FIXED INCOME ISG INSIGHT

INVESTMENT INSIGHT SERIES | November 2023

SHIFTING NARRATIVE

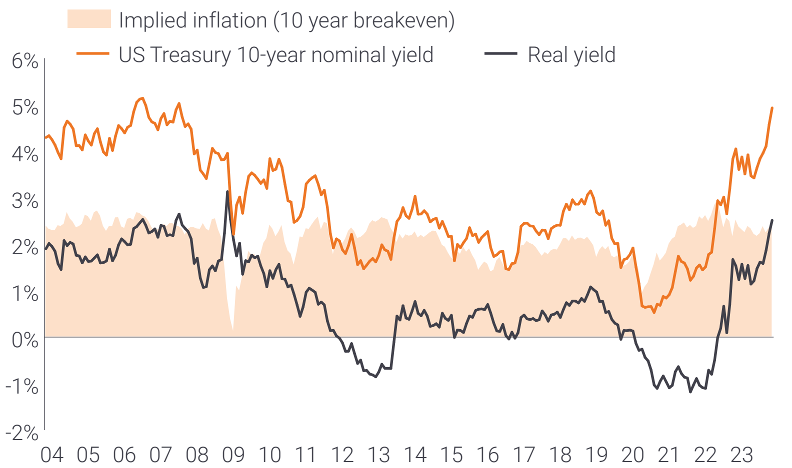
The Fixed Income Investment Strategy Group (ISG) brings together investment professionals from across the global fixed income platform and other Janus Henderson teams, providing a forum for debate around the fixed income asset class and key drivers of the market. The ISG Insight seeks to provide a summary of recent debate within the group.

The focus of debate among participants centred on the shifting narrative in the market. What should we read from recent economic data and were arguments around a changed natural rate of interest justified? This provoked discussion around the drivers of inflation and growth, how regional differences were affecting the response to policy and whether yields are correctly priced.

Rate shock is real

Recent months have seen a further spurt higher in yields, with various conjectures put forward for the moves. Economists have rowed back on recession fears in the US while fresh emphasis has been put on bond supply. Could more structural factors be behind the rise in yields?

Fig 1: Real yields at a post GFC high



Source: Bloomberg, US Treasury 10-year nominal yield, US Treasury 10-year Inflation Protected Securities (TIPS) yield (real yield). The 10-year breakeven rate is a measure of expected inflation, implying what market participants expect inflation to be in the next 10 years, on average. It is derived from subtracting the yield on TIPS from nominal bond yields of the same maturity. 31 October 2003 to 31 October 2023. **Yields may vary over time and are not guaranteed.**

For fixed income investors, the shifting narrative poses a particular dilemma. A stronger economy is potentially good for credit fundamentals but upward pressure on yields is an offsetting factor. Real rates have risen, reflecting a higher term premium and expectations for a "higher for longer" rates regime. Should we be reassessing our view that we are near peak yields?

KEY TAKEAWAYS

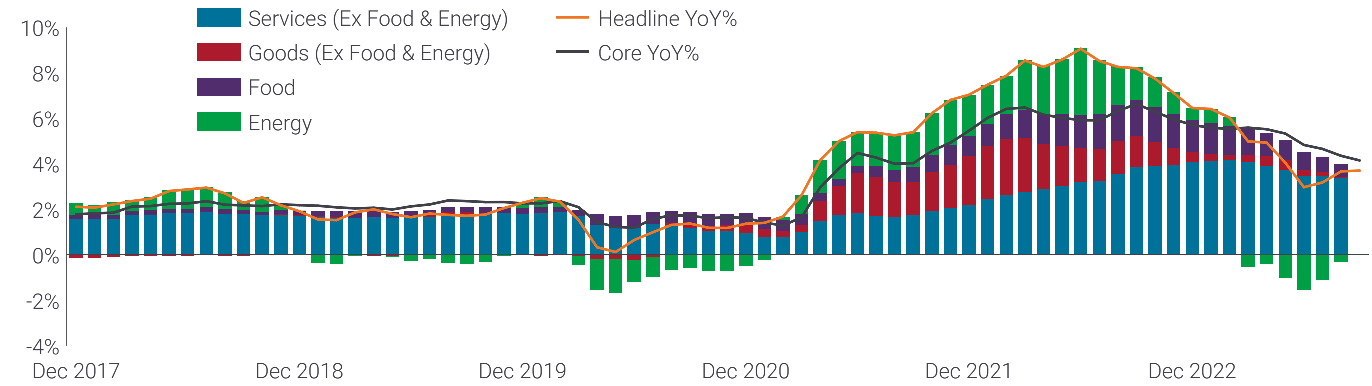
- Strong US economic data has tested the view that rates would slow the economy but narratives have swung violently in the past year and could easily reverse.
- Much of the shock of the bond sell-off may reflect the low starting point for rates (overvaluation) but there appears to have been a regime shift, with the natural rate of interest having bottomed.
- The yield reset has re-established the attractiveness of fixed income both on an absolute and relative basis and declining inflation should similarly restore negative correlations with risk assets.

