Macro Talking Points

Fixed Income Insights

Week of 29 April 2024

Author

Benoit Anne
Managing Director
Investment Solutions Group

In brief

- **Stagflation trying to stage a comeback**
- **Q&A from last week's Asian client trip**

Too early to fret over stagflation. Let's not panic about the prospect of stagflation in the United States just yet. Yes, US real GDP growth slowed in the first quarter while inflation surprised to the upside, reigniting stagnation fears. The statistical fine print matters, however. The composition of GDP growth was indeed robust, and overall the signals were reassuring, especially when it came to the health of the US consumer and the outlook for private investment. Deep down in the GDP report, the two line items that caught our attention were the growth in residential investment (housing), which recovered to 13.9% quarter over quarter, and the private fixed investment in information-processing equipment and software, which grew by a double-digit rate for the second quarter in a row.[1] That smells like an IT-driven positive productivity shock to us. Another potential source of comfort is that this first-release GDP number, officially known as the advance release, is prone to substantial revision. For quarterly GDP data, there are three different releases — one month apart, the advance, the second release and the final release. Guess what? Over the past ten years, the standard deviation of the revision between the advance and final releases for the same quarter was a staggering 1.4%. In other words, the latest GDP growth release of 1.6% for the first quarter could end up being revised up to as high as 3.0% or all the way down to 0.2%), based on historical patterns. It's therefore too early to draw any major conclusions. Yes, 1.6% quarter over quarter performance was disappointing, but we aren't too far off the GDP growth sweet spot, which we estimate to be in the low twos.

Moving on to the inflation side of the stagflation equation, there's no need to panic here either. The highly significant core PCE deflator number for March, which was also released last week, stood at 2.8%, stable from a month earlier.[2] This means that progress toward the US Federal Reserve's 2% inflation target is rather slow but at the same time there is little evidence of a big inflation flare-up. Overall, we believe the macro backdrop is still supportive for fixed income, despite the increased uncertainty over the timing and magnitude of future rate cuts.

You asked. I spent last week meeting with institutional investors in Southeast Asia. Many important topics were discussed. Here's a quick rundown of the issues on Asian investors' minds.

On the macro front, monetary policy was a major item of discussion, especially the outlook for Fed and European Central Bank policies. Fiscal policy was covered, with one investor asking whether fiscal dominance was a tangible policy risk. The no-landing scenario came up as well, including the upside risk to inflation. Turning from the US, investors wanted to know our view on Japan. Besides macro, there were a lot of questions related to our market views, starting with the appropriate stance on duration and curve positioning. Higher-for-longer was also raised, with the question being whether it was still a relevant theme. Fixed income valuation was a hot topic, including where we still saw attractive opportunities. Other market view questions included our view on the US dollar and why gold was rallying. Market risks were understandably a major topic, in particular which risks were the most serious and how we should position for rising geopolitical risks, including election risks, especially what will happen if Donald Trump wins the US presidential election. Other interesting themes came up, including passive vs. active management in fixed income, the appetite for green bonds in the context of sustainable investing, and the appeal of private credit.

We answered. On monetary policy, we still believe the Fed will deliver rate cuts, but the uncertainty over the timing and the magnitude of cuts has risen. It's still possible the Fed will deliver two or even three cuts this year alone. The good news is that the current market pricing backdrop is favorable, with the market potentially underpricing the magnitude of future rate cuts (in fact, the federal funds future curve only prices in 35 basis points of rate cuts by year-end right now).[3] Moving on to the ECB, it's likely to be more aggressive with rate cuts than the Fed, simply because the macro backdrop in the eurozone supports that outcome. We expect ECB rate cuts to begin in June, with several more following before year-end. Still on the topic of monetary policy, in Japan, we expect a gradual move to the exit. With that in mind, we aren't necessarily looking to be mega short duration there. Moving on to fiscal policy, yes, the lack of fiscal discipline in the US is an important issue, but not in the short term. Also, with the Fed's independence entrenched, we don't find fiscal dominance a tangible risk. Another issue is the inconsistent policy mix currently facing the US, with fiscal policy getting in the way of the monetary policy objectives.

In terms of the macro scenarios, the no-landing scenario is more likely to play out than the recession one, but our baseline is still a soft landing, simply because we're observing signs of a moderate growth slowdown in the US, as we discuss in our introduction above. For the strategic long-term investor, we still like being long duration given where we're in the rate cycle and the attractiveness of market rate valuation. Admittedly, the case for being long-duration is stronger in the eurozone than in the US. As for curve positioning, it makes sense to extend the position down the curve especially when the curve re-steepening process gathers momentum again. Higher-for-longer is a matter of definition, in our view. Rate cuts are coming soon but policy rates as well as market rates will stay higher than during the post-GFC era. That's a good thing, and we should celebrate the return to the "old normal." Meanwhile, spread valuations now look stretched in many markets, but the yield valuation story is still compelling. In addition, European fixed income looks more attractive than its US peer. On the USD, the macro backdrop should in principle lead to USD weakening in the period ahead, but there is more uncertainty around the macro drivers. With respect to the gold rally, the metal tends to be perceived as an inflation hedge, and the latest move aligns with recent fears about stickier inflation in the US.

On risks, it's virtually impossible and probably not even desirable to position for geopolitical risks. As a first line of defense, we advocate a diversified portfolio across regions, currency exposures and asset classes, including fixed income and commodities. As we say above, a Trump win is a major market risk, simply because it remains unclear what a second term would look like. Consensus errs on the side of Trump-II being less market-friendly than Trump-I, with a greater risk of tariff wars and protectionist policies. To be clear, the US election is still too close to call, and a lot can change before November. On the debate about passive vs. active management, we recognize that there is room for passive management in a broad portfolio. At the same time, the higher the macro volatility, the greater the value that can be extracted from an active approach to portfolio management. That's why we believe using an active manager still makes sense. On green bonds, Asian investors expressed great interest in them. We explained our approach to sustainability, which relies on the full integration of the consideration of sustainability factors into the investment process. Finally, on the appeal of private credit, an allocation to private credit is justifiable as part of a broader asset allocation. However, we believe caution is warranted, and given the restored attractiveness of public fixed income, we suggest not being overweight private credit at this juncture, especially as the asset class has become a lot more crowded.

Endnotes

[1] Sources: Bloomberg, Bureau of Economic Analysis. GDP chained dollars QoQ for Q1 2024.

[2] Sources: Bloomberg, Bureau of Economic Analysis. Core PCE price index for March 2024.

[3] Sources: Bloomberg, federal funds future curve. Data as of 26 April 2024.