

# Macro Talking Points

Fixed Income Insights

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## Author



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## In brief

- **Profit margin dynamics still strong in US**
- **Global fixed income challenged in first quarter**
- **Fixed income valuation in the eye of the beholder**

**The relentless pursuit of profit.** Karl Marx's expression aptly describes the current health of the US economy, which keeps bringing positive surprises. The latest revision of Q4 GDP shed light on recent profit dynamics, and the outcome is particularly impressive. Nonfinancial corporate profits rose by 7.7% year over year in Q4, its fastest pace in a year.<sup>1</sup> In the process, economy-wide profit margins rose to a remarkable 17.1%, their highest level since June 2021.<sup>2</sup> A few important takeaways: There is no sign of an imminent profit recession or profit margin correction. From a profitability perspective, the corporate sector remains robust. With that in mind, the latest update of our Business Cycle Indicator — a composite leading indicator for the US — suggests that the US economy is behaving as if it's just going through a mild midcycle slowdown. Overall, we believe the macro fundamentals are in great shape.

**First quarter time out.** Let's pause and check the fixed income leaderboard after Q1. It's been a mediocre start to the year, reflecting persistent rate volatility. Credit risk — *i.e.*, exposure to spreads — did much better than duration risk during the first quarter. In other words, you wanted to be exposed to high spreads, low duration to do well. In contrast, the sectors characterized by low spreads and high sensitivity to rates significantly underperformed. Only seven of the 16 fixed income subset classes we monitor produced positive returns in Q1. The top performer was leveraged loans, with a 2.5% return for the quarter, followed by emerging market corporate debt, global high yield and EM sovereign debt.<sup>3</sup> In contrast, the global aggregate index was the worst performer with a negative return of -2.08%.<sup>4</sup> Agency MBS and USTs also performed poorly. Looking ahead, global fixed income is going to need help from central banks for returns to bounce back. The good news is that not only is central bank easing coming but the current market-implied pricing of central bank easing is also in the right place. We believe that this, in principle, should help boost fixed income returns for the remainder of the year.

**Fixed income valuation: The bright and the dark sides.** Fixed income valuation is a hot topic these days as the valuation backdrop is clearly not as compelling as it used to be. But there are many ways to analyze fixed income valuation, and we believe there are still bright spots. For example, breakeven yields remain attractive by historical standards. The breakeven yield represents the total return cushion the investor gets from the level of yield and technically corresponds to the amount by which yields would have to go up over a year for the total return to be 0%. Put differently, the higher the breakeven yield, the lower the probability the asset class will register a negative return. Breakeven yields are particularly attractive for the global agg, the European egg and European high yield. But there is also a dark side of fixed income valuation: the current level of spreads. Looking at spread valuations, most fixed income asset classes look stretched, especially US taxable municipal bonds, US IG, EM corporate debt and US HY. But we believe the current valuation backdrop favors an active management approach to fixed income investing as active portfolio managers seek to take advantage of valuation dispersion and dislocations. Overall, looking at breakeven yields, a strong case can be made for showcasing the attractive valuation of fixed income for the long-term investor. ▲

## Endnotes

<sup>1</sup> Source: Bloomberg, Bureau of Economic Analysis. National Income and Product Accounts for Q4-2023: US corporate profits with inventory valuation adjustment and capital consumption adjustment. Domestic Industries Nonfinancial.

<sup>2</sup> Source: Bloomberg, Bureau of Economic Analysis. National Income and Product Accounts for Q4-2023: US corporate profits with inventory valuation adjustment and capital consumption adjustment. Nonfinancial domestic industries. Profit margins = ratio of corporate profits to US gross value added of Nonfinancial domestic industries.

<sup>3</sup> Bloomberg. Leveraged loan index = Morningstar LSTA US Leveraged Loan Index, data as of 31 March 2024.

<sup>4</sup> Bloomberg. Bloomberg Global Agg index, total return, data as of 31 March 2024.

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