Inflation – the last mile is the hardest

Central to the discussion on the shifting narrative was the prospect for inflation. Among participants it was widely agreed that inflation was trending in the right direction but the path to the Federal Reserve's 2% target was likely to be uneven.

Figure 2: Path lower is likely to be more uneven

US CPI contributions and YoY % change

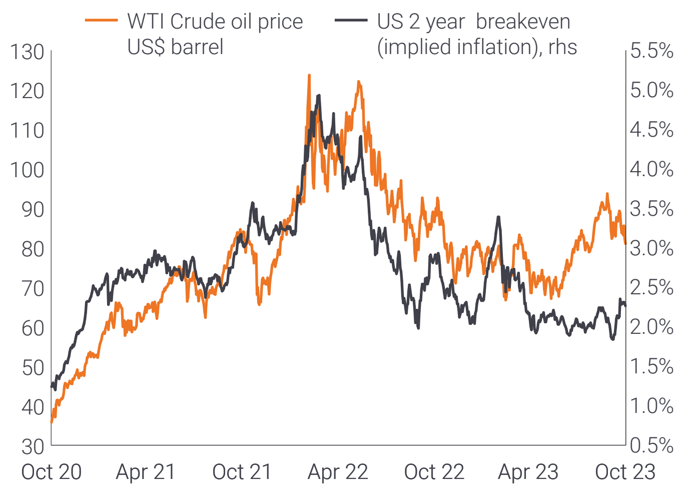


Source: Bloomberg, US consumer price index (breakdowns). 31 December 2017 to 30 September 2023.

Moderating rents were seen as helping to bring down inflation in the US. Energy prices, which had been a key contributor to inflation in 2022 had contributed to disinflation in mid-2023 but this beneficial impact was likely to fade given OPEC discipline on supply and tension in the Middle East. For Europe, however, the base effects were more dramatic given how high gas prices had soared last winter, so inflation was likely to moderate further in the final quarter of 2023.

There was some debate around the effect of higher energy prices – would there be a repeat of the input price shock, potentially putting upward pressure on producer prices, or would it act more as a tax on consumers and stymie demand? Evidence from the bond markets (2-year breakeven inflation had barely budged) leaned towards the latter.

Figure 3: Breakeven inflation remains anchored as oil price rises



Source: Bloomberg, West Texas Intermediate crude oil price in US$/barrel, US 2-year breakeven rate %, 31 October 2020 to 31 October 2023.

Consumption, however, appeared to be holding up. Retail sales growth remained buoyant, in defiance of what consumers were saying in surveys. According to the US Census Bureau, US retail sales between July and September 2023 grew 3.1% from the same period a year earlier despite the University of Michigan Index of Consumer Sentiment declining in the three months to October and remaining at a relatively low level compared with the last 10 years.

Participants noted that consumers were facing other pressures. Student loan repayments were recommencing. Excess savings were being depleted, although several noted that the starting point (the vast savings accumulated during lockdown) meant that this was yet to be exhausted, so the true effect may only be felt next year.

