



The *Viewpoints* series gives investors Lazard’s perspectives on the latest macroeconomic and fixed income news and trends. It reflects the views of the firm’s dedicated specialists, who independently manage portfolios across the entire range of asset classes and sectors.

## Sticky Situations

Inflation has been giving global bond markets the runaround.

Falling inflation in the United States finally gave the Federal Reserve a reason to not raise interest rates at its June meeting—welcome news for investors after 10 Fed hikes over 15 months. However, the inflation battle was not yet won: the Fed’s new rate forecast suggested two more increases before year-end, and inflation was “sticky” enough elsewhere to prompt a host of central banks to continue raising rates over the past few weeks.

The Bank of Canada surprised many investors by restarting its rate-hike cycle in early June after pausing for five months—and that followed closely on an unexpected rate increase from the Reserve Bank of Australia. Meanwhile, the Bank of England was expected to continue its hiking cycle later this month and possibly through the summer.

Of most concern to Lazard’s fixed income professionals when they met this month was the central bank tightening underway in Europe. Not only did the European Central Bank (ECB) increase rates in mid-June, but it was also about to take in some €500 billion in mandatory repayments on bank loans made during the COVID-19 pandemic through its Targeted Longer Term Refinancing Operations (TLTRO). At the same time, the ECB was winding down its quantitative easing program, and after June, no longer reinvesting the proceeds from its asset purchases.

This “significant drain of liquidity” from the financial system—at a time of year when liquidity is typically low to begin with—suggested to our experts that the bond markets, in particular the credit sector, were not out of the woods yet.

## US: Pivoting Away from Credit

A sharp drop in the May US Consumer Price Index (CPI) to 4% from 4.9% in April cleared the way for the Fed to leave the fed funds rate unchanged at 5%–5.25% after its meeting on 13–14 June. However, core CPI, which excludes food and energy prices, once again moved closer to sideways rather than decelerating and sat at an annual rate of 5.3%—still far above the Fed’s 2% inflation target.

With that and the release of the Fed’s “dot plot” rate forecast, bond investors’ rate expectations became more realistic: Pricing in the fed funds futures markets as recently as a month ago had shown that many were betting on 2–3 rate cuts before the end of this year, but after the Fed’s dot plot came out, expectations for rate cuts in 2023 all but disappeared.

To Lazard’s US fixed income team, the prospect of prolonged inflation and even tighter financial conditions was worrying, especially in light of the lingering stress on US regional banks. In fact, this concern took precedence over the deluge of new Treasury issuance expected in the next few months. Now that Congress has succeeded in raising the US debt ceiling, the US Treasury is expected to raise up to \$1 billion to rebuild its operating cash balance. Our specialists noted that it has raised similarly large amounts without much difficulty in the past and also pointed to the many tools available to manage the fed funds rate and liquidity if problems were to arise.

Lazard’s US portfolio managers were more focused on the potential for fundamentals to deteriorate and were therefore revisiting allocations to credit securities. In their view, both US investment grade and high yield corporate bonds were expensive, with spreads generally lower than 150 basis points (bps) and 450 bps over Treasuries, respectively—levels that did not reflect their risk in the team’s view.

As a result, our US portfolio managers have underweighted credit versus their benchmarks and pivoted to more attractive high-quality alternatives: Treasury Inflation-Protected Securities (TIPS), where 5-year and 10-year real yields were relatively high at 1.5%–1.7%, and US agency mortgage-backed securities (MBS), which offered much wider spreads and far less convexity than they have in the past.

### **Mortgage-Backed Securities: The Sweet Spot**

The secondary market supply and trading volume of agency MBS increased following several US regional bank failures in the spring and the subsequent sale of those banks’ investment portfolios through the Federal Deposit Insurance Corp. (FDIC). Until then, it had been nearly impossible to source such securities. As a result of the surge in securities on offer and higher volatility levels during the banking crisis, current coupon agency MBS spreads soared as high as 180 bps versus US Treasuries, a level that was not only attractive relative to investment grade corporate bonds but also within a range not seen since the height of the pandemic and the global financial crisis.

In the view of Lazard’s experts, spreads should tighten in the future and have already moved in that direction since April. The current slowdown in the US housing market and prohibitively high financing rates are likely to result in lower MBS pool

origination, and volatility has fallen from its peak in March. At the same time, demand for MBS is on the rise from investors that were underweighted to the asset class, have watched the success of the FDIC’s auctions and their positive effect on the broader MBS market, and fear missing out on the opportunity to source MBS in size and at attractive levels.

