

Q2 2024

Active Fixed Income Outlook: New rate regime?



A new regime for rates?



Colin Reddie
Head of Active Strategies

If US economic activity continues to be this strong, officials at the Federal Reserve (Fed) might have to start thinking about an environment of no interest rate cuts.

In the first issue of our Active Fixed Income Outlook, we look at how the possibility of no interest rate cuts in the US would impact investors. We'll also be looking at European credit, emerging market debt and global high yield, and outlining the current themes, risks and outlook for each of those markets.

Figure 1: Options market implied probability of no cuts from the Federal Reserve in 2024



Source: LGIM, Bloomberg as at 27 March 2024.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

1. Source: AtlantaFed GDPNow as at 1 April 2024.
2. Source: LGIM America as at 18 March 2024.

What's needed for a 'no cuts' base case?

Jay Powell and others have alluded several times to the fact that "monetary policy is too restrictive." So, to arrive at a 'no cuts' base case requires them to start believing that monetary policy is no longer restrictive. Inevitably, officials will be forced to change their minds if growth continues at the current heady pace.

US annualised growth registered 4.9% in the July - September 2023 period, and a revised 3.2% annualised pace for the final three months of that year. With 2.8% growth, revised up from 2.3% for the first quarter of 2024¹, we could now be settling into a growth environment that may negate the need for rate cuts.

Implications of 'no cuts' base case on yield curves and issuance

If the 'no cuts' theme were to become the base case, we believe that government bond yields would move higher, and curves would steepen, but it won't just be curves that react. If market participants start to believe that the current level of interest rates is sustainable, then others will start to think the same.

For example, corporate treasurers are more likely to issue longer-dated debt today as companies seek to lock in lower coupons after several years of higher refinancing costs. We're already seeing this play out. US corporate investment-grade (IG) supply is up 150% on the pace of the last few years, with the percentage of long-end issuance also increasing to 17% of supply, from 10% in the second half of 2023.²

Elsewhere, there are some investors who continue to believe that fixed income yields offer good value relative to historic levels, despite credit spreads being tight. However, those same investors may quickly change their minds if interest rates stay where they are, or even increase.



With markets seemingly priced for an abundance of good news, it's not easy to see where the next headwinds may come from.

Implications of 'no cuts': resetting where we are in the economic cycle

Just as an inverted yield curve typically signals an impending recession, does that mean that a normalised one relays that the economy is no longer in the late-cycle stages? Or could it mean that, potentially, it's in the early stages of a new one? It's tempting to think that might be the case, particularly when it comes against a backdrop of surging Artificial Intelligence (AI) positivity. That said, nobody can state with any confidence how much AI will increase economic growth and the jury is still out on its exact impact.



Outlook

For now, stronger US growth and a positive backdrop for credit and equity markets is something we welcome. But, if we're heading to a place where higher growth leads to interest rate curves normalising, coupled with the narrative of an economy that somehow manages to enjoy low unemployment, high growth and moderate inflation, then obviously we are concerned that everything is just too perfect. With markets seemingly priced for an abundance of good news, it's not easy to see where the next headwinds may come from. But's that's not to say there won't be any.

