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Insight INVESTMENT

APRIL 2024

QUARTERLY FIXED INCOME OUTLOOK Q2 2024

ECONOMIC OUTLOOK

Global

There is a widespread impression, particularly in the US, that economies are beginning to reaccelerate. But recoveries are expected to be relatively slow, and not sufficiently robust to reignite inflation. Central banks are likely to be mindful of the forthcoming raft of elections in their policy debates. Additionally, as the US presidential election moves closer into view, funding for the war in Ukraine will be an important topic for debate. The geopolitical situation and potential pivotal moments will be closely watched.

US

We retain a positive outlook on US growth, seeing almost 2% growth in both 2024 and 2025. There is now a widespread expectation that any 'landing' for the US economy is likely to be soft, as prospects appear more skewed towards acceleration than deceleration. Meanwhile further improvements in inflation continue to take time. Having fallen from its peak of 9.1% in mid-2022, the headline rate has made no headway since June 2023, while the previous steady decline in the core rate has tailed off close to 4%. Despite these features of the US economy, the Federal Reserve seems set to begin easing policy later in 2024. Though they envisage only three small cuts this year, with what appears likely to be an acrimonious election campaign across the country, policymakers may feel the window of opportunity could narrow quickly. We see Treasury yields reflecting the gradual easing in policy rates, taking 10-year rates back down below 4% in a year's time, though volatility may be expected in the meantime.

Eurozone

The outlook is for little meaningful growth to occur this year, but we see an improvement in 2025. Activity is likely to remain below trend for some time yet. Greater progress is being made on containing inflation back toward its target level than elsewhere, and we see inflation reaching 2% this year. Though the European Central Bank retains its long-standing cautionary stance, rate cuts are anticipated, with easing expected to commence sometime in the early summer months. Bond yields at longer maturities may not move much lower from current levels around 2.30% for 10-year German bunds, but they are likely to have scope to fall at shorter maturities.

UK

The UK faces a similar slow recovery from its recent shallow recession, with little overall growth anticipated in 2024, followed by anaemic growth in 2025. Inflation will continue to moderate but with core inflation currently only halfway to reaching 2%, from its peak above 7% in May 2023, it is likely to take longer than in the eurozone before the target is achieved. We believe the Bank of England want to start reducing rates but will be constrained by stubborn inflation until later in the summer. As with other markets, gilt yields at longer maturities may only decline modestly, but as interest rate cuts come through, shorter-dated yields may fall by more. We see 10-year gilt yields just below 4% in 12-months' time.

Emerging markets (EM)

Our view that China still faces difficult challenges, the rebound in Chinese inflation, if sustained, may be an initial indication that the country is turning a corner. We expect GDP to expand by around 4.4% in 2024, with a modest slowdown to about 3.6% likely in 2025. The residential real estate sector remains a key area of concern for policymakers and that could lead to further cuts to the one-year and five-year Loan Prime rates.

Across other emerging markets, it seems that economies and policymakers remain slightly ahead of developed market counterparts. Having already implemented six rate cuts since August 2023 taking rates from 13.75% to 10.75%, Brazil's central bank seems likely to continue to easing policy, as long as inflation does not rebound. Other central banks are likely to increasingly follow suit, though Turkey's ongoing inflation issues have yet to subside and further hikes could yet be required there. India embarks on its long general election process in April and May, with Narendra Modi looking to secure another term as Prime Minister.

ASSET CLASS OUTLOOK

Investment grade credit

With the Federal Reserve raising its 2024 growth forecasts from 1.4% to 2.1% but maintaining its expectation that monetary policy can be eased, the risk of a US recession appears to be receding. A soft-landing scenario should be a supportive environment for corporate profits and, although spreads have tightened to reflect a more benign outlook, the absolute level of yields has drifted higher since the start of the year. This creates a more attractive entry point from an income or liability matching viewpoint, but the prospects for further spread tightening would appear limited in our view. Dispersion amongst issuers remains elevated however, providing opportunities for careful credit selection in more active strategies. There has a surge of issuance in Q1 compared to the same period last year. This has been encouraged by tighter spreads and solid demand. A more stable backdrop for yields could see issuance volumes continue to increase through the year and we will be carefully monitoring further new issuance. Nonetheless, valuations are clearly getting tight, so we are happy to remain cautious on global credit, having enjoyed the steady strengthening of the market in recent months. Cross market opportunities do remain, and we believe there is greater value in European markets.