The mortgage securities on offer through the FDIC have been attractive to our US team for other reasons as well. First, buying down-in-coupon pools with relatively low underlying fixed mortgage rates in the current higher-rate environment means that, while prepayments are currently slow, these pools trade at deep discounts and offer positive convexity—acting like agency bullet debentures with significantly higher spreads. These securities also enjoy huge upside potential because prepayments typically ramp up as the mortgages season and as they enter lower interest rate environments. In general, current coupon MBS trading near par are much less appealing when rates are falling, largely due to their high negative convexity as prepayments rise.

Additionally, agency mortgage securitizations are very high quality, with the equivalent of a government guarantee. The national housing agencies—such as Fannie Mae and Freddie Mac—are backed by the US government and also have strict lending standards for the mortgages they purchase and securitize. Unlike many credit securities, agency MBS can provide investors with some insulation from a declining credit environment or recession while still offering spreads over US Treasuries.

### **Europe: Uncovered Opportunities**

Fixed income investors in Europe have been facing a similar dilemma—and a similar potential opportunity.

Credit quality in investment grade corporate bonds has deteriorated slightly, according to Lazard’s European specialists. The ongoing improvement in leverage has decelerated recently, growth in earnings has slowed, and interest coverage ratios have slipped. On top of that, lending conditions have been tightening, which suggests that quality could erode further, translating eventually into ratings downgrades.

Despite their attractive yields of 4% and higher, these signs suggested to our team that spreads on investment grade credit were “not immune” to widening, especially if a recession materializes in Europe.

As in the United States, however, an alternative has surfaced that has historically offered both high quality and more yield than government bonds: European covered bonds. Much like agency MBS, covered bonds are backed by high quality residential mortgages made by banks and typically carry the highest ratings of AA+ and AAA.

There are key differences: Unlike MBS, which offer limited recourse for investors beyond the underlying mortgage pools, covered bonds are senior secured debt with “dual recourse:” first to the issuing bank as senior unsecured bonds and second to the collateral (the mortgages) if the bank defaults. Of note, in their long history—going back to Germany’s original Pfandbrief law 300 years ago—no defaults have ever been reported on covered bonds.

The securities were out of favor with investors for several years when interest rates in Europe hit record lows—and even negative levels—and the ECB was purchasing many of these bonds as part of its quantitative easing during the pandemic. At the same time, the ECB’s TLTRO lending facility had reduced the need for banks to raise money by issuing covered bonds.

The TLTRO is now winding down, however, and will close at the end of 2024, having peaked at €2.2 trillion in September 2021. And of course, interest rates have risen to far more appealing levels for investors. As a result, supply has increased dramatically over the past 6–9 months, and Lazard’s specialists believe it is likely to set a new record (gross and net new issuance) in 2023.

Covered bonds have undergone a decisive re-pricing over the past few quarters due to this record supply, and as a result, spreads on the bonds have returned to attractive levels relative to their long-term averages and relative to government and investment-grade corporate bonds, according to our European team. In particular, at the short end of the curve, these secured bonds look cheap as covered bond yields are higher than those of short-dated investment grade corporate bonds on an absolute yield level basis.

At the other end of the credit spectrum in Europe, high yield bonds appealed to Lazard’s team in the medium term, although, like investment grade corporates, they were vulnerable to spread widening in the short term.

Current pricing on European high yield securities implied a default rate of around 4% going forward—below recent industry forecasts—and refinancing needs this year and next were quite low. Also, there have been more companies getting upgraded out of the sector (rising stars) than downgraded into it (fallen angels), keeping supply limited. Investment flows, meanwhile, have recovered since late last year, driven by demand from ETFs and global funds.

### Emerging Markets: Two Extremes

In the emerging markets, inflation and rising rates were generally in the rearview mirror. For that reason, local currency sovereign debt has been one of the best-performing asset classes this year. Our specialists were optimistic for the future as well—even after the banner performance.

Unlike in the United States, core inflation in the emerging markets has fallen quickly. For example, while US core CPI has slowly drifted down just over a percentage point from its peak of 6.6% as the Fed raised rates, core inflation has plunged from its peak of 10.7% to 6% in Brazil and from 14.7% to 8.5% in the Czech Republic. As a result, many emerging markets central banks reached peak interest rates last year and are expected to begin cutting rates before the end of 2023—Hungary, in fact, began reducing rates over the past month.

Because many countries started to hike rates as far back as 2021 and were determined to stamp out inflation, policy rates are now extraordinarily high: Brazil at 13.75%, Mexico and Chile at 11.25%, and Hungary at 13%–16%. These translate into very attractive yields for investors in local sovereign debt, and the likelihood that rates will soon fall also raises the potential for capital appreciation. Of particular interest to our portfolio managers were the high-yielding countries, including South Africa, Mexico, Brazil, and Colombia.