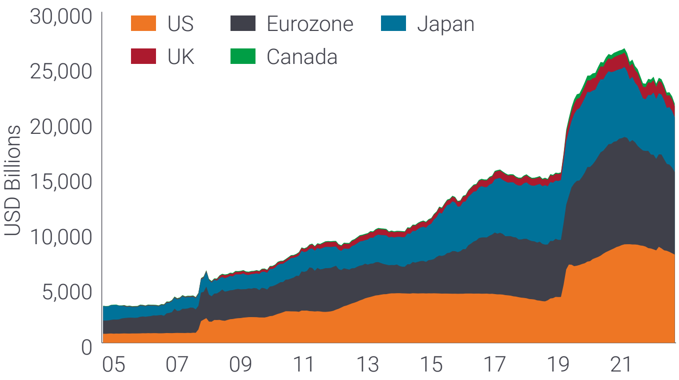
+ **Consumer holding up** but facing headwinds from higher financing costs, student loan repayments restarting in the US and depletion of excess savings.

– **Oil price could have two-way effect** as higher energy costs act as a tax on consumers but risk stalling the decline in producer price inflation.

Policy conundrum

In the same way that consumers are still working through excess savings, the stock of assets from quantitative easing (QE) on central bank balance sheets remains huge. Had too much emphasis been given to the flow (which had turned negative as central banks shifted to quantitative tightening) and not enough recognition that assets were still considerably higher than pre-COVID?

Figure 4: Central bank balance sheet assets



Source: Bloomberg, Assets on balance sheets of US Federal Reserve, European Central Bank, Bank of Japan, Bank of England and Bank of Canada, 30 September 2005 to 30 September 2023. The balance sheet is a financial statement of assets and liabilities.

Most participants were not convinced, believing that flows mattered more than the stock of assets. Pointing to the rise in real yields, the removal of a price-insensitive marginal buyer of government bonds (as central banks engaged in quantitative tightening) was likely a contributory effect.

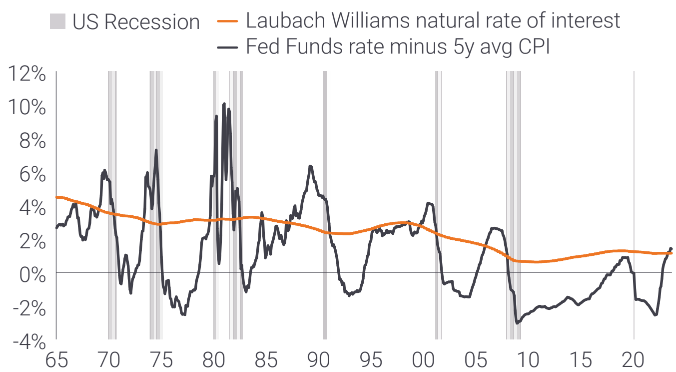
Research by Jefferies, however, noted that the pre-pandemic Federal Reserve balance sheet back in 2019 was around 18% of GDP and today it is at 30%. The extra 12% of GDP is worth about $3 trillion, with each $100 billion potentially equivalent to 7bp of easing, so 225 bp in total.[1] This puts a big dent in the 525bp of rate rises the Fed has undertaken. This may mean the neutral rate has to be higher until the balance sheet is restored to a neutral size, which could take a couple of years.

Some saw merit in this line of argument, which seemed to counter the notion that concerns around fiscal deficits were behind the recent rise in yields. Why then had bond yields been on a 40-year steady decline since the 1980s given that this period coincided with US debt ballooning? This was refuted, however, by the fact that higher supply had been met by higher demand – Treasuries were a home for excess savings and a key part of pension plans. Nevertheless, participants acknowledged that high levels of government spending recently could be working against tighter monetary policy.

The natural rate

Referring back to Figure 1, was the severe bear market in bonds simply a result of rates and yields having got absurdly low – a starting point that was likely to create deeper asymmetry in the risk/reward profile? Looking at interest rates compared with the natural rate of interest, i.e. the real short-term rate that would prevail when the economy is at full strength and inflation is stable – it could be argued that rates were only now becoming restrictive.

Figure 5: Real rates now modestly tight



Source: LSEG Datastream, Laubach Williams natural rate of interest (2-sided), Fed Funds rate minus 5-year average US Consumer Price Index, January 1965 to September 2025.

Participants, however, countered that the rapid pace of rate hikes would lead to payment shocks and the lagged effects would slow the economy.

But could we trust the natural interest rate given it was an estimate? Arguments were put forward as to why the natural rate might head higher. The last 20 years had been characterised by excess savings from China and income inequality rising in the West, together with low productivity, which had depressed rates. Looking ahead, rising costs to offset climate change, productivity gains from technology and higher government spending had the potential to lift the natural rate. If the natural rate were higher, then policy rates may have to be held at higher levels to be restrictive.

