Lazard Fixed Income Viewpoints

SEP
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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.

Life at the Top

For fixed income investors, the end of a central bank rate-hiking cycle can be a time of relief and anticipation: relief that the challenges of rising rates and falling bond prices are winding down and anticipation that rate cuts will follow—creating the potential for price appreciation in bonds.

Yet, as the United States and Europe appear near the end of their rate-hike cycles and many emerging markets are at peak rates and contemplating cuts, the global bond markets have shown more uncertainty and volatility than relief and anticipation. Since early August, the US 10-year Treasury yield has risen more than 20 basis points (bps) to around 4.33%,[1] weak economic reports have plagued much of Europe, and emerging markets have fallen under the influence of China's sharp growth slowdown.

At their meeting in mid-September, Lazard's fixed income professionals pondered this "messy" inflection point. Taken at face value, recent economic data may be pointing to a soft landing for the US economy, which would help sustain global growth. Looking below the surface, however, that outcome is far from certain. Crude oil prices, for one thing, have risen more than 25% since early July on OPEC+ supply cuts, threatening to reignite inflation and drive the Federal Reserve to resume rate hikes. On top of that, a torrent of new bond issuance has put upward pressure on bond yields over the past month.

Despite its time-honored attractions, life at the top of a rate cycle can be complicated.

US: Inflection Plateau

The US bond market has been at an inflection point since the Fed last raised rates in May, in the view of our US fixed income team. Based on current pricing in the fed funds markets, most investors expected the Fed to "skip" a rate increase at its meeting on 19–20 September, although the odds for a 25-bps rate hike in November were 50-50. After that, our US team expected rates to enter a "higher-for-longer" period that, in their view, could last into the second half of 2024 given how strong the US economy and labor market have been recently.

Based on performance in past rate cycles, now should be an attractive time to buy US fixed income. Bearing in mind that rates may stay near their peak well into next year and the not-insignificant risk of a hard landing, the question for investors was what to buy.

Treasury yields have swung back and forth in the past month, while trending higher, and volatility seemed likely to persist, according to our portfolio managers. Meanwhile, credit has been fairly priced or expensive, prompting our bond teams to shed some individual bonds rather than increase their holdings. Although debt coverage and leverage ratios have held up well in investment grade corporate bonds and even improved in the high yield sector over the second quarter, spreads were more likely to widen than tighten, in our analysts' view.

Instead of Treasuries or credit, the solution to our US portfolio managers has been securitized debt. Agency mortgage-backed securities (MBS), for example, have offered high quality and attractive prices since the banking crisis in March. Asset-backed and commercial mortgage-backed securities are similarly high-quality investments, and moreover, spreads have hit their widest levels in years relative to corporate debt, our US team noted.

So far, the Fed's plan to pull inflation down to its 2% target appears to be on track, and the potential for fiscal support from recent legislation like the Inflation Reduction Act and the CHIPS Act could help sustain growth if and when the impact of 11 (or more) rate hikes finally kicks in, according to our US experts.

Reflecting the current strength in the US economy relative to other developed markets, the trade-weighted US dollar appreciated significantly over the past month.

Europe: Snowed Under

In sharp contrast to the United States, Europe was mired in softening economic data. In response, the European Commission cut its forecast for 2023 growth in the European Union to a slim 0.8% from 1% in its spring forecast, citing pressures from the war in Ukraine, inflation, rising interest rates, and recent natural disasters.[2]

With activity so subdued in the region but inflation slow to drop, the European Central Bank (ECB) faced a difficult decision at its meeting on 14 September; concern over inflation won out, resulting in a 25-bp rate hike. This increase—the ECB's 10th in a row—may come down hard on households in Europe, but the bond markets were unlikely to be fazed, in our global team's view. In fact, anticipating that the ECB, like the Fed, was nearing the end of its rate-hiking cycle, our European specialists had a generally positive outlook on fixed income and have started to take longer duration positioning in several countries.

In terms of specific opportunities, our portfolio managers found covered bonds attractive, but they were very selective in European credit. New issuance has been heavy and showed no signs of letting up soon. Although credit spreads have widened somewhat in response, the sector overall was still expensive in their view.

European Banks: Riding the Tailwind

Despite the weakening macroeconomic picture in Europe, banks logged their best earnings season since 2007 in the second quarter, according to our banking specialists. Even though loan growth had slowed to just 1.6% year over year as of July, net interest income rose 17%—meaning that interest rates on bank loans climbed faster than those on deposits. At the same time, loan losses were lower than expected, resulting in a net profit increase of about 28%, based on data from Goldman Sachs.

Seizing the day, banks have been actively issuing new bonds to replace funding from the ECB's pandemic-era Targeted Longer-Term Refinancing Operations (TLTRO), which is in the process of winding down, as well as other maturing debt. New issuance this year had reached €323 billion by early September, according to Morgan Stanley figures, and our bank analysts expected it to hit last year's level by the end of September.

Banks' performance has largely tracked earnings so far in 2023, with equity returns for Euro STOXX bank indices in an impressive range of 15%–18% through 7 September. Even after a full year of ECB rate hikes, bond returns were healthy overall at around 3%–4% for the same period, according to JP Morgan's European debt indices.

