Macro Talking Points

Fixed Income Insights

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Author

Benoit Anne
Managing Director
Investment Solutions Group

In brief

- **As case for "no landing" in US weakens, macro environment more supportive**
- **Macro volatility remains elevated: good news for active asset managers**
- **Monetary policy pricing more reasonable than a week ago**
- **Eurozone macro fundamentals strengthen, boding well for European credit**

Buy in May and stay here. Our sense is that the adage "sell in May and go away," might not work out this year. This is because the recent overshooting in market rates may actually offer a tactical opportunity. Indeed, the current level of rates is attractive by historical standards and may represent an interesting entry point for the fixed income investor to reestablish a long duration position. To be clear, the market psyche has been unstable, especially when it comes to US Federal Reserve policy expectations. Over the past few months, we've seen the market position for "the Fed is going to cut soon, by a lot" scenario, which turned out to be wrong. We've also seen the market position for "the Fed may not cut at all," which we believe is also wrong. And now, we're transitioning back to the middle ground, a more reasonable scenario that's supportive of fixed income: Yes, the Fed has grown more cautious, but we expect that rate cuts are nevertheless coming. From a top-down macro perspective, the backdrop has turned more supportive. This is mainly because the dreaded "no landing" scenario has now virtually been ruled out, compliments of a string of softer data. Over the past week, we've seen some more weakness in the US labor market, along with softness in a major leading indicator for activity in services. Overall, we believe the Goldilocks macro scenario is still alive, which bodes well for risky assets and fixed income.

Thank you, Mr. Powell. It may be an unintended consequence, but we aren't going to complain. In a way, the Fed's new monetary policy style has supported the case for active asset management. You see, back in the day, the Fed was more reliant on macro forecasting models and forward guidance. That's long gone. These days, the Fed has become more data-dependent. Overly so, some argue. With the data volatile, that data-dependency has made the Fed policy signals more unstable. This in turn has contributed to more macro volatility. That sort of market backdrop tends to benefit an active approach to portfolio management. Under a high-volatility environment, active asset managers can potentially take advantage of market distortions and value dispersions to generate alpha. So while Fed-induced volatility can sting, it has also helped promote a more supportive alpha generation environment.

The price is right. The pricing of monetary policy is getting to a better place. Just a week ago, the market was pricing in only one rate cut by year-end. The federal funds future curve is now pricing in 43 basis points of cuts before year-end, one full cut and a 72% chance of a second one.[1] That is still probably too little, but closer to a reasonable policy outcome. Ultimately, the fact that the Fed confirmed that cuts aren't off the table is a major signal for global fixed income and supportive of long duration.

A soft landing now also a European thing. In the United States, until recently we were concerned about the no landing scenario. Now it seems that a soft landing scenario is more likely. Meanwhile in Europe, we were earlier concerned about a recession. Not anymore. The macro fundamentals in the eurozone have strengthened in recent weeks, but this hasn't prevented the European Central Bank from cutting its policy rate, which places Europe in a sweet spot. Overall, with the macro backdrop, the outlook for policy easing, the asset class fundamentals and the more favorable valuation landscape, we see the stars aligning for European fixed income.

Endnotes

[1] Source: Bloomberg. Based on Fed funds future curve. Data as of 3 May 2024.