High yield credit

A combination of resilient growth, better than expected earnings, elevated yields, and rapidly improving capital market access underpinned the asset class in the first quarter, helping drive spreads tighter. This led to a significant increase in refinancing activity as issuers looked to take advantage of the increased demand to extend their capital structures, prefinancing 2025 and even 2026 maturities. This is providing opportunities to lock in issues with higher coupons. Defaults continue to run below long-term average levels and we believe there is little reason for this to change in 2024. Where defaults are occurring, they are normally well flagged and concentrated in CCC rated credits, meaning that sensible security selection provides ample opportunity to avoid those names. We believe the attractive absolute level of yields should keep demand elevated, which combined with a benign default environment should underpin spreads over the rest of the year, allowing the asset class to generate attractive income-driven returns.

Emerging market debt

Though taking some risk remains warranted, we believe the probability of achieving extraordinary returns is low compared to the situation of two years ago. We are marginally positive on high yield sovereigns and corporates, while we are marginally negative on investment grade equivalents. We also remain modestly positive on local currency markets and EM currencies, primarily on tactical grounds. There remain plenty of potential geopolitical flashpoints too, which should continue to be carefully considered.

Structured credit / Secured finance

Resilient growth, still tight labour markets and an expectation of lower interest rates ahead has provided a strong backdrop for structured credit markets at the start of the year, and there seems little reason to believe that will change in the months ahead. Issuers took advantage of robust levels of demand to return to markets in size, and issuance in the first two months of the year was around 50% higher than the same period in 2023. Despite the surge in issuance, many issues have been oversubscribed, particularly mezzanine tranches. Spreads have tightened from their highs but the premium available in structured credit remains elevated relative to history and this is underpinning high income-driven returns from the asset class. We continue to favour issues with seniority in the capital structure and robust transaction structures that divert cashflow in the event of underperformance, and strong underwriting and servicing policies, all of which should act to insulate investors if the economy weakens.

Municipal bonds

The shift in rhetoric at the Fed, from projecting rate hikes to rate cuts, is broadly supportive and municipal bond markets are benefiting, with inflows returning. In the short-term, this is likely to be met by an increase in issuance, with some issuers preferring to issue early in an election year. Most state and local governments are in a strong position given successful efforts at building reserve funds in recent years. Additionally, local governments could benefit if there is further strength in the residential property market. We continue with a bias towards revenue bonds issued to fund essential services over state and local general obligation issues which rely on more cyclical sources of tax revenue. We also see opportunities in sectors that continue to recover from the impact of the pandemic, such as issues financing airports and toll roads. Idiosyncratic buying opportunities across all sectors and quality ranges mean there appear to be good opportunities to add value via stock selection. Given the prevailing outlook, we have become more comfortable taking longer-duration purchases, as we believe maturities beyond 10-years could offer a favourable income and return profile in the current environment.

Currencies

Strategically, the USD appears overvalued, and we believe it should weaken over time. There are a lot of USD assets owned globally that are unhedged because the cost to hedging was prohibitive and the price momentum was one way. The cost of that hedging is dropping as US rates begin to decline and the price momentum may be turning. De-dollarisation is a secular theme that continues, which adds weight to USD sales. To us, the tactical challenge is timing the entry to a short USD trade. The market is currently battling with issuance, geopolitical worries, some price pressures forming and positioning. With the Fed expected to begin cutting rates this year, data and macro developments will continue to drive expectations, and thus rate volatility more than likely is here to stay. Electoral uncertainty in the US could create additional volatility.

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