Macro Talking Points

Fixed Income Insights

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In brief

- **As a right-tail risk, techno-optimism could help boost long-term growth prospects.**
- **Credit spreads may be tight, but it does not mean the risk of a spread correction is imminent.**
- **In fixed income, rate volatility is currently high and rising and spread volatility is low. This may be changing.**

Doom and Bloom. There are plenty of reasons to feel gloomy about the outlook for global markets. Political risks look ominous in many countries including the United States. Separately, the geopolitical landscape is as bad as we've seen it for a while. Based on the Geopolitical Risk Index put together by a Fed economist, geopolitical risks are estimated to be broadly 50% higher than during the 15 years that preceded the Ukraine/Russia war.[1] Some market participants would also add their concerns over stretched valuations and fears of bubbles to that list. But there may be reason to rejoice over long-term growth prospects. What if, as a right-tail risk, we were entering another positive productivity shock? Looking at long-term labor productivity data, the US economy has benefited from a few productivity waves since World War II.[2] These positive shocks, be it driven by electrification, the advent of computers or the internet, all contributed to boosting US economic growth to spectacular levels for at least a few quarters. When the US economy was mainly driven by goods and manufacturing, the relationship between labor productivity and economic growth was particularly strong. Back then, a temporary impulse from labor productivity to the tune of 8% — the typical level for a substantial shock — would help real GDP growth accelerate to at least 6% year over year. Admittedly, measuring productivity in services has become a lot more complicated. But if we assume that artificial intelligence and its multiple applications qualifies as a productivity event of the same significance as its well-known predecessors — admittedly still a strong assumption — then we could see a case for turning considerably more bullish about the long-term prospects for the world economy. The benefit of a major productivity shock is that you get a boost to growth without the collateral damage of inflation, since productivity shocks tend to be deflationary. Basically, you get Goldilocks on steroids! If this techno-optimistic scenario materializes, growth assets would be well-positioned over the medium and long term, with the caveat, of course, that there would inevitably be winners and losers.

The historical persistence of tight spreads. One major topic of interest — and perhaps of concern — has been credit spread valuation, especially in the US. There is no denying that spreads are on the tight side in both US IG and HY. But does that mean that a spread correction is imminent? Not necessarily. For a start, we would probably need a catalyst to emerge to trigger that correction, and for now, it is hard to see where this catalyst would come from. We would argue it is unlikely to arise from the macro backdrop, given the Goldilocks conditions that we currently enjoy. That leaves us with exogenous risks such as the election calendar or geopolitics — and these risks are indeed present. Separately, a technicals-driven correction cannot be ruled out, but that type of correction tends to be short-lived and typically represents a buying opportunity. More importantly, spreads can stay in tight territory for a long time. Here is where some historical analysis could be useful. When looking at fixed income valuation, our favored approach is to use 10-year z-scores.[3] When the spread z-score falls below -0.5, it signals that spreads are stretched, with 0 representing long-term fair value. Overall, there have been six periods during which US IG spreads have stayed in tight valuation territory for a significant amount of time since 2000. Not counting the current episode — which is only five months long, so far — the average duration of tight spread periods was 17 months. In other words, spreads can stay tight for a while. What happens then? Unless a severe crisis breaks out — such as the GFC or Covid — the process of valuation convergence back towards fair value tends to be gradual and orderly. For instance, it took US IG spreads over a year to get back to fair value after being in stretched territory for a long time in 2014. Overall, while it is true that spread valuations are clearly not as attractive as they were a few months ago, they are just one piece of the bigger puzzle. Indeed, one must also look at the valuation of total yields to assess the strength of asset class fundamentals and that of the macro backdrop as part of the broader investment process. With that in mind, from a strategic perspective, there is still a strong case for fixed income, in our view.

The law of opposing forces in fixed income. In fixed income, it is all about rates and spreads. Interestingly, there are some striking contrasts between these two nowadays. Rates are high by historical standards and are likely to move lower, driven by future central bank action. Meanwhile, spreads are low by historical standards, with the risk being skewed to the upside. Although, as we discussed above, the risk of a spread correction may not be imminent. Likewise, there is also an interesting contrast when looking at the drivers of return volatility. For both US IG and EUR IG, rate return volatility is much higher than excess return volatility — with the latter reflecting the volatility of spreads. Not only that, but rate return volatility has risen over the past few months, while excess return volatility has declined, both in the US and Europe. In the case of the US, rate return volatility is actually now more than twice as high as that of excess return vol. This unusually high-rate volatility has caused total return volatility to be elevated, at 8.7% for the US IG index as of February 2024.[4] Looking ahead, we expect the picture to change. Ultimately, rate volatility should subside, while excess return volatility may rise at the same time. Overall, we should not be scared of volatility, which is inherent in financial markets. But we believe an active approach to asset management is essential to helping navigate the risks attached to these volatility shifts.

Endnotes

[1] Source: Geopolitical Risk Index, https://www.matteoiacoviello.com/gpr.htm. The Caldara and Iacoviello GPR index reflects automated text-search results of the electronic archives of 10 newspapers: Chicago Tribune, the Daily Telegraph, Financial Times, The Globe and Mail, The Guardian, the Los Angeles Times, The New York Times, USA Today, The Wall Street Journal, and The Washington Post. Caldara and Iacoviello calculate the index by counting the number of articles related to adverse geopolitical events in each newspaper for each month (as a share of the total number of news articles). Monthly data up to Feb. 2024.

[2] Source: Fed, FRED Database. Nonfarm Business Sector: Labor Productivity (Output per Hour) for All Workers, Index 2017=100, Quarterly, Seasonally Adjusted. Up to Q4-2023.

[3] Sources: 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.

[4] Sources: Bloomberg, ICE BofA. US IG = ICE BofA US Corporate index, C0A0 index. Total return and excess return data. Monthly, up to Feb. 2024.

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