Nevertheless, participants pointed to the fact that money supply growth was negative and real narrow money growth was negative, which typically heralded an economic downturn and lower inflation.

\+ **Negative money supply growth** has typically heralded a slowdown in the economy and declining inflation

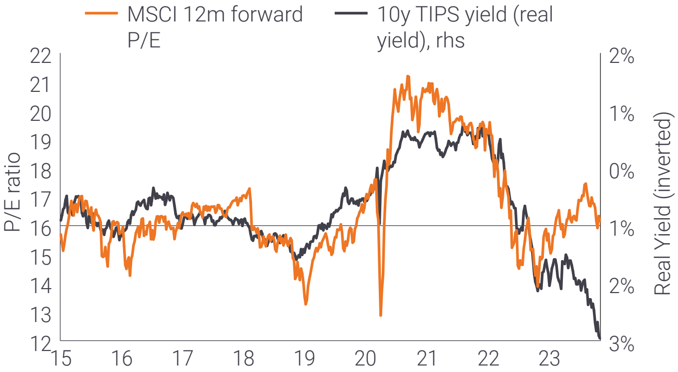
− **A higher natural rate** of interest would necessitate higher policy rates to be restrictive.

[1] Source: David Zervos at Jefferies, 4 October 2023. Basis point (bp) equals 1/100 of a percentage point, 1bp = 0.01%.

Does anybody care?

Participants noted that higher real rates seemed to have had little effect on equity markets in 2023. Could this dislocation last?

Figure 6: A chasm between risk and real rates

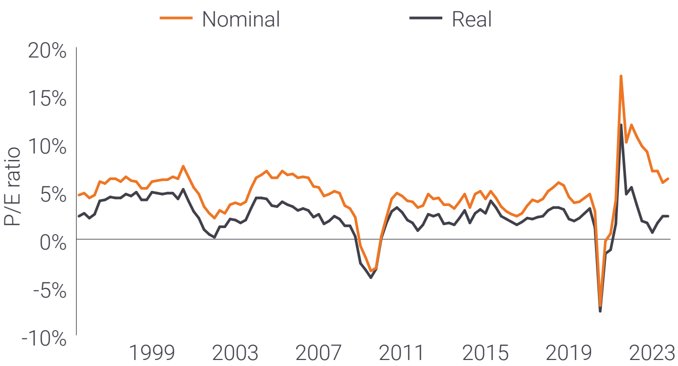


Source: LSEG Datastream, MSCI World 12m forward price/earnings (P/E) ratio, US 10-year Treasury Inflation Protected Security yield (real yield), 1 January 2015 to 25 October 2023. **Yields may vary over time and are not guaranteed.**

The view was that real rates work with a lag but they always work. The equity market may be pricing in a retreat of real rates in the months ahead or it could mean equity markets could be at risk of a sharp correction.

Some participants pointed to the disparity between nominal and real metrics. Economic growth was typically reported in real terms but companies report their earnings in nominal terms so inflation had not been disastrous for many companies – in fact quite the opposite for many.

Figure 7: US consumer and corporate strength has been supported by nominal GDP growth



Source: Bloomberg, US gross domestic product (GDP) in nominal dollars, US GDP chained dollars (real GDP), year on year percentage change, Q2 1995 to Q2 2023. As at 30 September 2023.

Real pain was likely to be felt around major financing events such as house purchases and re-mortgaging. Evidence was beginning to accumulate that higher mortgage costs were slowing the housing market in the US and Europe. Delinquencies on credit were also beginning to rise. The strong Q3 2023 GDP growth in the US felt like an outlier rather than a step change.

