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.

Arrival Time

What a difference a month can make.

On 23 October, the US 10-year Treasury yield—the reference rate for financial valuations, US mortgages, and a range of other loans and bonds globally—crossed 5% to hit its highest level in 16 years,[1] and many bond investors were facing the possibility of losses in their portfolios for 2023. Just a few weeks later, the 10-year yield had plunged by some 60 basis points (bps) to 4.44% on 17 November, and the clouds had lifted.

Why the sudden turnabout? Almost every economic report and data release pointed to a cooldown in the US economy, from lower inflation to higher unemployment and fewer job openings. That, in turn, suggested that the Federal Reserve may have arrived at the end of its rate-hiking cycle—or at least, the end appears well within sight.

What that means for bond investors was the main topic when Lazard's fixed income professionals met this month. While speculation on when the Fed will start *cutting* rates has quickly ramped up in the bond market, our experts were more focused on the current scenario: Across sectors, many bonds likely offer enough yield now to "cushion" them from any further potential losses due to rising rates.

Put another way, after a year-and-a-half of Fed rate hikes and two years of losses, fixed income investors can finally look forward to a higher likelihood of positive returns, in our teams' view.

Emerging markets bonds from many higher quality issuers, for example, could withstand some 140 bps of rate increases from here and still offer positive return potential thanks to their ample yields, by our team's estimate. And in the Treasury bond market, the five-year real yield hit 2.50% recently—an impressive premium for what is regarded as a risk-free investment and an indication to our analysts of the myriad opportunities that may be found across the fixed income market.

The coast is not entirely clear. Usually implicit in falling inflation and a softening job market is slowing economic growth. Indeed, the euro zone has stalled, and a recession there appears likely,

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according to our specialists. In the United States, several signs have been pointing to a soft landing, but the risk of a bumpier one has also increased, in the view of our US fixed income team.

US: Focus on Fundamentals

It has been more than a year since the US yield curve inverted—often seen as a harbinger of recession—and forecasts for a downturn have ebbed and flowed over that time, leading to what our US experts called “recession fatigue.” In their view, however, the possibility of a recession not only still exists but has also risen lately due to tightening credit conditions. Specifically, they pointed to banks’ business loans, which have topped out in the past few months.[2]

Our US team also saw other signals typical of recessions in the past. First, the fed funds rate at 5.25%–5.50% now significantly exceeds the rate of inflation. Second, borrowing costs for regional banks have remained elevated, which normally leads to a curtailment in lending.

The Fed has effectively stepped back from the market since it started allowing its bond holdings to run off its balance sheet (quantitative tightening) and began raising interest rates in March 2022, our US analysts noted, and over that time, institutional investors have taken back the reins—albeit with less liquidity than in the past. As a result of this handoff, volatility has increased, but as our analysts put it, the relationship between risk and return has started “to make sense” again.

With institutional investors setting the tone, our US specialists are encouraged that the bond market appears to be returning to the normal conditions that existed prior to the interventions by the government and the Fed during the global financial crisis (GFC) in 2008. Ten-year US Treasury premiums are once again positive, and implied interest volatility has returned to levels of 100 bp or more per annum. Such an environment can create the opportunity for active management to add alpha because valuations on individual investments should disperse absent government support.

For investors, the return to pre-GFC market conditions along with the lingering possibility of recession mean that credit quality will be crucial in bond selection, according to our US analysts. In their view, the key to above-market returns in such an uncertain environment is choosing credits and securities carefully to “avoid mistakes”—lending to issuers that may not be able to withstand greater financial pressures.

Technical Troubles

Fundamentals were only half the story in the US bond market over the month: Technical factors also played a large role.

The Treasury auction of $24 billion in 30-year bonds in early November turned into the worst in recent memory, according to our US team. The auction came with a 5 bps “tail,” or the difference between the average and lowest yield in the auction, and even then, the primary dealers still had almost 25% of the bonds on their hands after the auction, compared with the long-term average of around 12%.[3]

What happened? Simply put, supply was about $1 billion higher than the previous 30-year auction, and demand was lower than expected.

