Lazard Fixed Income Viewpoints

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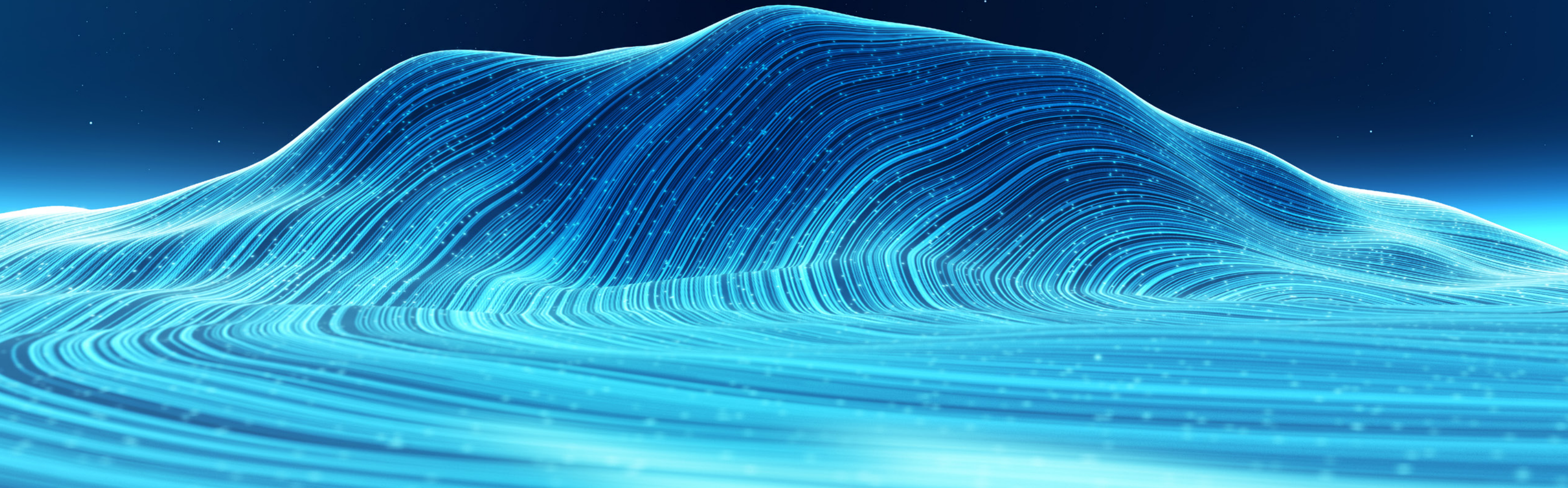

The *Viewpoints* series gives investors Lazard's perspectives on the latest macroeconomic and fixed income news and trends. It reflects the views of the firm's dedicated specialists, who independently manage portfolios across the entire range of asset classes and sectors.

Outlook for Bonds: Riding the Crest

A bond investor who took a sabbatical in 2023 could perhaps be forgiven for thinking that not much had happened. On the last trading day of December, the benchmark 10-year US Treasury bond yield was literally unchanged from a year earlier at 3.88%.[1]

Appearances can be deceiving, though. Our bond investor would have missed the best market performance since 2020 and the highest market volatility in years. Amid central bank interest-rate hikes and pauses, a US banking crisis, falling inflation globally, stalling growth in Europe, and resilience in the United States, the 10-year US Treasury yield swung to 3.30% in the spring and to 5% in October—its highest level in 15 years. A stunning two-month rally then closed out the year. The result: The Bloomberg Global Aggregate Bond Index gained some 9% over November and December alone, turning the tide for fixed income and leading to a total return of 5.7% in 2023.

After such a dramatic performance, what lies ahead for bonds in 2024?

A falling rate environment generally bodes well for bonds, and many central banks—in the United States, Europe, and emerging markets—look likely to cut interest rates in 2024, judging by declining inflation rates over 2023 and the banks' own forecasts.

But as Lazard's fixed income professionals discussed at their meeting this month, the interest rate picture is more complicated than that. The bond rally late last year already drove the US 10-year yield down by 100 bps as many investors anticipated central bank easing—pricing in up to six Federal Reserve cuts for 2024—as well as a soft landing for the US economy.

These conditions are not even assured. Rate cuts in the developed markets may not come soon, depending on how economies fare and how long it takes inflation to make the final leg of its journey toward central banks' 2% targets. And soft landings after Fed rate-hike cycles have been rare. In our experts' view, the "runway" is narrow, bordered by a recession on one side and a sudden rekindling of inflation on the other. With wars in the Middle East and Ukraine and major elections for half of the world's population, a rise in geopolitical risk could also push a soft landing off course.