European credit – no stopping the flow



Connor Olvany
Portfolio Manager, Active Fixed Income



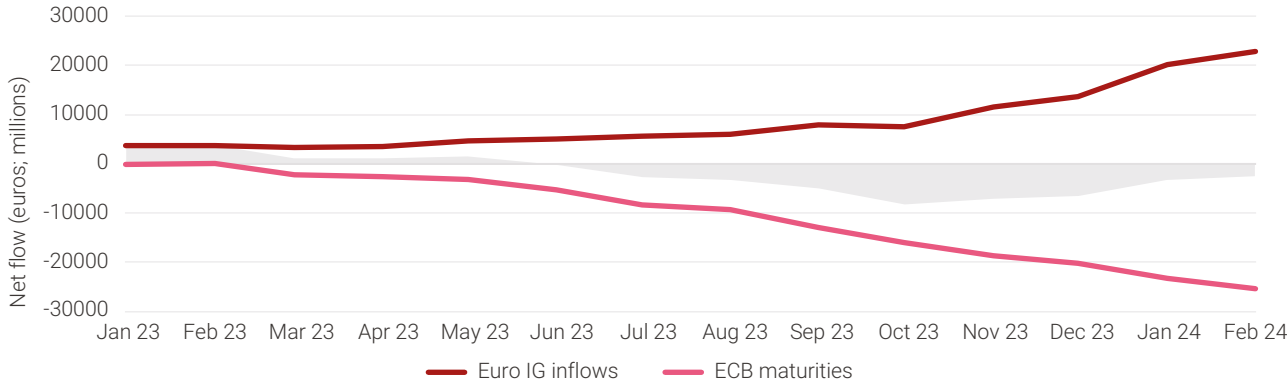
Marc Rovers
Head of European Credit

Strong flows into European corporate bonds have, so far, made up for the lack of buying by the European Central Bank (ECB).

The past: what just happened?

The two components driving returns of European corporate bonds moved in opposite directions in the first quarter, as the rise in government bond yields was offset by tighter credit spreads. Following a strong fourth quarter in 2023, government bonds sold off on the back of strong economic data and upside inflation surprises, but risk assets reacted well as the soft-landing narrative remained intact. Strong flows into euro investment grade (IG) have continued to drive spreads tighter.

Figure 2: Euro IG inflows keeping up with ECB maturities



Source: JP Morgan as at 28 February 2024 and ECB as at 29 February 2024.
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Indeed, the last six months have seen more inflows than any of the previous six calendar years (see chart below). We flagged the gap in demand and the fact that the ECB is no longer buying corporate bonds in a [blog](#), but these historically strong inflows have thus far made up for the lack of central bank buying. Supply has responded to the increase in demand, and corporate issuers now appear comfortable with the new level of interest rates after the aggressive hikes of 2022/23. Interestingly, new issuance has been especially high from non-financials, having dropped in recent years.

The present: quality rules

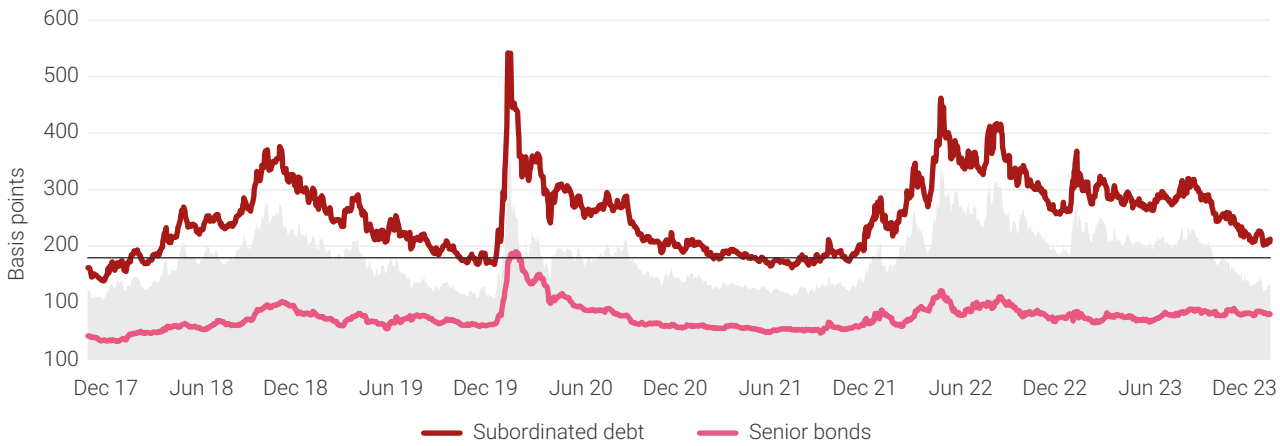
We believe the best risk/reward can be found in higher quality euro IG bonds as the recent compression has resulted in less attractive valuations in higher beta segments of the market. Subordinated bonds, for example, have performed well since October 2023, with spreads looking relatively tight compared to senior bonds (see chart opposite).