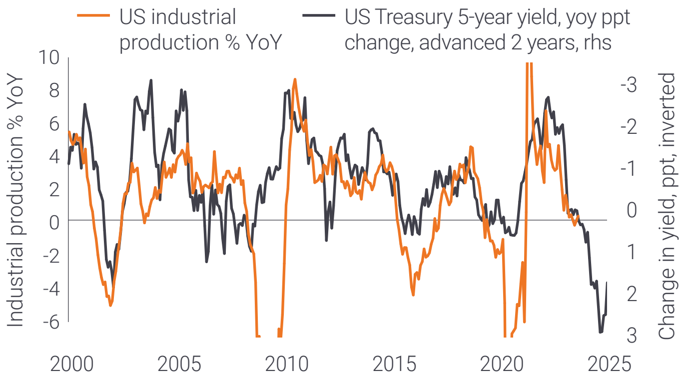
Participants also agreed we should avoid reading too much into single monthly payrolls data as employment data was a lagging indicator. Research by the Federal Reserve of Kansas City was cited, which stated that since 1985 the average peak response by employment markets to a change in rates was 27 months later.[2] While this research had referred to cuts in rates, if we were to flip it round and consider rate rises and the impact on unemployment, then it would suggest job losses in the US could be most severe in Q2 2024 (27 months since the first rate rise in March 2022).

Moreover, it was common for employment data to be robust heading into a recession and then for unemployment to jump sharply. Participants noted that labour hoarding post COVID and the rises in wages meant there was likely more fat that could be cut should corporates earnings come under pressure. Labour retrenchment could therefore be fast once catalysed.

It's getting cold outside

With the northern hemisphere heading towards winter, falling temperatures are being met by rising financing costs. History has shown a strong relationship between slower economic activity and a rise in bond yields (borrowing costs).

Figure 8: Activity follows a normal path



Source: LSEG Datastream, US industrial production, US 5-year Treasury yield, percentage point change over one year, advanced by 2 years, 31 January 2000 to 31 August 2023, yield change advanced so that chart ends at 30 September 2025.

Participants agreed that this was the most telegraphed recession in history. Had concerns about recession meant that many companies had taken pre-emptive action, ensuring balance sheets were in a stronger shape? It was agreed that credit fundamentals were in reasonable shape, although earnings tend to be highest ahead of a recession which typically makes leverage and interest coverage ratios look favourable. Signs of deterioration were forming, however, as leverage ratios crept up and interest cover fell.

+ **Nominal growth has supported** the household and corporate sectors.

– **Labour markets are a lagging indicator** so we cannot rely on them for a clear steer on the future.

[2] Source: Federal reserve Bank of Kansas City, "Has the U.S. Economy Become Less Interest Rate Sensitive", Jonathan L. Willis and Guangye Cao, Economic Review, Second Quarter 2015. **There is guaranteed that past trends will continue, or forecasts will be realised.**

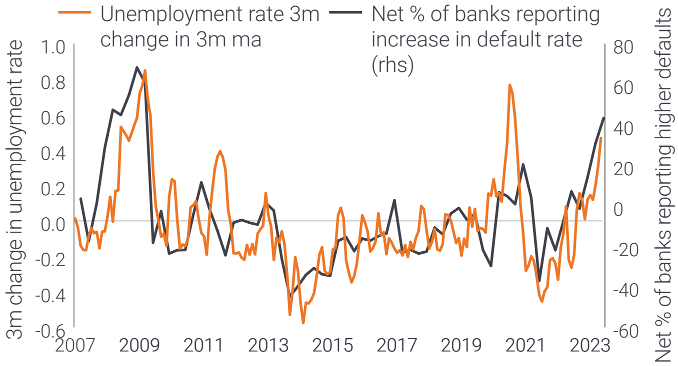
Regional differences

Much of the discussion had centred on the US – given its outsized influence on global markets – but did economic weakness in Europe reflect a stronger response to monetary tightening?

While there were specific factors affecting Europe, such as greater reliance on exports to China (which was experiencing lacklustre growth), a notable factor was the region's shorter refinancing periods, both at the household level and corporate level.

Unlike the US, where 30-year fixed-rate mortgages are common, the UK tends to fix mortgages between one and 5 years. The transmission effect of monetary policy is therefore faster, as evidenced by a quicker slowdown of the housing market and more rapid pick-up in unemployment compared with the US. Banks in the UK were already reporting increased delinquencies on household secured credit.

