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Macro Talking Points

Fixed Income Insights

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In brief

- **Rate volatility is still elevated, but at least it is now correcting lower.**
- **The bond-equity correlation is likely to stay elevated, but this time for good reasons.**
- **The income in fixed income is back.**
- **The Fed cuts are still being priced out.**

The right MOVE. Rate volatility is finally normalizing lower, with the MOVE index — the main indicator of US rate volatility — breaking decisively through 100 to the downside.[1] The last time the index was comfortably in double-digit territory was in March 2022, before the Fed initiated its aggressive tightening cycle. Looking ahead, lower rate volatility is likely to be more supportive of global fixed income. Lower volatility should make it easier for investors with asset-liability management constraints to manage their duration-matching process. It should also provide further support for long-duration assets or for assets that tend to be vulnerable to elevated rate volatility, such as MBS. Finally, it shifts the premium away from rates onto other drivers of expected returns, such as credit risk and security selection, which should ultimately favor active asset managers with a large credit research platform.

The good kind of elevated correlations. Back in 2022 and early 2023, during the fear of the Fed macro regime, the correlation between bonds and equities shot up to historically high levels. At the time, this spelled bad news for global markets as it meant that both fixed income and equities were struggling. Looking ahead, it is no longer obvious to us that the bond-equity correlation will quickly correct lower, but that may actually be a good thing, because we are going through a macro regime transition that may still favor elevated correlations, although this time, all for a good cause. Think of the opposite of the Fear of the Fed. Perhaps it should be the *Anticipation* of the Fed. In the process, fixed income gets a boost from the US Federal Reserve initiating a policy easing cycle. At the same time, the appetite for risky assets, including equities, increases, reflecting the supportive policy signals. That keeps the correlation elevated, because both asset classes seem likely to do well. In addition, the 60/40 portfolio is back with a vengeance, but not because of its great diversification benefits, which are still on hold for now. One of the greatest appeals of global fixed income at this juncture is its de-risking characteristics, which are designed to not sacrifice expected returns.

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The income in fixed income. That is the other appeal of fixed income. With US market rates going back up, at least in the near term, the differential between the US government bond yield and the equity dividend yield is back near its historical high. At the moment, 3.07% is that differential.[2] Fixed income is back to providing income. We nonetheless believe that given the favorable macro environment, deploying some credit risk makes sense, enhancing the income component as part of the total return, simply because US credit yields are of course even higher.

Where is the landing zone? The rates market is struggling to see the landing zone and seems to be moving toward pricing in no landing at all for the US economy. Currently, the federal funds future curve is positioned for two rate cuts and just a third of a third cut before year-end. That is probably too few, we think. Further guidance will come this week with the release of the US CPI for March. At the end of the day, it is all about inflation. If the path towards disinflation is confirmed by the latest data, it is likely that the rates market will walk back toward adding a bit more market-implied easing in the pipeline, which would ultimately be supportive of fixed income. On that note, the key datapoint to watch is going to be core CPI, where the Bloomberg consensus forecast is 3.7% year over year.[3] Markets are always an expectations game. The good news is that the fewer rate cuts that are priced in, the greater the room for the Fed to overdeliver on cuts relative to market expectations. The US 10-year rates are back to above 4.40% for the first time in several months, mainly reflecting concerns over rising inflation risks and the possibility of the US economy overheating.[4] While it is true that no landing has become a greater risk than a hard landing, there is no cause to panic at this point. Our baseline scenario is still that we are going through a moderate midcycle slowdown. ◢

Endnotes

[1] Source: Bloomberg, ICE BofA. The MOVE Index measures U.S. bond market volatility. The Index tracks implied normal yield volatility of a yield curve weighted basket of at-the-money one month options on the 2-year, 5-year, 10-year, and 30-year constant maturity interest rate swaps. Data as of 5 April, 2024.

[2] Source: Bloomberg. The differential is estimated as the difference between the 10-year US treasury yield and the US S&P 500 dividend yield. Data as of 5 April, 2024.

[3] Source: Bloomberg. Consensus forecast. Data as of 5 April, 2024.

[4] Source: Bloomberg. US 10-year Treasury yields. Data as of April 8, 2024.

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