The higher beta segments of the market will also be more vulnerable in negative market scenarios. We've taken profits recently by selling higher beta bonds and rotating into higher quality issues. As spreads approach the lower percentiles of historic ranges, we tend to witness a lack of dispersion between sectors and ratings within euro IG. We have seen that compression recently, but the post-pandemic era, and higher rates, have also resulted in more issuers coming under pressure, such as those in the real estate sector and some consumer-related names linked to struggling brands.

What could go wrong?

Credit markets more broadly have, so far, been buoyed by the strong economic data, but they could suffer if bond yields increase much more, or central bank cuts are not delivered.

Figure 3: Subordinated bonds: motoring along



Source: LGIM as at 27 March 2024.
The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Under that scenario, the higher interest rate environment could continue to put pressure on weaker capital structures. Coupled with any major disruptions (further geopolitical risks and significant changes regarding AI) we believe this could present challenges for certain companies. Politics will remain a key focus in the coming months, with several major economies coming to the polls. There could be important implications for fiscal policy, inflation and bond yields.



Outlook

Sector and issuer specific challenges have thus far been relatively well contained, but there is a risk certain pressures could evolve into systemic problems. This is not our base case, and we believe that euro IG offers an attractive risk/reward ratio and some relative cheapness versus other parts of the credit market. We urge caution on weaker names in the investment universe and put significant focus on bottom-up credit analysis and issuer selection. We expect to see strong interest from investors, which will continue to support the asset class, but we believe active credit management is necessary to avoid credit events in this new regime for rates.

Global high yield – ain’t no mountain (or wall) high enough



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In short: we believe the current environment remains favourable for high yield bonds. Worries over upcoming maturity walls are unfounded, in our view. We believe the key reason for any delay in refinancing for many companies is to gain access to better terms, not an inability to access capital.

The past: what just happened?

The first quarter of 2024 registered positive returns (~2%³) across the globe in high yield, with emerging markets leading the way, followed by Europe and the US. Credit spreads tightened and single B rated bonds outperformed BB rated bonds. Demand for the asset class continued during a period which saw a supportive earnings season, decent global growth, and market expectations that central banks will begin cutting rates in 2024. Defaults remain around historic averages and we expect this will continue – largely on account of flexible bond terms, sensible levels of indebtedness among most issuers, and robust profitability and cash generation.

The present: key themes

We’ve added higher income bonds correlated more to credit improvement and less to long-term interest rates. Our view remains that spreads adequately compensate for credit risk and, in our strategies, we are targeting a higher yield than the benchmark.

From a regional perspective, we have reduced our exposure to US high yield in favour of European and emerging markets. US credit spreads appear relatively tight, while the US region has a higher interest rate environment compared with Europe and developed Asia. As the global economic outlook is set to improve, we seek to take credit risk in core parts of the economy in consumer, services and industrial sectors. By contrast, we have underweight positions in the global automotive, utilities and shipping sectors.

Underpinning our investment choices is our incorporation of behavioural finance – we are constantly on the lookout for imbalances between hard data and the interpretation and valuation ascribed to companies by the market.

What could go wrong?

One key risk in 2024 is growth remaining strong in the US despite the interest rate hiking cycle, which could force the market to reassess its expectations for multiple Federal Reserve rate cuts in the second half. This could negatively affect the price of longer-dated corporate bonds and compromise the strong inflows into fixed income asset classes that we’ve seen so far this year. That said, we believe strong growth would protect high yield bonds (and more importantly keep open the refinancing window by supporting corporate creditworthiness).