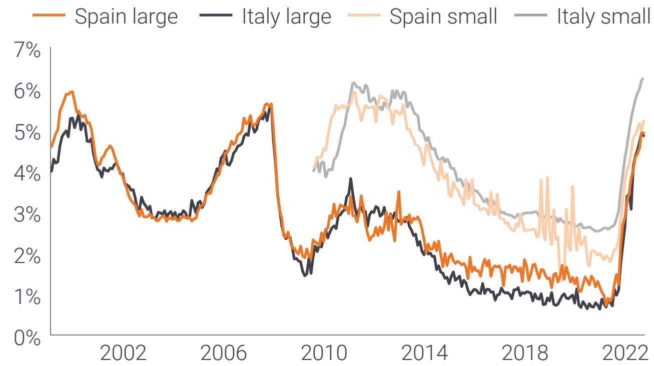
Figure 9: Rise in household credit defaults consistent with rise in unemployment



Source: LSEG Datastream, UK unemployment rate, Net % of banks reporting increase in default rate, Bank of England Credit Conditions Survey, 31 January 2007 to 30 June 2023.

Similar stress was being felt in mainland Europe. Companies in Europe typically rely more heavily on bank lending than their US counterparts. The cost of loans had spiked since late 2022.

Figure 10: Cost of credit has surged in European periphery, bank loan rates %



Source: European Central Bank, new business loan costs with an initial rate fix (IRF) of up to one year, large = loans > €1m, small = loans < €250k, January 2000 to August 2023.

Research by HSBC noted that 60% of eurozone business bank loans are subject to interest rate fix periods of under 3 months, with over 80% of loan rates fixed for under a year, while 80% of UK business lending is on floating rates according to Bank of England data.[3] To some extent, government subsidies on loans (to offset the US Inflation Reduction Act and legacy assistance from the COVID pandemic) together with higher interest earned on cash on balance sheets had offset some of the rise in financing costs.

Nevertheless, participants agreed that a "higher for longer" scenario was expected to take its toll. Within the bond markets, European debt was typically issued with shorter maturities, as the weighted average of maturities table shows, so refinancing in aggregate comes round more quickly. Taken together, European households and corporates were experiencing a more rapid transmission effect from higher rates.

Figure 11: Average maturity in corporate bond markets

Region and credit grade	Years to maturity (weighted average)
European high yield	3.5
US high yield	4.8
European investment grade	5.0
US investment grade	9.8

Source: Bloomberg, ICE BofA Euro High Yield Index, ICE BofA US High Yield Index, ICE BofA Euro Corporate Index , ICE BofA US Corporate Index, average years to maturity, at 31 October 2023.

+ **US growth appears to be holding up**

– **The transmission effect appears more acute in Europe** which is already displaying recessionary characteristics in some areas.

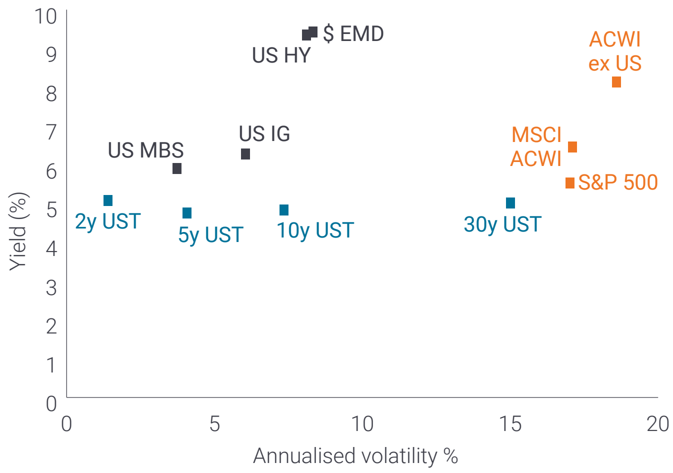
[3] Source: HSBC, Counting the cost of capital, 5 September 2023.

Time to get bullish on bonds?

With the worst seemingly over for bonds – reflected by major central banks pausing/reaching peak rate, inflation declining and yields back at levels that look competitive against both money market and risk assets, was it time to get more bullish on fixed income?

To avoid the risk of appearing to mark our own homework, the question was posed to our multi-asset colleagues who were in attendance. They highlighted that relative to equities, fixed income was looking cheap. Investors are able to achieve yields from bonds that compare with earnings yields for considerably less volatility.

