Lazard Fixed Income Viewpoints

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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.

The Yield Curve Conundrum

Whether a blessing or a curse, fixed income investors are living in interesting times.

One of the most extraordinary developments has been the inversion of the US Treasury yield curve. Short-term yields have been higher than long-term yields, creating a downward slope to the US curve, for an exceptionally long time—exactly a year this July—and the inversion has been the deepest since the inflationary period of the 1970s and 1980s.

What makes it even more unusual: An inverted yield curve has preceded every US recession in the past, but the economy has proven resilient over the past 12 months, even after more than 500 basis points (bps) in interest rate increases from the Federal Reserve.

Is this harbinger of recessions just part of the market landscape now, or is it telling us something more? At their meeting in mid-July, Lazard's fixed income professionals tackled the curve conundrum and what it may mean for investors in the months ahead.

US: Shape Shifting?

As a warning sign of recession, the inverted yield curve has been at odds with other indicators in the US financial markets.

For one, risk assets have strengthened, especially in the last quarter. The spread for US high yield credit was some 125 bps below its long-term average by early July, and the equity risk premium—as estimated by the earnings yield of the S&P 500 over 10-year Treasuries—had shrunk to just 0.9% compared with the usual range of 3%–4%. Also, the yield curve inversion has been generally out of sync with recent US economic data: unemployment near a record low at 3.6% for June, healthy increases in hiring, and buoyant consumer spending.[1]

Starting in early July, however, the Treasury curve showed some signs of relenting; the difference between the 2-year and 10-year yields fell from -108 bps to -84 bps over the first 10 days of July. Historically, when an inverted yield curve has started to reverse, short-term yields have fallen the most and longer-term yields

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have dropped less or held steady. Judging by the 20 bp–25 bp drop in the 2-year Treasury and the lack of change in the 10-year yield at 3.86% for the month through 12 July, the curve does appear to be moving away from its steep inversion.[2]

The latest economic reports may have played their part by hinting at some softness in the economy and raising investors' hopes that the Fed may soon end its rate-hiking cycle. For June, an increase in nonfarm payrolls was lower than predicted, and the headline Consumer Price Index (CPI) plunged more than expected—by a full percentage point to 3% year over year from 4% in May. On this inflation news alone, the 2-year Treasury yield plummeted 16 bps.[3]

Lazard's fixed income team currently expects the yield curve to continue flattening from its deep inversion—a shift known as a bull steepener. Also attractive in their view were five-year Treasury Inflation Protected Securities (TIPS), offering the highest real yields in years at 2.1%–2.2%, while the 10-year Treasury yield at around 4% represented fair value.

Could the inverted yield curve still be a precursor to recession? In the US team's view, yes. The team believes that the key issue holding back a recession has been the lack of a tightening in financial conditions that normally coincides with an aggressive Fed tightening cycle. However, new signs have emerged that tighter financial conditions may be on the way, First, the fed funds rate is now higher than the core CPI rate, and second, regional bank market borrowing costs have remained very elevated since the crisis in March, even after the Fed's balance sheet support. Our US experts expect that these headwinds to profitable lending will eventually lead to a decline in loan volumes and a widening in BBB rated industrial debt spreads—signaling a pending recession. Absent other developments, our US experts now believe a recession will materialize in 2024.

US High Yield: Sunny Side Up

Rather than recession fears, the US high yield markets have been driven by investors' appetite for risk. For 2023 through early July, the sector returned around 5% thanks largely to a rally in lower quality credits in the second quarter. Bonds rated CCC outperformed in April through early July, with a return of 9%—more than double the return for BB credits.[4]

For the sector as a whole, option-adjusted spreads (OAS) narrowed 51 bps in the second quarter and reached just over 400 bps—well under their long-term average of 525 bps. New issuance has trended higher since 2022, rising to $55 billion in the second quarter from $40 billion in the first. Many high yield issuers refinanced much of their debt 2–3 years ago when interest rates were extremely low, which means the next big cluster of debt maturities in the sector is not expected until 2026–2027.

Amid all this positive news, a few clouds were gathering. Defaults rose to 2.7% by the end of June from 1.7% at year-end 2022, although our high yield experts noted they remain under the long-term average range of 3.2%–3.6%.

Worthy of note to our analysts was an increase in the volume of distressed debt exchanges—essentially debt restructurings—which have historically preceded defaults. Distressed debt overall makes up around 8% of par value in the high yield market, and some 40% of corporate bonds rated CCC have been trading at very high spreads of 1,000 bps or more, according to our high yield specialists.

Emerging Markets: Flows Are Slow to React

Recession seemed far from the minds of investors in local currency-denominated emerging markets debt. Local currency bonds have been a standout in the asset class, with an absolute return of more than 16% since the end of October 2022 when the rally in emerging markets debt began. With inflation falling but local interest rates still high, yields have been in the double-digits in many countries, contributing to returns.