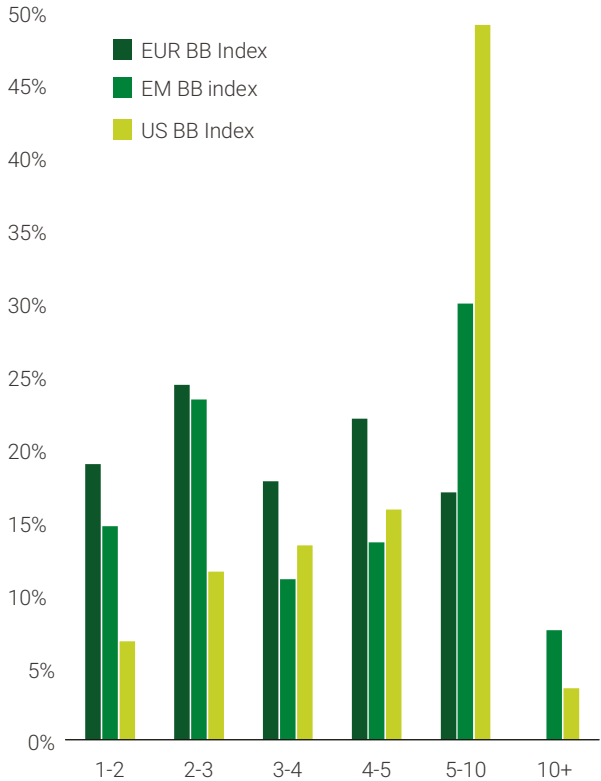
Outlook

Many investors pay particular attention to maturity walls – the total amount of debt that will mature in coming years. Overall, the majority of global high yield, BB and B rated bonds are at least three years away from maturity (see chart below for BBs) with almost all having call structures which enable flexible refinancing. Both BB and B have a considerable amount of debt (although still less than one-fifth) maturing in 2025 but we don’t believe this should ring alarm bells.

The low default rate (which we expect to stay low as the global economy rebounds) tells us companies have not been squeezed into default just because of upcoming maturities. The refinancing requirement for 2025 translates to similar levels of historic average issuance volumes in each of the areas. Furthermore, many issuers are moving to the leveraged loans and direct lending markets, potentially taking the pressure off the high yield bond market.

Our final consideration highlights the still low average bond price (around 95 for BB and B rated bonds) and so, we believe, the refinancing cycle represents an opportunity for investors as those bonds move to par.

Figure 4: Global BB maturity walls (%)



Source: ICE BAML Indices as at January 2024.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

3. Source: HW00 ICE BofA Global High Yield index as at end Q1 2024, total returns, local currency.

Emerging market debt – a fair wind

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We believe emerging market (EM) credit returns this year will be led by both carry and a rally in high yield credit spreads. Assuming interest rates in the US remain range-bound, our belief is that EM credit could post positive total returns of high-single digits for 2024.

The past: what just happened?

EM debt has had a mixed start to the year, with the selloff in US rates being offset by positive returns due to spread tightening. The latter has largely been driven by stronger-than-anticipated US growth, a positive factor for the EM universe.

While EM investment grade has produced negative returns year-to-date, EM high yield credit (hard currency sovereigns and corporates) has registered returns in excess of 4%.⁴ Despite continued outflows from EM bond funds, the asset class has seen record primary market issuance year-to-date, which has been well absorbed.

The present: key themes

Favourable macroeconomic environment

According to the IMF, EM economies are estimated to grow by c.4% this year, more than their developed market (DM) counterparts, resulting in the widest EM-DM growth differential for eight years⁵.

In addition, we’ve already seen interest rate cuts by many EM central banks throughout 2023 and 2024, which, we believe, will provide an additional impetus to domestic demand.

Renewed market access for some issuers

Idiosyncratic stories in distressed credits such as Pakistan, Egypt, Nigeria, Ghana, Sri Lanka and Argentina are also registering positive returns year-to-date⁶. As borrowing costs in these countries continue to fall, we believe several high yielding credits should regain market access, further reducing refinancing risks. We’ve already seen the likes of Ivory Coast, Kenya, Montenegro and Benin come to the market this year.

Renewed market access, strong IMF support and good macro fundamentals are being reflected in rating developments, with the number of upgrades and positive outlooks outweighing downgrades and negative outlooks so far in 2024, as actioned by various credit rating agencies.