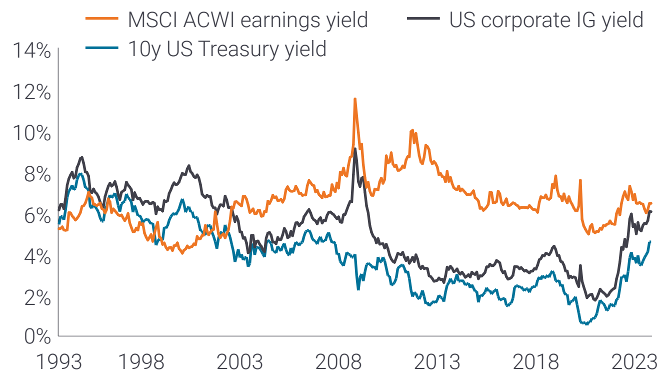
Fig 12: Fixed income yields comparable to equity earnings yields



Source: LSEG Datastream, annualised volatility (based on standard deviation of weekly price movements over 20 years to 31 October 2023) and yields at 31 October 2023. Earnings yield on MSCI All Countries World Index, MSCI All Countries World Index ex US, S&P 500® Index; yield to worst on Bloomberg U.S. Corporate High Yield Bond Index, Bloomberg U.S. Backed Securities Index, Bloomberg U.S. Corporate Index (Investment Grade), J.P. Morgan EMBI Global Diversified; redemption yield on 2 year, 5 year, 10 year and 20 year US Benchmark Government Indexes. As at 31 October 2023. **Yields may vary over time and are not guaranteed.**

Investors did not even have to stretch too far down the credit spectrum, with US investment grade, for instance, offering comparable yields to global equities. And this is at a time when equity markets are deemed to be around peak earnings. Moreover, the equity risk premium (expected rate of return from the equity market minus the risk free rate) is low and on average this has historically heralded low returns on equities over the subsequent decade.

Fig 13: IG corporate yield comparable to equity earnings yields



Source: LSEG Datastream, MSCI AWCI earnings yield, Bloomberg US Corporate Investment Grade (IG) yield to worst, Benchmark US 10-year Government Bond redemption yield. 31 October 1993 to 31 October 2023. **Yields may vary over time and are not guaranteed.**

But was it worth taking additional credit risk? Could a case be made for high yield bonds? This question led back to the earlier remark about the importance of the starting point. With US high yield offering 9%+ yields[4], it would require some negative assumptions (severe spread widening and/or higher default rates) to get a negative return. This was not impossible – and a recession in the US could easily sour sentiment and cause spreads to gap wider – but this sub-sector of fixed income was clearly more attractive today.

But would investors swing back behind bonds when hedge funds were still net short? Many wealth managers were also still more comfortable buying shorter-dated debt. Would a likely decline in money market rates see investors switching to fixed income and also moving longer duration? There was broad agreement that defined benefit pension schemes were switching to fixed income but the jury was out on defined contribution pensions. For many households, fixed income was an asset class they understood less and recent experience in the past decade had been that buying equities on dips tended to be rewarded. The yields on bonds, however, were becoming more enticing. And more debt was being issued, so by definition someone has to buy it. This raised a key point about yields and diversification.

+ **Yields on bonds compete with equities** and this is at a time when many equity markets are still at peak earnings.
  Lower volatility on bonds means on a risk-adjusted basis that bonds look even more attractive.

– **Equities may simply be overvalued** since low equity risk premiums (as exist today) have typically led to low future returns on equities.

[4] Source: ICE BofA US High Yield Index, yield to worst at 31 October 2023. **Yields may vary over time and are not guaranteed.**

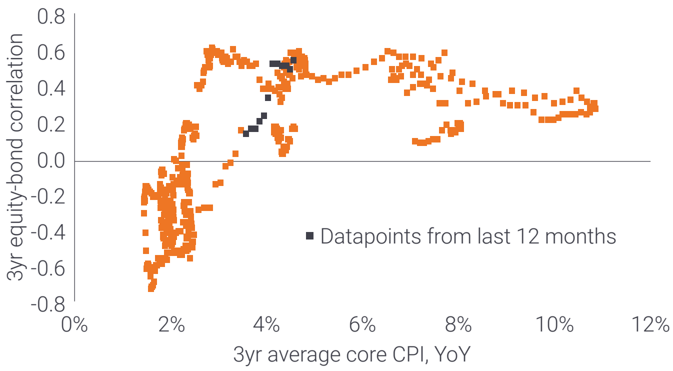
Different paths

What had made recent history particularly challenging was the close correlation between bonds and equities. Treasuries had struggled to perform their traditional role of a diversifier against risk assets. Again, this partly reflected the low initial yields meaning there was limited potential to generate positive capital returns from declining yields. Figure 14 shows how positive correlations tended to occur in periods like now when rates are pulled up, eg 2000, 2006-7 and 2013. Figure 15 demonstrates that when inflation averages below 3%, we have typically been in a period of negative correlation.