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Instead of counting on rates as the major source of return in 2024, then, our bond teams were focused on accumulating yield, or carry, as well as preparing for another year of market volatility.

US: Pain Ahead?

The latest reports on the US economy presented a mixed picture to our US team, who maintained the view that a recession was looming for the United States this year, albeit a shallow one.

As a US portfolio manager explained, it wasn't until last summer that the fed funds real rate finally exceeded the historical inflation rate threshold of prior rate-tightening cycles (as measured by the Personal Consumption Expenditures Index) and going forward, the US economy should feel more pain from the Fed's tightening campaign. In addition, banks' commercial and industrial (C&I) loans started to decline after April 2023, according to data from the St. Louis Fed, as banks started passing on the full added cost of funds to their C&I customers.[2]

With Fed rate cuts likely, based on the central bank's own "dot plot" forecasts, the US yield curve is likely to steepen this year in the team's view. They currently expect the 10-year yield to stay relatively steady as short-term rates drop. Positioning correctly for this reshaping—and timing it right—is no small feat and could potentially add significant return for investors in 2024, according to our analysts.

Yield, another potential source of above-market return this year, was not attractive to our team in the most obvious place. Investment grade corporate bonds—with an average spread on the ICE BofA US Corporate Index at just over 100 bps in early January—did not reflect the risk of a recession, or much of any downside risk for that matter, in their view.

As a result, the US team continued to favor structured products, where spreads have widened. In Agency mortgage-backed securities, which are backed by the US government, supply has exceeded demand since the US banking crisis in March, driving up the average spread over Treasuries to around 55 bps and pushing prices down to the $90 range. Our analysts also found spreads on asset-backed and commercial mortgage-backed securities attractive.

High Yield: Not a Wall But a Hurdle

Spreads on high yield corporate bonds have lately been too tight for our US team as well, averaging 354 bps over Treasury bonds based on the ICE BofA US High Yield Index—around the 30th percentile historically, based on Lazard's estimate. However, that was not the biggest concern: With the potential for a bumpy US economic landing this year and the increase in the cost of capital after 11 Fed rate hikes, the question of whether lower-rated companies will be able to access the bond market to refinance their debt loomed large.

Companies rated CCC have some 30% of their debt maturing over the next 24 months, according to our high yield specialists, and as 2024 unfolds, our team believes some could struggle to refinance if their financial health deteriorates due to slowing growth or tighter credit conditions. With even more debt coming due, the transport, gaming, and retail sectors were especially vulnerable, although these three together make up only about 8% of high yield bonds, our analysts noted.

Moody's projects that its 12-month corporate default rate, now well below average at 2.8%, may hit 3.4% this year, and our team believes US defaults could be far higher, depending on how much economic growth drops.

Though weaker issuers may be at risk, the much-discussed "debt maturity wall" in the high yield sector overall is within normal levels, according to our specialists. It may look high compared with other fixed income segments, in part because high yield bonds generally have short tenors, but bond maturities appear well balanced, in their view.

Our US high yield team was optimistic overall for 2024. Attractive opportunities may stem from developments in corporate earnings, in our experts' view. Fourth-quarter results should look healthy, they explained, but after that, if some companies run into refinancing troubles or businesses stumble as economic growth slips, spreads could increase 50 bps–100 bps in the months ahead and create an attractive entry point for investors.

The team estimated potential returns for the entire sector at 5%–6% based on what they see now, a little less than the average coupon but still a cushion for investors in the event of losses or spread widening. "A good bit" of positive performance may have been pulled forward, the team observed: In 2023, the sector returned an impressive 13.5%, as measured by the ICE BofA High Yield Index, including an 8.5% gain in November and December.

Emerging Markets: A Changed Game

Market access for lower-rated issuers was also a serious concern in US dollar-denominated emerging markets debt as US interest rates rose in 2023. At the height of worry—and the peak of US rates—in October, the cost of funding was becoming prohibitively high for several sovereigns including Egypt, Kenya, and Nigeria.

However, the Fed's "pivot" in December toward easing and away from tightening policy was a game-changer for emerging markets, according to our experts. The floodgates opened to new issuance in US dollars from many countries in January, spreads have generally tightened, and with the potential for Fed rate cuts, the outlook for BB and B countries has brightened.

The Fed's tilt toward easing was also a signal for Lazard's emerging markets team. Having reduced risk to their lowest levels ever in October, our portfolio managers have been adding high yield bonds recently and aim to "harvest yield" across emerging markets.

