Macro Talking Points

Fixed Income Insights

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In brief

- **Rate cuts are coming, but we may have to wait a little longer.**
- **How to navigate geopolitics.**
- **The growth outlook in Europe is improving.**
- **Financial conditions in the US are not restrictive. In fact, quite the contrary.**

Waiting for Pivot. Let's go (and buy fixed income). We can't. Why not? We're waiting for Pivot. And not unlike in the famous Samuel Beckett play, some patience is going to be needed. But in contrast to the Godot version of the pivot, we do believe that US Federal Reserve rate cuts will eventually come, just not as soon as we had initially thought. At this juncture, July looks a bit more realistic than June, owing to stubborn inflation data. Given the macro uncertainty, especially around inflation dynamics, near-term market conditions remain challenging. On a strategic level, fixed income remains well positioned, but some more decisive policy signals on the part of the Fed would be welcome. For that to happen, inflation data need to cooperate. June as timing for a possible rate cut is not totally off the table, but it will probably take a downside surprise in the core PCE print, to be released on 26 April. Worryingly, the Godot scenario — that is, we are waiting forever for rate cuts that will never come — is getting some traction. Also known as the no-landing scenario, it is a risk worth watching. At the same time, we are much less convinced at this point that the threat of rate hikes will come back. Overall, for the investors with a longer-time horizon who can ignore short-term macro volatility, we do not see any cause for panic. The main narrative has not shifted: Yields are attractive by historical standards, which potentially bodes well for future fixed income returns, and the central bank policy support is coming. We are waiting.

How to position for elevated geopolitical risks. As evidenced by the latest developments in the Middle East, geopolitical risks are a constant feature of global markets these days. The reality, however, is that geopolitical risks are virtually impossible to position for. Geopolitical events are, by definition, unpredictable. First, the probability of a potential geopolitical crisis occurring is very difficult to ascertain. Second, its timing is always uncertain and, finally, its magnitude and duration, together with its possible ramifications, are difficult to anticipate. With that in mind, we believe it is challenging or even counterproductive from a risk management perspective to position portfolios with the sole objective of protection against geopolitical risks, simply because a geopolitical crisis can be likened to a "black swan" event — an extremely rare and impactful event that is beyond the pale of what might be predicted. There are nonetheless useful strategies that we believe investors can implement to help optimize their geopolitical risk management. First and foremost, some portfolio diversification is essential, both in terms of asset classes and regional exposures. Fixed income, especially government bonds, has helped mitigate the return impact of geopolitical crises historically. Likewise, a few currencies have historically acted as safe-haven assets and therefore constitute interesting hedges, including the USD, the CHF and the JPY. Finally, we believe commodities, especially oil and gold, present some good defensive characteristics when it comes to the potential impact of geopolitical events.

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The growth outlook in Europe is improving. To be clear, we are not talking about a spectacular bounce, but it seems — at least based on our eurozone business cycle indicator — that the risk of a recession looks less ominous. This is good news for European fixed income, especially after the ECB has dropped a few more hints that the rate cuts are coming, possibly in June. Overall, European fixed income is our favored region at this point, both from duration and credit perspectives.

Tailwind from financial conditions. There is a whole debate these days about whether Fed policy is tight enough or not. Some of that debate is a bit too academic for these Macro Talking Points, but the key observation is, looking at financial conditions, it does not seem like it. The financial conditions backdrop, as monitored by the Fed, is as growth friendly as it has been since December 2021. No wonder the US economy is thriving. This also provides support to the idea that the economy has grown less sensitive to interest rates in recent years. We believe the combination of accommodative financial conditions, rate cuts in the pipeline and a possible productivity shock, bodes well for longer-term growth expectations, which ultimately should support risky assets from a macro-fundamental standpoint.

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