In sharp contrast, emerging markets dollar-denominated sovereign debt has shown signs of stress in the high yield segment. The weakest countries have been trading as low as 60 cents on the dollar—in line with what our specialists would expect leading up to a negative global growth development and thus a warning sign that our team was watching carefully. Such weak performance has dragged average spreads on the bond indices much wider. BB+ bonds were trading around 450 bps, above their typical range of 300–400 bps, while bonds rated B have jumped to 675 bps.

Investment grade dollar-denominated debt was faring far better, however, with spreads just 30 bps higher than their all-time lows—a level more in line with continued growth and relative stability, our experts noted.

### Holding the Champagne

The long-awaited “skip” in the Fed’s interest rate cycle this month has proved anticlimactic. Hawkish surprises from other central banks and from the Fed’s own rate forecast mean that tightening is very likely to continue into the second half of 2023. The issues of stubbornly high inflation, rising rates, and slowing growth, which have troubled the bond markets for more than a year, linger.

Yet, they seem at least closer to resolution. Inflation has decelerated; many emerging markets central banks have reached the end of their hiking cycles while developed economies appear far closer to the end than the beginning of theirs; and recession in the world’s largest economy has been put off until later—again. Importantly for fixed income investors during this post-pandemic recovery period, attractive lower-risk opportunities have continued to arise.

## Fixed Income Platform

Investment Teams	Investment Strategies
Global Fixed Income	The Lazard Global Fixed Income strategy seeks to enhance returns by rotating through global bond and credit markets, taking currency risk when appropriate. The portfolios invest in global government, agency/supranational, corporate, municipal, mortgage, and asset-backed bonds.
US Fixed Income	The Lazard US Fixed Income team manages the US Short Duration, US Core, US Tax Exempt, and US Corporate Income strategies. The team seeks to derive benefits from the mispricing of securities based on various factors, including but not limited to, their assessment of credit quality, structure, and market sponsorship.
European Fixed Income	The Lazard European Fixed Income team manages the Scandinavian & Euro High Quality, Euro Covered Bonds, Euro Corporate and Euro Total Return Balanced strategies. Within these strategies the team seeks to generate performance through active management in European capital markets.
Emerging Markets Debt	The Lazard Emerging Markets Debt team manages the Emerging Markets Debt – Blend; Emerging Markets Debt – Core; Emerging Markets Debt – Corporate; Emerging Markets Debt – Local Debt; and Emerging Markets Debt – Total Return strategies. These strategies offer exposure to emerging markets bonds in local and/or hard currencies across regions.
Emerging Income	The Lazard Emerging Income team offers the Emerging Income and Emerging Markets Income strategies, which seek to invest in local emerging markets instruments, including currency forwards and local currency debt.
Lazard Frères Gestion	The Lazard Frères Gestion (LFG) Fixed Income team provides a range of strategies covering the full credit spectrum: Investment Grade, High Yield, Subordinated Debt. The team seeks to generate alpha through an active and flexible approach of interest rate and credit risk. The team also manages Fixed Income Credit Maturity strategies.
Absolute Return Credit	The Lazard Coherence Credit strategy is an absolute return credit strategy focused primarily on investing in investment grade and high yield bonds, credit default swaps, preferred stock, and index products predominantly in North America and Europe. The team's investment thesis is designed to identify sector and credit migration trends to create outsized risk-adjusted returns. The strategy seeks to preserve capital through dynamic risk management.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

## Important Information

Originally published on 20 June 2023. Revised and republished on 21 June 2023.

An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Emerging markets securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in these countries. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

This document reflects the views of Lazard Asset Management LLC or its affiliates ("Lazard") based upon information believed to be reliable as of the publication date. There is no guarantee that any forecast or opinion will be realized. This document is provided by Lazard Asset Management LLC or its affiliates ("Lazard") for informational purposes only. Nothing herein constitutes investment advice or a recommendation relating to any security, commodity, derivative, investment management service, or investment product. Investments in securities, derivatives, and commodities involve risk, will fluctuate in price, and may result in losses. Certain assets held in Lazard's investment portfolios, in particular alternative investment portfolios, can involve high degrees of risk and volatility when compared to other assets. Similarly, certain assets held in Lazard's investment portfolios may trade in less liquid or efficient markets, which can affect investment performance. Past performance does not guarantee future results. The views expressed herein are subject to change and may differ from the views of other Lazard investment professionals.

Certain information contained herein constitutes "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "intent," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events may differ materially from those reflected or contemplated in such forward-looking statements.

This document is intended only for persons residing in jurisdictions where its distribution or availability is consistent with local laws and Lazard's local regulatory authorizations. Please visit [www.lazardassetmanagement.com/globaldisclosure](http://www.lazardassetmanagement.com/globaldisclosure) for the specific Lazard entities that have issued this document and the scope of their authorized activities. Information and opinions presented have been obtained or derived from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions expressed herein are as of the published date and are subject to change.