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Macro Talking Points

Fixed Income Insights

Week of 22 April 2024

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In brief

- **In fixed income, it is all about the macro regime.**
- **Rate return volatility is overwhelming spread return volatility in IG credit.**
- **There is monetary policy divergence, and that creates opportunities.**

The importance of getting the macro regime right. When we think through what drives fixed income total returns, there are essentially two big buckets that can explain the moves: the income and the macro regime. The income part is pretty straightforward: The coupons are known, they are stable, and therefore are fairly predictable. But unfortunately, they are not the whole story. In fact, the other bucket — which we have labelled as the macro regime — is a lot more important. But what do we mean by macro regime? Basically, it is the price return which reflects both rate and spread moves. In turn, these moves can be characterized as illustrating different macro regimes. Let's, for instance, take the example of a severe recession. Under the recession-fear regime, rates are likely to fall, especially as the central bank may ease monetary policy, but credit spreads will correct higher. There are three other potential macro regimes: the fear of the Fed, the liquidity impulse and growth recovery. Here's the thing: When looking at total returns for both US credit and EUR credit over the past 15 years, 92% of the annual total returns were explained by the price return, that is, the macro regime.[1] The income always helps, but in the big picture, it does not play a big role in explaining the variability of fixed income total returns from one year to another. In other words, it is critical to get the macro regime right, which is what an active fixed income asset manager will always try to do for its clients. If you get the macro regime wrong, meaning the duration and credit risk exposure is ill-positioned, then the return implications can be severe.

Rates are not overrated. Another way to illustrate the significance of the rates view in fixed income these days is to look at the source of the volatility of total returns. The volatility of total returns in investment-grade credit can be broken down between the rate return volatility and the credit return volatility (the latter is sometimes also called excess return). For US IG, the total return volatility currently stands at 8.6% (using a rolling 3-year estimate), but most of this can be explained by the rate return volatility (7.1%).[2] In contrast, the spread return vol has been much lower. The story is the same for EUR IG, although it is worth flagging that overall volatility is markedly lower in Europe (6.3% for total return volatility). It is only when we perform the same analysis for high yield that the relationship understandably flips. High yield is characterized by lower duration risk and higher credit risk, and therefore, for both US and EUR HY, it is the spread return volatility that is the most significant component. One last interesting fact that illustrates that it is all about rates (and not spreads) these days: The total return volatility of US IG and US HY have been virtually the same in the recent past. That is quite unusual but illustrates the impact of the elevated rate volatility in US IG.

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Long live policy divergence! At this juncture, there are almost twice as many cuts priced in from the European Central Bank over the next year than there are for the US Federal Reserve. Policy divergence is not that uncommon, simply because, while global markets are interconnected, local macro conditions and constraints can be different. In the case of the ECB, slowdown risks are more pronounced, and at the same time, disinflation dynamics are on a stronger footing than across the pond. As a result, the case for more aggressive rate cuts in the eurozone is considerably stronger. Policy divergence typically represents a great opportunity for active asset managers with a global mandate. Indeed, that divergence can be a major driver of currency markets, differentiated duration views or geographic relative value opportunities. Sometimes, that policy divergence can also self-correct. Looking at the rates markets, only 55 basis points of market-implied rate cuts for the Fed over the next 12 months seems too little to us, and this could well be a case of the market overshooting again.[3] US 10-year rates are trading at their year-to-date highs, mainly reflecting the pricing out of these Fed cuts. This could represent an attractive opportunity for fixed income investors. On that note, the front end of the US treasury curve — the 2-year segment in particular — no longer prices in any rate cut this year. To us, this is an interesting observation, as it means that the bar for the Fed to produce further policy disappointment is now quite high. There is no evidence that the Fed has given up on rate cuts. It is just the timing that has become more uncertain. In other words, we do not believe that the upside correction in rates is likely to be sustained in a major way in the period ahead. Soon enough, fixed income will likely be back in the sweet spot from a macro standpoint, with market yields that are elevated but subject to downward pressures.

Endnotes

[1] Source: Bloomberg. Bloomberg US IG Credit index. Annual data. A simple regression of the price returns and the total returns produces a coefficient of determination (R-squared) of 0.92, which signals a high explanatory power from a statistical perspective.

[2] Source: Bloomberg, ICE BofA. US IG = ICE BofA IG Corporate credit index. Monthly data up to March 2024. The volatility is estimated using a 36-month rolling window.

[3] Source: Bloomberg. Based on Fed funds future curve. Data as of 22 April 2024.

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