What could go wrong?

The biggest risk for the asset class, in our view, remains US data, which could impact US rates and equity markets. If inflation prints come out higher than expected, the ‘higher for longer’ rates narrative might still come true, proving a headwind for the asset class. As a result, we remain cautious in our duration positioning, maintaining sufficient flexibility to act in different scenarios.

Geopolitical issues are another concern, even though markets have somewhat looked beyond these. This year will also see many countries hold elections, including India, Mexico, South Africa, Korea and Panama.

Furthermore, the outcome of the US election could have consequences for emerging markets – via its impact on geopolitics and macroeconomic fundamentals.

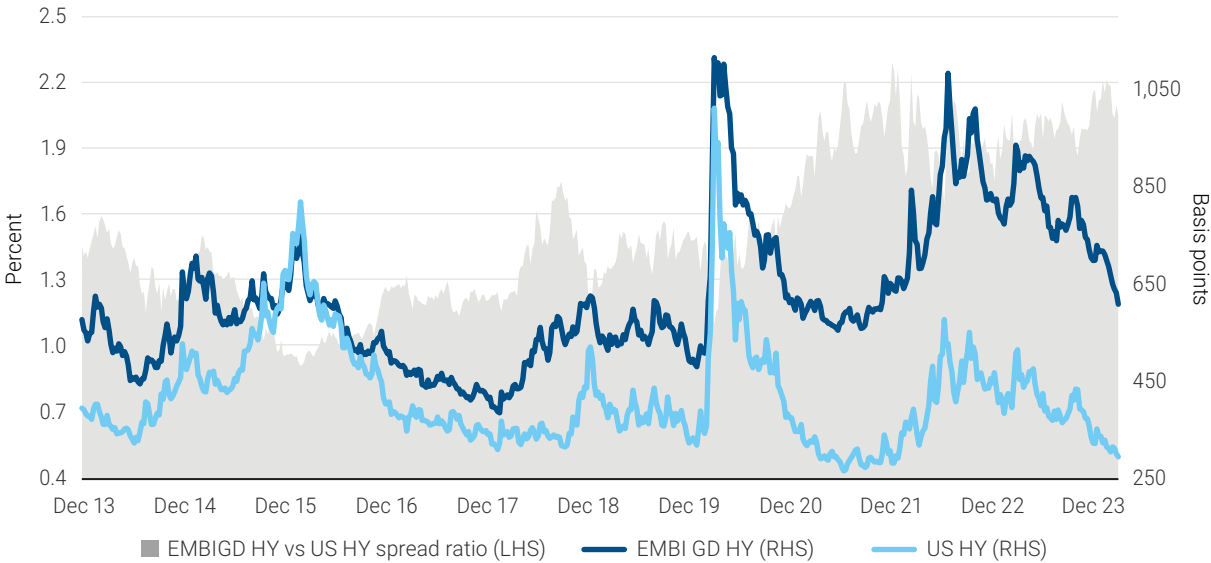


Building on a strong performance in 2023, we believe the outlook for EM debt looks favourable, with EM growth holding up, inflation heading down, supportive monetary policies, strong support from multilateral agencies and capital markets reopening for several high yield credits. As more confidence builds around the rate-cutting cycle in the US, the focus will shift towards duration.

Despite the recent rally in spreads, we believe EM high yield valuations still appear cheap relative to historic levels. Yields remain elevated, particularly within the EM high yield sovereign area, so contributing to the carry trade.

By contrast, within the EM investment grade universe, spreads are not cheap on a relative basis and, we believe, spread tightening opportunities are limited. However, all-in yields still provide pickup over developed fixed-income markets, which could grow if we see the Fed delivering two to three interest rate cuts this year. This expectation has likely driven strong participation from crossover investors into EM bond strategies.

Figure 5: Emerging market debt – high yield sovereign spreads



Source: JP Morgan, Bloomberg as at 22 March 2024.
Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Contact us

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Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. It should be noted that diversification is no guarantee against a loss in a declining market.

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