While the Fed's pivot may have been the call to action, our specialists noted other supportive developments for emerging markets debt. First, inflation has been falling in many developing countries and has dropped more than expected in some.[3] That may be good news in itself for bond investors, and it also reinforced our team's observation that inflation has fallen quickly around the world in the last six months or so.

Another plus for emerging markets to our analysts, some central banks have accumulated significant foreign exchange reserves. This is a timely development because they could use those reserves to potentially limit, or manage, any currency appreciation against the US dollar, which is expected to soften over the Fed's next easing cycle.

Policy has also improved in several large countries. Turkey and Argentina have turned almost 180-degrees in many respects, and our team has been watching closely to see if the changes stick. In general, many recently elected leaders have had less success than the team expected in boosting fiscal spending—for example, in Chile, Colombia, and Peru—another encouraging sign for bond investors, in the team's view.

More policy change, along with geopolitical risk, could be in the offing with the raft of elections scheduled for this year. After Taiwan on 13 January, among the most significant to our team were in India, Indonesia, Mexico, South Africa, Turkey—and the United States.

Emerging Markets Rates and Currencies: Waiting on Flows

The Fed's pivot last month took the tailwind from the US dollar and strengthened our team's already positive outlook for local currency bonds this year. Although returns in 2024 seemed likely to fall short of last year's 11%, current yields of 6%–6.5% for the sector were attractive, and careful selection could potentially add another 1%–2% to returns, our specialists estimated.

Latin American countries have led the way in cutting rates in emerging markets, and in the team's view, also offered attractive real yields after aggressive rate hikes and the drop in inflation so far.

By contrast, investor sentiment toward China has remained poor; the property sector has not yet bottomed out, though it has shrunk significantly,[4] our analysts observed. While many foreign investors have taken to India as an alternative for the past year or more, our team discussed the possibility that interest in China could increase over 2024 if geopolitical tensions remain in check, growth holds at 4%–5%, and corporate earnings are allowed to shine. In terms of yield, however, India still comes out on top at around 7% currently.

Our fixed income teams also discussed a wildcard that could improve return potential for emerging markets in general this year: the possibility of higher demand. Our experts were cautiously optimistic that investors would return to the asset class after investment outflows in 2023; and flows for emerging markets bonds did in fact turn positive in late December and early January.[5] Allocations to cash and short-term bonds soared last year as rates rose, with the Investment Company Institute reporting almost $6 trillion in US money market funds alone as of the first week of January, and our experts pointed out that rate cuts from the Fed could push investors off that fence in search of higher yields.

Europe: Cautious Beginning

Much like the Fed, the ECB was expected to start cutting rates this year, and similarly, the timing was widely debated among investors—with predictions ranging from March to July. As a result, lengthening duration for the medium and long term has been in order for our European portfolio managers, but they have taken a different tack for the short term.

For the early part of 2024, our bond specialists have reduced duration—to as low as 2–2.5 years in credit, for example—because they see the potential for bond yields to rise, or "reprice" after last year's rally. In their view, inflation could reignite or give a last gasp—inflation did rise more than expected in both Europe and the United States in December—possibly inducing a rate hike or a higher-for-even-longer stance from central banks. On the other hand, our European team expected a US recession this year, and the European economy has appeared to be on the brink of one for some time. So with the immediate path for rates unclear, the team was taking a cautious approach.

That defensive strategy extended across credit sectors, where spreads were tight after last year's rally, in our analysts' opinion. In 2023, the high yield market took top honors with a 12% return, while investment grade corporates returned a healthy 8%, based on Bloomberg's Euro High Yield and Corporate indices. Any potential spread widening in early 2024 could be a good buying opportunity, in their view, and their outlook for the second half was optimistic. All in all, they expected a good year for carry, but a volatile one.

The Nordics and Covered Bonds: Out of the Fray

European markets have offered some pockets of relief from volatility. In the Nordics, for example, almost 75% of the high yield sector consists of floating-rate notes, which means interest rate risk—and volatility—tends to be low, our team noted.

For that reason, Nordic high yield securities did not partake in the bond rally late last year, and accordingly, the Nordic-EUR high yield spread reached a historically wide level of 260 bps, offering an attractive relative value, in our analysts' opinion. The average yield-to-worst in the sector has been stable at around 10%, which also gives investors a comfortable cushion against risk, they added.

