuation backdrop for MBS has also deteriorated — it is only deemed fair relative to Treasuries — but not to a point that would make Jake Stone, the portfolio manager in charge of our MBS portfolio, particularly worried at this juncture. Meanwhile, interest rate volatility, always an important consideration for MBS, has been trending down, despite the recent hiccup. Jake underscores that the technical picture remains broadly positive, with a large segment of the natural buyers of mortgages (*i.e.*, the banks) likely to resume a more normal pace of purchases. Looking ahead, it will be important to keep an eye on the potential impact of housing finance reform under Trump 2.0, but we don't think that it will ultimately be a source of dislocation. Overall, the investment team believes that the MBS sector continues to offer an attractive opportunity, especially from the perspective of risk-adjusted carry. ◢

Endnotes

[1] Source: Bloomberg, the American Association of Individual investors. The net score is calculated as the difference between the bullish reading and the bearish reading. Analysis is performed using month-end data. Data as 27 February 2025.

[2] Source: Bloomberg, the American Association of Individual investors. The threshold for the extreme bearishness signal was estimated based on a z-score of -1.5: a z-score of -1.5 or below for the net bearish reading signals extreme bearishness. A z-score is a normalized measure of deviation from the average in terms of units of standard deviation. Analysis is performed using month-end data. Data as 27 February 2025.

[3] Source: Bloomberg, Citi. Citi Economic Surprise index for the United States and the eurozone. Data as of 3 March 2025.

[4] Source: Bloomberg. EUR IG = Bloomberg pan-European Corporate credit index. Spreads = option-adjusted spreads. Data as of 28 February 2025.

[5] Source: Bloomberg. US IG = Bloomberg US Corporate IG credit index. Spreads = option-adjusted spreads. Data as of 28 February 2025.

[6] Source: Bloomberg. EUR IG = Bloomberg pan-European Corporate credit index. US IG = Bloomberg US Corporate IG credit index. Break-even yield = yield divided by duration. Data as of 28 February 2025.

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