In a persistent trend for the asset class as a whole, however, investment flows have so far lagged performance. After record outflows in 2022 of $90 billion, representing almost 15% of the asset class, another $2 billion–$3 billion has left in 2023 so far. Most of the outflows have been from the hard-currency emerging markets bond sector, in part due to weak performance from several high yield countries. But if local currency bonds continue to perform well, Lazard's team would anticipate that investment inflows should pick up in that segment and could last for some time based on past flow patterns.

Looking further ahead, investment flows, as well as currency flows, could be dramatically affected by the addition of India's sovereign bonds to JP Morgan's local currency emerging markets bond indices. India has been on "watch" for inclusion in these benchmarks, with the next review reportedly slated for this October. Our experts expect to see the country's bonds accepted into local currency indices within the next two years. China's bonds became part of the indices in 2020.

Global Rates and Currencies: Dispersion Is the Word

With inflation subdued in many emerging markets but still too high for comfort in many developed markets, interest rate cycles have remained out of sync globally. The resulting dispersion has been the key to opportunity for our global rates and currency team recently.

In the United States, some alternative inflation measures have pointed to a rate well below the 3% headline CPI for June, which suggested to our global fixed income portfolio managers that more Fed rate hikes could overshoot the mark and slow the economy too much. Meanwhile, inflation in the United Kingdom and Europe, while declining in the past year, has dropped more slowly, and additional rate hikes were widely expected from central banks there. Our global fixed income team expected to see some smaller economies also continue to raise interest rates even after inflation has been brought under control in an effort to keep their currencies strong.

In currency markets, the euro has been testing an important level of 1.10 against the US dollar—and could break through it to hit 1.15 if the European Central Bank (ECB) appears inclined to raise rates aggressively or the Fed puts its rate-hiking cycle on hold. Overall, our experts expected the US dollar to weaken over the next few quarters.

Europe: Less of a Conundrum

While the ECB's rate increases have helped support the euro, they have created challenges for the region's economy and bond markets.

To start, the ECB must impose one policy rate on the entire region, which risks stifling growth in countries where inflation is not a problem. Spain and Switzerland, for example, have reported inflation rates as low as 2% lately, while Germany has come in close to the euro zone average of 5.5% and parts of Eastern Europe have been struggling with price increases in the double-digits.

In addition, with the euro zone essentially at full employment for the first time in its existence, our European bond team believes the ECB may continue raising rates until the labor market cools and wage pressures ease—in other words, to the point of recession. Already, growth for the region has stalled in the first half of this year, but the ECB is expected to raise rates twice in the next two months nevertheless.

As investors anticipate more rate hikes, short-term government bond yields have remained well above long-term yields, and the premiums are likely to rise even further, according to Lazard's European team. Our analysts believe this creates another dilemma for the region: The inversion of Europe's bond yield curves, notably Germany's, is likely to deepen from its current record level, and in this case, the yield curves seem to be sending clear signals that recession is on the way.

Still, our experts saw positive developments for bond investors. In their view, based on long-term inflation and growth expectations, the yield on the 10-year German Bund reflects fair value at around 2¾%, not far from the current level. Also, investment grade corporate bonds, with yields averaging 4%–5%, have been very appealing from a buy-and-hold standpoint.

The Silver Lining

Buy-and-hold has currently become a more popular strategy for investors not only in Europe but also in the United States and emerging markets, a sign that some "normalcy" may be returning to the bond markets.

After more than a decade of record-low interest rates compelled bond investors to focus on price appreciation, yields have finally risen to the point that many investors are buying bonds for their attractive coupons—their fixed income.

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.

Notes

1 Sources: High yield credit spreads: ICE BofA US High Yield Index 7 July 2023; earnings yield of the S&P 500 over 10-year Treasuries: Bloomberg 30 June 2023; economic data: Bureau of Labor Statistics 7 July 2023 *The Employment Situation - June 2023; (bls.gov)*; Bloomberg 18 July 2023: *US Retail Sales Edge Higher as Key Metric Shows Resilient Demand - Bloomberg*

2 Source: US Treasury Par Yield Curve Rates July 2023: *Resource Center | U.S. Department of the Treasury*

3 Sources: Bureau of Labor Statistics 7 July 2023: *The Employment Situation - June 2023* (bls.gov); CNBC 7 July 2023: *Jobs report June 2023: Payrolls rose by 209,000, less than expected (cnbc.com)*; Bloomberg 12 July 2023: *US Inflation at 3% Signals Turning Point for Fed Rate Hikes - Bloomberg*; US Treasury Par Yield Curve Rates July 2023: *Resource Center | U.S. Department of the Treasury*

4 Source: ICE BofA US High Yield Indices 7 July 2023

Important Information