The Nordics are considered "niche" markets, however, with many small companies involved and lower liquidity than in larger markets. Also, as in many countries, the weak commercial real estate market has been a concern, particularly in Sweden, our analysts observed. Nevertheless, elevated yields entering 2024 made a compelling case to them for healthy total return potential in Nordic high yield.

At the other end of the quality spectrum, covered bonds-— which are issued by banks, typically secured by a pool of high quality mortgages, and backed by strong domestic covered bond laws—have long offered stability to investors, and in a recent reversal, they have also been offering higher spreads, according to our European team. The ECB was the biggest buyer of euro-denominated covered bonds for years through its asset purchase programs but has scaled back a large part of these programs. At the same time, issuance has been setting records, according to our analysts—€200 billion in 2022 and €190 billion in 2023—as banks seek cheap funding via covered bonds again.[6]

On the back of these structural shifts in the market, spreads on these highly rated bonds have reached historical highs of around 80 bps over German bunds. Increased demand from institutional investors as a result of these high spreads should support the asset class going forward, our specialists added.

Convertibles: Embracing Their Inner Bond

There is another fixed income class that that could potentially benefit from higher carry and movements lower in interest rates over 2024: convertible bonds. These hybrid securities come with an option to convert to the issuer's stock at a set price, which links their valuations and behavior to equities as well as bonds.

Returns last year averaged 8%–10%, according to our specialists—helped by positive equity markets and the return of carry. Overall, the universe of convertible bond issuers more closely resembles that of the small-cap Russell 2000 Index, which posted strong returns but underperformed the broader equity market where a select few megacaps dominated performance, our experts pointed out. Looking ahead, lower interest rates could provide a tailwind for convertible bonds, in their view, as the underlying equities of these issuers have proven highly sensitive to rate movements in the recent past.

Coupons on new issues have averaged around 3% recently, by our analysts' estimate, which is high relative to the past decade but still low for issuers relative to other bond sectors currently. Some companies can therefore lower their financing costs by issuing convertible bonds—but in exchange for the embedded equity call option. Indeed, coupon levels have lured some investment grade companies to issue convertibles in the past year after a long absence, improving the diversification and convexity of the asset class, our analysts noted. Yields do range, they also pointed out, with 5% or higher in volatile sectors like information technology. And for investors, the equity call option offers potential upside, depending on how the underlying equities fare.

Even convertible bonds, which in the lower interest rate environment were most influenced by the value of their equity options, now have increased return potential from yield and the fixed income drivers of the asset class, as our fixed income professionals discussed at their meeting this month.

Seeking Yield

The "search for yield" has taken on a new meaning in 2024. Rather than being challenged by the lack of yield when interest rates were at historical lows, investors are now in a land of plenty, including some of the highest yields in more than a decade as central bank rates hover at or near their peaks.

Although the pace of gains in global fixed income in November and December, when government bond yields plunged, seems unlikely to continue, by taking a selective and accretive approach to yield, our bond professionals believe investors can add above-market return potential in 2024 and beyond.

Fixed Income Platform

Investment Teams	Investment Strategies
Global Fixed Income	The Lazard Global Fixed Income team manages the Global Core, Scandinavian & Euro High Quality, Euro Covered Bonds, Euro Corporate, Nordic High Yield and Euro Total Return Balanced strategies. Within these strategies the team seeks to generate performance through active management in Global capital markets.
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.
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.

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Notes

1 All Treasury yields in this Viewpoints were sourced from the U.S. Treasury Department. Resource Center | U.S. Department of the Treasury

2 Commercial and Industrial Loans, All Commercial Banks (BUSLOANS) | FRED | St. Louis Fed (stlouisfed.org)

3 Based on data from JP Morgan Global Bond Index (GBI) Emerging Markets Headline CPI. For a discussion on emerging markets inflation, see Fixed Income Viewpoints: December 2023 | Lazard Asset Management

4 10 Charts That Show How China's Property Crisis Is Spreading Across Economy - Bloomberg

5 Global equity funds draw robust inflows on rate cut hopes | Reuters

6 European Banks in Deposits Tussle Rush to Sell Ultra-Safe Debt - Bloomberg

Important Information

Published on 16 January 2024.

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.

The indices referenced in this document are included merely to show general trends in the market during the periods indicated and are not intended to imply that investments made pursuant to the strategy are or will be comparable to any index in either composition or element of risk. The strategy is not restricted to securities comprising any index. The strategy may use various investment techniques not reflected in an index. The indices referenced herein are unmanaged and have no fees. One cannot invest directly in an index. There is no guarantee that the strategy's performance will meet or exceed any index.

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