Macro Talking Points

Fixed Income Insights

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In brief

- **The new Fed data points to higher "slowflation" risks**
- **The potential end of US exceptionalism**
- **We don't see a US recession coming**
- **EM is back**
- **Japan's yields are sharply on the rise**

Watch for higher "slowflation" risks. At this week's FOMC meeting, the US Federal Reserve kept its policy unchanged. That was not the most exciting development. Rather, the item of interest was the Summary of Economic Projections (SEP), which included new macro projections, namely moderately slower growth, combined with slightly higher inflation. Talking about stagflation risk is probably misplaced, in the view of our chief economist Erik Weisman, but it is also true that the Fed now recognizes that economic activity may be slowing down somewhat going forward. There is no cause for panic as we are far away from any tangible recession risk. Overall, the Fed has provided some welcome reassurance that the US macro-fundamentals remain solid. Another source of relief is that the well-followed median DOTS have kept the two prospective cuts for the remainder of the year, signaling that the Fed remains committed to further easing. To be clear, we will have to wait much longer to see more rate cuts. At this juncture, cuts may be a second half story. The Fed is in wait-and-see mode for now and is taking its time to see how the potential impact of tariffs on the macro backdrop will play out. We shall see.

From exceptionalism to normalism. Everyone, Market Insights included, thought that the so-called US exceptionalism was going to be a major market theme this year. Everything was stronger in America: the dollar, the stock market, the growth outlook . . . you name it. However, this theme has been under attack in a major way. At this point, it may be more fitting to talk about US normalism, which of course represents a major shift. The US economy is doing fine, but growth expectations are being revised upwards elsewhere and downward in the US. In other words, instead of growth divergence, we are observing convergence again. Meanwhile, the ongoing tariff noise has had unintended consequences: The dollar is declining as investors move away from US markets, taking advantage of valuation gaps and the repricing of European growth expectations. Lately, it has become a lot harder to be bullish on the USD, especially as Europe is staging a German-sponsored comeback. This is truly a fascinating time to be a global active asset manager given all the shifts in macro regimes and market narratives. The elevated level of macro volatility also puts a premium on a sound investment process and strong risk management, with volatility and dislocations offering potentially attractive opportunities.

US recession fears are overdone. The market is back to worrying about a potential recession. Nobody is talking about the risk of no landing anymore. The main reason is that investors are growing concerned over the impact of tariffs and other policy moves on the growth outlook. As a result, most of the soft, sentiment-based data have deteriorated substantially recently. Take consumer sentiment, for instance. The University of Michigan reading has dropped to 57.9, its lowest level since late 2022.[1] The fears are not backed up by the actual hard data, however, so there may be a disconnect. When looking at the Market Insights' Business Cycle Indicator (BCI) — which aggregates selected leading indicators — it's clear the US economy is in moderate slowdown mode, but the BCI is still really far away from signaling an imminent recession because there are resilient pockets of strength, including the labor market and corporate profit margins.

The tactical case for EM debt. The challenge to US exceptionalism as a prevailing market theme may have major global asset allocation implications. Emerging markets debt was at risk of becoming unpopular as an asset class under Trump 2.0, but as it turns out, the reality has been quite different and now there is an opportunity for EM to stage a comeback. A weaker USD could also act as a tailwind. Meanwhile, it seems that the global growth outlook is holding up nicely, as illustrated by the most recent global composite PMIs, mainly driven by the stronger growth outlook in EM. It is also worth noting that the source of global risks has mainly been concentrated in developed markets over the past few weeks, so exposure to EM may well represent a diversification strategy. To be clear, valuations are on the tight side in global fixed income, and that also includes emerging markets. But we believe there are plenty of opportunities across the EM universe.

The land of the rising yields. In Japan, local yields have been rising substantially, with the 10-year JGB now trading around 1.5%, a multi-decade high.[2] According to Asia fixed income strategist Carl Ang, this is mainly driven by monetary policy expectations. The Bank of Japan appears to be firmly in tightening mode, with a policy normalization strategy that may extend well beyond 2025. With that in mind, Japan stands out to us as one of the few markets where being short duration makes sense. The higher local yields have the potential to influence local investor behavior and allocations, including a less pressing need to chase higher yields abroad. It will be interesting to watch how that plays out, but given the size of the Japan's investor base, we cannot rule out a global impact in the period ahead, perhaps another factor that may contribute to further USD weakness down the road.

Endnotes

[1] Source: Bloomberg, University of Michigan. Consumer confidence index. Data as of March 2025.

[2] Source: Bloomberg, Japan's generic government bond 10-year yields. Data as of 17 March 2025.