Macro Talking Points

Fixed Income Insights

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In brief

- **Higher for longer is better, as this positions fixed income well for the long term**
- **The risk of monetary policy disappointment has gone down**
- **The days of cash outperformance may be behind us**
- **There is significant spread valuation dispersion across global fixed income**

Is higher for longer dead? Market rates have rallied quite a bit since their peak back in October. So what does that mean? We don't think that higher for longer has disappeared as a market theme, but it's much less scary than it used to be. In fact, we would argue it has turned into a positive development. It's also a matter of definition, especially when it comes to the reference period. Will policy rates (and accordingly market rates) settle at a much higher level than during the post–global financial crisis era? Yes, they will. The opposite would mean we're in deep trouble again, so let's take this higher for longer theme as a statement of good health. During the post-GFC era, federal funds rates averaged just 0.63%.[1] While the US Federal Reserve policy rate is still at 5.50%, the long-term plan is for federal funds to converge towards 2.5%.[2] To be clear, the sharp upward adjustment in rates has caused and will continue to cause funding and financing frictions, especially for the most vulnerable economic entities. But the upcoming rate cut cycle should provide some relief going forward. Just a few months ago, almost everybody was concerned about the future maturity wall. That topic has now fallen out of fashion. From a structural market regime perspective, higher for longer simply means that fixed income is in a much happier place: Fixed income has gone back to providing income for the long-term investor.

The price is right. The implied pricing of future monetary policy has moved a lot over the past few weeks, and the good news is that we're in a much better place. In other words, the risk of policy disappointment — *i.e.*, smaller rate cuts than priced in — is now considerably lower. This is a positive signal for global markets. At this juncture, local curves price in only 100 basis points and a pinch more for rate cuts in the United States until year-end and some 125 bps for ECB rate cuts during the same period.[3] This looks reasonable to us. Indeed, four rate cuts in the US looks much more achievable than six, which is where the market was several weeks ago. Central banks could actually overdeliver, especially the ECB. In our view, this all means that monetary policy is likely to be supportive of risky assets in the period ahead.

Cash in, cash out. December 2023 was a special month in more ways than one. But for the investor who was still overweight cash in their portfolio, it was a momentous point, and not in a good way. Indeed, December was the first month when short-tenor credit (as illustrated by the 1-3 year US investment-grade index) outperformed cash (as proxied by the 3-month CD rate) on a 12-month basis.[4] So things are going downhill, at least in terms of the expected cash returns. That's simply because the cash return is going to closely track the federal funds rate in the US and that rate is set to close the year at a much lower level. Overall, the days of cash outperformance over credit may be over.

Valuation overview in global IG and global HY. With valuations having moved recently, it may be worth taking stock. We're going to base our valuation analysis on one of our favored indicators: the breakeven spread z-scores.[5] Here's the fine print: The breakeven spread z-score tells us where a given asset class stands in terms of valuation relative to its own history when it comes to spreads per unit of duration. On the IG side, the cheapest asset class remains European IG, followed at some distance by UK IG. Canadian IG is close to its long-term fair value. Meanwhile, US IG and emerging market corporate IG are in stretched valuation territory while EMD sovereign IG looks outright overvalued. Moving on to high yield, the story is quite different. This time, EMD sovereign HY appears to be the cheapest asset class, although it looks attractive only because the distressed segment of that bucket trades at extraordinarily cheap levels. In other words, there is major fundamental risk involved in capturing the attractive valuation. European HY also trading in attractive territory. At the other end of the spectrum, US HY trades well through its long-term fair value. Overall, all this valuation dispersion presents attractive opportunities for an active global fixed income manager with a global mandate. Separately, the total yield valuation picture continues to be favorable across global fixed income.

Endnotes

[1] Source: Bloomberg, US Federal Reserve. Federal funds rate, upper bound. Average from Sept. 2008 to March 2022.

[2] Source: US Federal Reserve, "Summary of Economic Projections," December 2023.

[3] Source: Bloomberg. Federal funds future for the Fed. Forward cash curve for the ECB. Data as of 9 Feb. 2024.

[4] Sources: Bloomberg, ICE BofA, Fed FRED (St Louis). 1-3yr US IG corporate credit index. Cash = 3-month CD rate. Monthly data up to Dec. 2023.

[5] Source: Bloomberg. A z-score is a measure of deviation from long-term average in terms of units of standard deviation.