Macro Talking Points

Fixed Income Insights

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In brief

- **Active portfolio managers and long-term investors look differently at asset classes.**
- **Fixed income spreads have rallied, but European spreads have lagged, which is a good thing.**
- **There are hidden risks and issues associated with the no-landing scenario.**

The active portfolio manager vs. the long-term investor. Both invest in global fixed income, but they may do it in diverse ways. In fact, the active portfolio manager and the long-term investor are likely to have different investment processes, time horizons and investment goals. For the active manager, it is all about beating the benchmark and therefore generating alpha, the difference between the portfolio return and the benchmark return. There are many potential sources of alpha, ranging from asset and sector allocation to currency allocation to duration and curve positioning to relative value to security selection. On the valuation front, the portfolio manager is likely to pay close attention to spread valuation and to excess returns, the component of total return that originates from the credit risk exposure. They must also navigate short-term rate volatility and manage duration exposure against the benchmark duration. In contrast, the investment goal of the long-term investor, such as the manager of a pension fund, will likely focus on total return or risk-adjusted return over the longer term. In other words, the investor will think about global fixed income in the context of their asset allocation and holistic portfolio. With that in mind, they will likely pay attention to total yield valuation as it influences the total return picture over time. Duration management is also likely to be important for some investors, not against a market benchmark but rather under the framework of a liability-matching process.

Here lies an interesting and important nuance: the active portfolio manager and the long-term investor are likely to view fixed income valuation through very different lenses. US IG credit currently represents a good example in this regard. At a current yield of 5.37%, based on historical data, the median annualized return for US IG over the subsequent five years lies at 6.73% — using a 30 basis point margin around the starting yield for historical data analysis —with a return range of 5.08%to 7.92%.[1] In other words, the long-term investor is likely to conclude that US credit offers an attractive total return potential from a strategic asset allocation perspective. But what will the active portfolio manager think about the same asset class? Looking at spread valuation this time, US IG spreads have rallied to 91 bps, corresponding to a 10-year valuation z-score of -1.14.[2] A z-score below -1 typically designates a level in sell territory. Put differently, if only considering the z-score, the active manager is likely to turn tactically cautious vis-à-vis US IG credit given current credit spreads.

Overall, the two approaches are not incompatible. They just apply to two different time horizons and two different investment objectives. While we advise caution when looking at US IG tactically, we also want to emphasize our view that US credit, along with other asset classes in global fixed income, has become strategically attractive.

Europe is lagging in the race to the bottom, but that is a good thing. In fixed income spread land, it just looks like a race to the bottom these days. Potentially good for excess returns, but perhaps less so for the valuation backdrop. This begs the question: How low can spreads go? Perhaps one useful benchmark is the spread low reached in 2021, following the post-COVID risk rally. With that in mind, we measured the distance to the 2021 low for each individual fixed income sub-asset class. The good news for European fixed income valuation is that it is lagging its US peer in a substantial way. This means that there is still room for European credit spreads to challenge the 2021 level. Indeed, European IG spreads are still 42% away from their 83 bp lows.[3] Likewise, European HY spreads are 19% away from their lows of 282 bps.[4] Meanwhile, US IG spreads are only 14% away from their 2021 bottom. In emerging markets, while there is still room for EM sovereign debt spreads to go to their lows of May 2021, we are already there for EM Corp. Similarly, taxable municipal bond spreads are now trading at multiple-year tights. The last will be the first when it comes to valuation, and that is excellent news for agency MBS, the ultimate laggard, according to our analysis. Current MBS spreads are some 600% away from their 2021 lows. A word about MBS spreads: Given the highly volatile duration of that asset class, it may be best to assess the valuation using a breakeven spread measure, which yields a more sober valuation.

No-landing zone. One macro scenario has emerged in the US as a stronger possibility in recent weeks: the "no-landing" zone. At first glance, it appears ideal, but there are many risks and issues attached to it. No landing in the business cycle taxonomy means growth staying at or even above its long-term potential. In contrast, a soft landing is economic growth dipping temporarily to below its long-term potential but not to a point that it would trigger a recession.

So what is the main issue with no landing? Essentially, it could add fuel to an already overheating economy, and that could cause inflation to flare up again owing to renewed domestic demand pressures. This is a scenario that global investors want to avoid as it would induce global central banks to give up on the idea of rate cuts or even worse, resume policy tightening. Under a no-landing scenario, rates would correct higher and risky assets would likely come under pressure, reflecting the fear of another inflation shock.

To be clear, this scenario could occur. At this juncture, we attach a higher probability to no landing than to a recession in the United States. The latest data seem to support that view, with both the New York and Atlanta Fed GDP Nowcast estimates still comfortably above 2.5%.[5] The good news is that not all growth indicators are signaling that the risk of overheating is imminent. The Conference Board US LEI, for instance, still looks very depressed. Our own overheating risk indicator — which combines eight level and momentum macro variables — remains in benign risk territory. This all means that the odds of a soft landing look good, which we believe is a positive outcome for global markets.

Endnotes

[1] Source: Bloomberg. US IG = Bloomberg IG Corporate credit index. Monthly data from Jan. 2000 through Dec. 2023. Current yield as of 23 Feb. 2024. Past performance is no guarantee of future results.

[2] Source: Bloomberg. US IG = Bloomberg IG Corporate credit index. The valuation scores are calculated using z-scores. Z-scores are estimated using a 10-year average rolling window. A positive z-score indicates a valuation that is more attractive than the long-term average. Conversely, a negative z-score indicates a valuation that is less attractive than the long-term average. A value of 0 for the z-score indicates that the current valuation is in line with the 10-year average. The z-score is a measure of deviation from the average in units of standard deviation.

[3] Source: Bloomberg. Pan-European EUR credit index. Option-adjusted spreads. Data as of 23 Feb. 2024.

[4] Source: Bloomberg. EUR HY index. Option-adjusted spreads. Data as of 23 Feb. 2024.

[5] Bloomberg, Fed. Atlanta Fed GDP nowcast. As of 16 Feb. 2024. New York Fed GDP nowcast, Federal Reserve Bank of New York Nowcast GDP Growth for Current Period. As of 23 Feb. 2024.

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