Macro Talking Points

Fixed Income Insights

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In brief

- **Looking at the source of expected fixed income returns**
- **US inflation story still looks good, despite recent disappointing data**
- **We still favor a long duration bias**
- **Macro backdrop in Europe is improving, which is supportive of EUR assets**

Where are fixed income returns going to come from this year? This year, it's fair to say we can no longer rely on major spread compression to boost fixed income returns in the way we have been expecting. This is because spreads have already rallied a lot, especially in the US. By some valuation metrics, US IG spreads now look to be in sell territory. Overall, we'd argue that the best-case scenario at this juncture is for stable spreads. Credit spreads are subject to some moderate widening risks — but only moderate — since the soft-landing scenario seems to be prevailing. We believe there is, nonetheless, a silver lining: Our investment team thinks that near-term technicals remain broadly favorable for credit. Does this mean that the outlook for credit is gloomy? Not so fast. Global fixed income remains an attractive carry play given where yields are on a historical basis. In other words, fixed income will continue to provide income. And then there is the rate story, which we believe will play a major role in terms of return generation, looking ahead. The major central banks will soon embark on sizable easing cycles, and the forthcoming rate compression may more than offset the potential risk for spread widening. With that in mind, a robust year for global fixed income returns is still very much on the table, but it is likely to hinge on global central bank sponsorship.

Data disappoints. The US inflation data have been disappointing recently. However, it is important to make the distinction between market expectations and the bigger trend. Market expectations raised the bar high, hoping for a fast and furious disinflation process. Against these elevated expectations, the data indeed disappointed. Now looking at the broader trend, the disinflation process is still under way, just not as fast as we had initially hoped. There seem to be a few bumps in the road, but the overall picture still points to inflation slowing down going forward. Statistically speaking, both the 3-month and the 6-month annualized rates for US CPI as well as core CPI remain negative, hence reinforcing the case for continued disinflation. After the US CPI and PPI releases, all eyes will now turn to the publication of the core PCE price index, the US Federal Reserve's favorite indicator, on 29 February. The last core PCE print stood at 2.9% YoY, starting with the correct big figure but still some distance away from the Fed's 2% inflation target.[1] As long as core PCE does not climb back over 3%, we will be on a strong footing. Admittedly, there are two current challenges with respect to the inflation story: 1) housing inflation, which accelerated sharply in January, and (2) inflation expectations, which appear to be back in an uptrend. Regarding the former, it is still unclear whether the inflation pickup, which appeared outsized last month, will be permanent. Conventional wisdom points to a slowdown in housing inflation coming through later this year. On inflation expectations, the signals have become more mixed, with a few indicators showing signs of a resurgence. Overall, let's not overreact to the January data. Fed rate cuts are coming. Maybe not in March as the market implied some time ago, but the inflation trajectory remains broadly supportive of fixed income.

Short or long duration? We have seen a sizeable upside move in market rates since the beginning of the year, mainly reflecting the repricing of Fed policy and the recent data disappointment on the inflation front. That move, however, now appears to have gone a long way, after the US 10-year rates backed up to 4.28%.[2] Does long duration, then, no longer make sense? We think it does. It's hard to imagine that the upward rate correction can be sustained for much longer. This is mainly because the process of monetary policy repricing is virtually complete. It's possibly even gone too far. At this point, there are only 80 basis points of implied cuts priced in for the Fed until year-end.[3] That is three cuts and a bit. That seems a bit stingy to us. The good news is that the Fed may now be able to over-deliver relative to current market expectations. This will be supportive of a long duration bias, which we think is the appropriate stance for an investor with a long-term time horizon, given the current macro backdrop.

The European macro bounce. Nothing spectacular just yet, but we're detecting some green shoots of improvement in macro conditions in the eurozone. To be clear, the baseline scenario remains one of stagnation. The good news though is that the risk of severe recession seems to be fading away. Our Business Cycle Indicator for Europe, which aggregates a number of relevant indicators, points to a noticeable uptick from a couple of months ago. For instance, the well-followed ZEW indicator for eurozone growth expectations just reached its highest level in a year. Why does this matter? A recovery in growth expectations is likely to be supportive of EUR credit spreads. If we consider the fact that the ECB is likely to ease soon, it means that the macro backdrop is overall favorable for EUR assets. Valuations have tightened considerably across global fixed income, but there are still some pockets of attractive relative value, primarily for EUR IG and EUR HY.

Endnotes

[1] Bloomberg, Bureau of Economic Analysis. Data for December 2023.

[2] Bloomberg. US 10-year generic rates. Data as of 16 Feb.

[3] Bloomberg. Based on Fed funds curve. Data as of 16 Feb.