Fig 14: Correlation between US equities and US Treasury 10-year yield

Source: Morgan Stanley, 52 week rolling correlation of S&P 500® Index with US Treasury 10-year yield, 13 October 1999 to 13 October 2023. **Past performance does not predict future returns.**

Fig 15: Negative correlation should reassert itself as Core CPI falls below 3%



Source: Bloomberg, 3-year correlation of Bloomberg US Treasury Total Return Index with S&P 500® Total Return Index, US Core CPI, monthly datapoints, February 1976 to October 2023. **Past performance does not predict future returns.**

With inflation moving back down towards trend, this should allow central banks to begin pulling down the front end of the yield curve and for correlations to normalise. In such an environment, core sovereign bonds should return to their role as principal diversifier against risk assets.

Participants speculated on what could flip correlation into negative territory rapidly as opposed to the more gradual decline of inflation. A financial event (e.g. Silicon Valley Bank crisis revisited on a grander scale) or the turn in the employment market were the key candidates. While this had the potential to be good for rate sensitive securities there was likely to be a negative impact on more credit-sensitive securities.

A challenging denouement

On balance, the prospect of a soft landing seemed more realistic in the US than Europe, which is already beginning to display signs of stress. Greater fiscal support in the US, together with less immediate sensitivity to higher rates appears to have delayed/tempered the impact of monetary tightening. Real yields, however, are at restrictive levels and most participants reckoned a slowdown was still on the cards for the US in 2024.

It was agreed that a mixed picture warranted a neutral approach to credit risk beta and ongoing selectivity in terms of securities. In terms of duration, the reset higher in yields, particularly at the longer end following a bear steepening was creating an increasingly asymmetric risk-reward outcome that was likely to favour a patient investor. Asset markets were displaying lots of contradictions and historical relationships were likely to reassert themselves over time. The big unknown remained geopolitics, not least the events unfolding in the Middle East, which had the capacity to alter the story on inflation and economic growth prospects globally.

+ **Return of diversification potential** as inflation heading towards 3% or lower creates the conditions where negative correlations can reassert themselves.

− **Volatile geopolitical climate** has the potential to disturb established trends.

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Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

High-yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

Mortgage-backed securities (MBS) may be more sensitive to interest rate changes. They are subject to extension risk, where borrowers extend the duration of their mortgages as interest rates rise, and prepayment risk, where borrowers pay off their mortgages earlier as interest rates fall. These risks may reduce returns.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

10-Year Treasury Yield is the interest rate on U.S. Treasury bonds that will mature 10 years from the date of purchase. Volatility measures risk using the dispersion of returns for a given investment. MSCI All Country World Index reflects the equity market performance of global developed and emerging markets. S&P 500® Index reflects U.S. large-cap equity performance and represents broad U.S. equity market performance. Bloomberg U.S. Corporate High Yield Bond Index measures the US dollar-denominated, high yield, fixed-rate corporate bond market. Thomson Reuters/University of Michigan Consumer Sentiment Index is a barometer of the US economy based on a monthly survey of consumers' attitudes about present conditions and expectations of future economic activity. Bloomberg U.S. Mortgage Backed Securities (MBS) Index tracks fixed-rate agency mortgage backed pass through securities guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac. Bloomberg U.S. Corporate Index measures the investment grade, fixed-rate, taxable corporate bond market. J.P. Morgan EMBI Global Diversified Index tracks liquid US dollar emerging market fixed and floating-rate debt instruments issued by sovereign and quasi-sovereign entities. ICE BofA Euro High Yield Index tracks the performance of EUR denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. ICE BofA US High Yield Index tracks the performance of USD denominated below investment grade corporate debt publicly issued in the US domestic market. ICE BofA Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

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