Our analysts noted one exception: AT1 debt. Still recovering from the "trauma" in March when Swiss regulators wiped out all $17 billion in Credit Suisse's AT1 securities during the takeover by UBS, returns were down 2.4%, as measured by Bloomberg's sector index. However, the total return on AT1s *after* that—between 31 March and 7 September—exceeded 5%, the highest return across the bank debt sector as well as the main fixed income segments in both Europe and the United States. The market for new AT1 business was also clearly open, with 7 offerings completed since March, our analysts noted.

Asia: Pockets of Opportunity

Like Europe, Asia offered pockets of value. India was an attractive risk-reward proposition in our global team's view, with the 10-year government bond yield as high as 7.2% on an unhedged basis. The country's bonds are widely expected to enter JP Morgan's emerging market bond indices and the Bloomberg Global Aggregate Index in the foreseeable future, according to our specialists, which should boost demand for India's bonds and strengthen the rupee.[3]

Another potential opportunity was found in Hong Kong. For the past couple of years, Hong Kong has been building out a CNY-denominated bond market—and yield curve—that could offer exposure to the region without the risk associated with onshore Chinese Government Bonds (CGBs), the global team noted. Hong Kong Government Bonds have generally been less liquid but are higher quality, with ratings in the double-A range, and in some cases, carry higher spreads than CGBs currently do, according to our experts.

The global bond team has also been closely watching developments in Japan. In mid-September, Bank of Japan (BoJ) Governor Kazuo Ueda unexpectedly commented on the potential for increasing the bank's reference rate, which prompted investors to drive the 10-year Japanese Government Bond yield to a nine-year high of 70 bps.[4] Although Ueda did not provide specific timing, he noted that the BoJ may have enough information by year-end to make a decision.

Emerging Markets: Green Shoots?

As in Europe, the overall mood in emerging markets has been far from upbeat, and Lazard's team has maintained very defensive positioning in its emerging markets debt portfolios.

China's sharp slowdown in the past few months has cast a shadow over the sector's recent performance, but perhaps more significant, it has negative implications for global growth—usually the main driver of emerging markets economies.

Overall, fundamentals in developing countries have improved to pre-COVID-19 levels, thanks mainly to investment grade countries, especially the Gulf states, our specialists noted. In the more vulnerable high yield segment, high debt levels and rising real rates in the developed markets have led to more defaults, and some 50% of high yield countries have turned to the International Monetary Fund for help, they added.

Despite the uncertain outlook, however, there have been several positive developments in emerging markets. Although spreads were on average around 50 bps tighter than fair value, according to our team, yields were attractive, and barring a hard landing in the global economy, emerging markets debt returns could reach double-digits over the next 12 months, by the team's estimate.

India's economy has remained the standout, but Indonesia, Brazil, and Mexico have also outperformed expectations this year, our analysts pointed out. The result is that the growth gap between emerging and developed markets, which widened to 3.8% last year, looks set to hold that level through this year and next.

Finally, China may be seeing light at the end of the tunnel. The government has taken almost non-stop incremental policy steps to help boost the economy, and our China specialists have started to see results.

Mortgage demand has stabilized, for example, which our analysts attributed to recent easing in requirements for borrowers.[5] Exports contracted less than expected in August, while credit data, too, came in better than forecast. And Purchasing Managers Indices (PMIs) appeared to be bottoming out, in the view of our emerging markets team. The central bank has also reduced banks' foreign currency reserve requirements to 4% from 6%, a small step in itself but highly significant to our analysts as an indicator that the bank plans to limit the yuan's weakness. Because the yuan's correlation to emerging markets currencies has been running high at 0.7%, they noted that the action also bodes well for all emerging markets currencies.

The Long View

China's bumpy journey this year is a tangible reminder of the profound economic impact of the COVID-19 pandemic. Though not as obvious, the uncertainty that permeates the global bond markets today may also be a lingering effect of the pandemic period.

While the view may be marred by this uncertainty, life at the "top" still has much to offer fixed income investors: Yields are relatively high, pockets of value can be found even in expensive sectors, and for active investors, opportunities are continually unfolding.

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 Source for all US Treasury bond yields is the US Treasury Department. Resource Center | U.S. Department of the Treasury

2 Source: European Commission, 11 September 2023. Summer 2023 Economic Forecast (europa.eu)

3 Source: Bloomberg, 16 August 2023. JPMorgan Index May Include India Bonds in 2024, Pictet Says - Bloomberg

4 Source: Nikkei Asia, 11 September 2023. Japan's 10-year bond yield hits highest since 2014 on Ueda remark - Nikkei Asia

5 Source: Bloomberg, 10 September 2023. China Shows Signs of Stability as Credit, Inflation Improve - Bloomberg

Important Information

Published on 19 September 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.

The Bloomberg Global Aggregate Bond Index provides a broad-based measure of global investment-grade fixed-income debt markets, including government-related debt, corporate debt, securitized debt, and global Treasury. The index is unmanaged and has no fees. One cannot invest directly in an index.

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