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A Steady Ship in Stormy Waters

Fixed Income Markets in the Spotlight

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In brief

- Lending standards have tightened in the wake of the turmoil in the banking sector in the US and Europe.
- Market commentators are focused on whether tighter financial conditions will prompt the Fed to stop raising rates, raise them by less or start cutting them sooner rather than later.
- While there has been some disinflation in the US, in our view it is too early to consider this sufficient to warrant a pivot by the Fed, *i.e.*, for the Fed to start cutting rates.
- Storm clouds abound, but active security selection in fixed income has the potential to provide yield, diversification and risk management — especially important in the event of a US recession, our base case.

The financial markets have weathered significant storms since the onset of the pandemic in 2020, not least among them the recent turmoil in the banking sector in the United States and Switzerland. Given how important banks are for economic growth, banking and credit growth are key factors in assessing financial conditions. Central banks are not the only entities that create money. Regular banks do too.

We are witnessing significant tightening of lending standards, which invariably feeds through to higher default rates as the economic cycle plays out over time with a lagged effect. A key question is how long the lag will be this time. Two factors are worth noting. The first is that there is now a much larger pool of private credit assets that can fill the gap when banks are unwilling to lend. The second is that high-yield companies are generally in better shape because they refinanced extensively in 2021, providing them breathing space until the maturity walls kick in toward the end of 2024 and in 2025.

Nevertheless, if this pattern of tightening lending standards continues in Europe and the US, default rates could easily rise to mid to high single digits. Much will depend on the macro environment, specifically inflation, but also employment levels, which are holding up surprisingly well.

We have seen a decline in bank credit growth in the US and in Europe in tandem with lower demand for loans in both markets, a trend that accelerated significantly due to the regional banking crisis in the US. If we examine the evolution of deposits in both small and large banks, two realities emerge.

For small banks, the challenges have centered around liquidity and managing the securities portfolio against the duration of deposits as well as the rapid withdrawal of deposits fostered by new communication methods and social media. The larger banks have also seen deposit outflows, and these have been shifting into higher-yielding money market funds, a trend that is likely to continue. The reality is that large US banks do not want outsize deposits. Lending opportunities are limited, and the banks are measured and diligent with regards to their lending growth, the reason they are paying low yields on these deposits. Intervention by policymakers has led to stabilization of the banking situation in the US. Deposit outflows have moderated, and banks are reporting greater normalization of the banking environment.

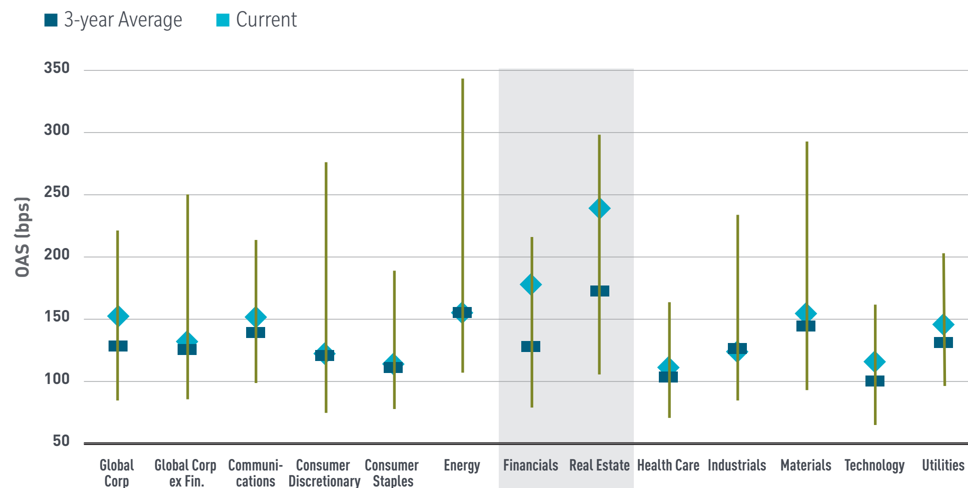
> There has been some disinflation in the US core data, but it has been very gradual, and in our view it is too early to consider this evolution in the US data sufficient to warrant a pivot by the Fed, *i.e.*, for it to start cutting rates.

Market response to banking turmoil

What does this mean vis-à-vis the market stress we have seen because of the lending crisis? A lot of the discussion centers around the degree to which banks will curtail lending to the economy and whether the Fed will stop raising rates, raise them by less or start cutting them sooner rather than later as a result.

When we examine valuations in the global credit markets, we see that the impact has been limited to the financial sector, which includes banks and real estate, another rate-sensitive sector (See Exhibit 1).

