Macro Talking Points

Fixed Income Insights

Week of 11 March 2024

Author

Benoit Anne
Managing Director
Investment Solutions Group

In brief

- **Fixed income returns better than they look**
- **Rate cuts coming**
- **Dollar under pressure**

Striving for averageness. We have some good news and some bad news for fixed income. First, the bad news. The current yield is below the historical annualized return for a few sub-asset classes. In other words, if we do not get any help from either rate or spread compression this year, the total return is likely to be mediocre by historical standards for these groups. But here is the plentiful good news: First, being average is actually much better than you think. For example, what is the average annualized return for US investment grade since the inception of the Bloomberg IG Corp index? 7%.[1] Not bad! Likewise, the average annualized return for the tax-exempt municipal bond index is 6%.[2] Who knew? So even though these are long-term annualized returns, we believe these numbers are still attractive by today's standards. More important, these long-term average returns are not out of reach. Take US IG, for example. Its current yield may be only 5.25%, but to boost its expected return to 7%, which would match the index's long-term average, we need the total yield to move down by a mere 25 basis points this year, assuming everything else held constant.[3] This is doable, but for it to happen, we will need help from the US Federal Reserve. Put differently, the Fed will have to deliver the promised rate cuts.

Another piece of good news is that this is a US fixed income problem. Elsewhere, the valuation backdrop looks much stronger. In particular, the current yield on European IG stands at 3.68%, above the historical annualized return of 3.54% for the asset class.[4] In other words, the odds for European IG to produce an above-average year look favorable, especially if the European Central Bank eases. And the cushion is even greater for European high yield. In emerging market sovereign debt, the current yield at the index level also sits above the historical annualized return. Overall, while we have seen some solid yield compression in recent weeks, we believe there remain attractive pockets of value in global fixed income, as well as a robust case for relatively attractive subsequent returns.

Spring —and rate cuts — in the air. For global fixed income, it is just what the doctor ordered. It is payback time for global central banks, especially after they caused so much trauma in 2022. It looks to us like global fixed income is going to need a boost from central banks in the period ahead, but the stars seem aligned for that to happen. What we have heard recently is that the ECB has pivoted to a much more dovish bias and that a rate cut in June now seems like a strong baseline scenario. It could happen even sooner, but there is no rule in global markets that the Fed should be the first central bank to move. In fact, proactiveness on the part of the ECB would be welcome and viewed as a strong signal in support of European fixed income. There are more cuts priced in by the cash curve for the ECB than for the Fed, another reason we believe to favor European fixed income against the United States on a relative value basis.

USD under pressure. The US dollar enjoyed a strong bounce back from the beginning of the year up to mid-February, but the tide appears to have turned. Looking ahead, we believe that the risks for the USD are still skewed to the downside. When looking at front-end rate differentials with the eurozone (adjusted for inflation), the USD seems to be tactically overvalued. And there are other macro factors that may also undermine it, including the recovery in global growth expectations and the improvement in risk appetite. From a longer-term valuation perspective, the currency is markedly overvalued, sitting some 15% above its fair value as defined by the Fed real dollar index.[5] Looking ahead, downward pressures on the USD may provide support to non-US assets, in particular EM hard-currency and local-currency debt.

Endnotes

[1] Sources: Bloomberg. US IG = Bloomberg IG Corporate credit index. Annualized returns from Jan. 1973 to Feb. 2024.

[2] Sources: Bloomberg. Bloomberg Municipal Bond Index Total Return Index. Annualized returns from Jan. 1980 to Feb. 2024.

[3] Sources: Bloomberg. US IG = Bloomberg IG Corporate credit index. Yield to worst, data as of 8 March 2024. The difference between the average annualized return and the current yield (Diff.) allows us to calculate the necessary yield move (matching yield move) to match the expected total return and the average annualized return. The matching yield move = diff. divided by duration of the index, i.e. 0.25% = 1.75% / 7.

[4] Sources: Bloomberg. Pan-European IG Corporate index. Yield to worst, data as of 8 March 2024. Annualized returns from June 1998 to Feb. 2024.

[5] Sources: Bloomberg, US Federal Reserve. US Fed Trade Weighted Real Broad Dollar Index. Monthly. Up to Feb. 2024. Fair value = average of the index since Jan. 2000.

FOR INSTITUTIONAL AND INVESTMENT PROFESSIONAL USE ONLY

MFSE_FLY_2604812_3_24
57753.1