Exhibit 1: Global Corporate Spread Range by Sector



Source: J.P. Morgan. Daily data from 1 January 2018 through 4 April 2023. Bar lengths represent the minimum and maximum spread over the period.

Exhibit 1 illustrates that most corporate and industrial sectors are not offering compelling value relative to the past three years' average spreads. We have seen the spreads of additional tier one (AT1) bonds rise sharply because of the banking stress. The bonds that are lower in the capital stack, with AT1s being the most junior, have become significantly cheaper because of the distortions created by Silicon Valley Bank, Signature Bank, Crédit Suisse and other regional stresses. In periods of market stress, bank bonds become more correlated, and the March experience was no exception, with a generalized selloff in the sector globally.

Mortgages was another part of the market impacted, with spreads remaining at wider levels even as corporate credit spreads recovered. Regional banks have sizable loan exposures to the commercial real estate sector, so worries about their continued ability to lend (as well as the need to sell the existing portfolios of the failed banks) have led to pressure on spreads in structured credit such as CRE CLOs, along with CMBS and even MBS passthroughs.

Rates

An important question is what this means for inflation, growth, central bank policy and the rates markets. Are we in a more fragile environment that will lead to an earlier recession than expected? Core inflation numbers in the US and elsewhere, in the UK, for example, remain quite sticky. There has been some disinflation in the US core data, but it has been very gradual, and in our view it is too early to consider this evolution in the US data sufficient to warrant a pivot by the Fed, *i.e.*, for it to start cutting rates.

If a recession were to occur sooner and prove severe, the timing of rate cuts would accelerate, but given the stickiness of US core inflation at present, our premise is that a recession would need to be evident for the Fed to pivot. While leading growth indicators such as PMIs have declined along with manufacturing, services have been stronger than anticipated. Services have propelled both growth and inflation, especially in the US, and led growth in the large core blocks — in the Eurozone and the US, and in the early stages of China's reopening — surprising to the upside relative to our expectations. We expect the downside risks to increase as the year progresses and our base case continues to be for a recession in the US given the lagged effects of tighter monetary policy. Central banks continue to prefer to react to data, increasing the likelihood of a policy mistake.

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It is noteworthy that many small and midsize companies in the US, the backbone of the US economy, are serviced by regional banks. If these banks curtail lending, this will impact services growth and potentially shift the employment paradigm.

Investment implications

As our base case is for a US-centric recession, if not a global recession, we will need to see how Europe and China fare in the next several months. Given that we have seen peak inflation in the US and some deceleration in the markets based on core inflation numbers, we are now likely to have left the "taper tantrum" regime we lived in for much of last year. In the next six to 12 months, we expect to be in a "Goldilocks," or risk-off, regime.

Both regimes would advocate adding duration. We are starting to look for opportunities to do so in our global multisector fixed income strategies. Not all duration is created equal, and in general what we have been looking to do is to start by neutralizing our position in the US. We have been looking for opportunities in rate-sensitive markets like Canada, Sweden and some of the local emerging markets such as Mexico. At this point, we prefer local EM bonds issued by some of the Latin economies, which have been ahead of the curve with regards to the tightening cycle and what is priced into the market.

On the FX side, we are neutral the US dollar. Over the last several months, we have been adding euro and yen to offset an underweight position in the dollar; and looking for EM FX elsewhere to add FX risk. We are looking for pair trades based on a fundamental approach to valuations.

Regarding securitized and structured debt, mortgages are now more attractive considering the spread widening, though they are not as interesting as they were in the fourth quarter of 2022. We remain focused on idiosyncratic opportunities and dislocations within some of the CMBS parts of the portfolio. We are adding ABS securities that are not consumer-driven and have proper asset backing in the form of equipment collateral. In general, we remain relatively neutral in ABS and continue to be underweight traditional mortgages.

In credit, we have been adding exposure to investment-grade credit with a bias to markets that have become more dislocated. In EM, while we are still overweight EM hard currency, this overweight has been reduced; we have been selling some of our EM investment-grade bonds and finding value in other parts of the investment grade or corporate market versus emerging markets. In high yield, we are not seeing many defaults priced in as we mentioned earlier, and spreads have come in. Many investors are looking at the front end of the HY yield curve to provide additional spread and yields. In our case, while we still have exposure to HY bonds, it is driven by a bottom-up process based on our research platform. We are not necessarily looking to add high-yield risk at these spread levels.

Conclusion

While storm clouds continue to hover over the markets, this is an interesting time for investors in fixed income. We have not seen yields at these levels in years, nor this level of inflation in years either. We continue to favor an active approach and diversification in fixed income considering the many uncertainties. A research platform able to identify idiosyncratic opportunities amid the turbulence, along with a longer investment time horizon, is key in our view.

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