Many investors seeking long maturities had already bought Treasuries a few weeks earlier when the 30-year yield was briefly higher than 5%, while some other potential buyers may have been scared off by the US government’s rising budget deficit and record debt level, according to our analysts. Non-US buyers have also been less involved in the Treasury market of late; China has reduced its holdings this year to their lowest level since 2009,[4] while demand from Japan has been fluctuating and is expected to decline as its central bank gradually “normalizes” interest rates there.

Another factor in the view of our specialists: Short-term Treasuries have been more attractive than the 30-year Treasury for many investors. The fear of higher rates and the increased duration of 30-year Treasury bonds can make them less appealing to risk-averse investors, particularly as year-end approaches. While long-end yields do provide the opportunity to lock in optically attractive yields, if rates were to sell off, the losses could be rather large. In contrast, short Treasuries 1) have lately had higher yields than long Treasuries, 2) have less duration and therefore less risk in a selloff, and 3) provide investors with the flexibility to roll into other curve points or asset classes when opportunities arise.

Until Treasury demand and supply are better matched, our US team plans to take a very cautious approach in the immediate aftermath of upcoming auctions. According to data from Morgan Stanley, Treasury issuance overall is slated to increase in the coming months: to $1 trillion for the rolling three months ending in February from $958 billion in the previous period and from $865 billion before that.

Global: Yield Plus Duration

In Europe, the macroeconomic picture was less open to interpretation than in the United States. Ten rate hikes from the European Central Bank (ECB) since mid-2022 have not only brought inflation below 3% but also reined in growth. In mid-November, the European Commission cut its forecast for 2023 GDP growth in the European Union to 0.6% from 0.8% with an uptick to 1.3% expected in 2024.[5]

While the news was hardly encouraging, the lack of growth has provided clear direction to our global bond team. ECB rate hikes are likely winding down—if they haven't ended already—and yield curves have re-steepened in the past few months, leading our portfolio managers to lengthen duration decisively across portfolios.

Turning to Asia, our global analysts were eyeing the potential for a similar dynamic in Australia. A large part of the yield curve there is steep in a number of key maturity buckets, or "normal," which means investors should be able to increase duration without giving up yield. They also found short-term bonds in Japan attractive—primarily as a substitute for the prohibitively expensive alternative of acquiring yen exposure via currency forwards. The yen has been steeply undervalued recently—by around 2.6 standard deviations (SD) based on our team's calculations—leading our specialists to wonder whether the Bank of Japan would help stabilize the currency with more policy moves soon.

Elsewhere, Chile was attractive once again to our global team, and in the United States, some municipal bonds, 5-year Treasury Inflation-Protected Securities (TIPS), and 30-year Treasuries were also appealing recently.

On the currency side, exposure to the Indian rupee held promise, in the team's view, with attractive yields and the impending addition of India's bonds to JP Morgan's widely tracked emerging markets bond indices next year. The team held fast to its underweighting of the yuan as China's economy has remained slow to reignite.

Emerging Markets: Sigh of Relief

The quick turnaround in US yields over the last month was more than welcome in emerging markets.

Dollar-denominated bonds bounced back from their historically wide valuations last month as investors swooped in to take advantage of their high yields. By mid-November, yields averaged around 6% for investment grade bonds and were in a range above 9% for the asset class as a whole.[6]

As in the United States, quality was paramount to our team. Though eager to harvest yield to increase return potential, our portfolio managers were cognizant of the left-tail risks, including the potential for a global growth slowdown or a shock that could exert pressure on weaker sovereigns and corporates. Only last month the sharp rise in Treasury yields had made borrowing in dollars too costly for many lower-rated issuers—threatening their ability to refinance debt.

Bonds denominated in local currencies were already faring much better this year than dollar-denominated debt, notably in Latin America, and the plunge in US yields was icing on the cake.

Having raised rates well ahead of most developed economies, many emerging markets central banks have started to ease monetary policy. Our analysts favored countries where inflation was falling and central banks were likely to reduce rates with care, especially with the Fed so far inclined to hold its policy rate "higher for longer."

Brazil was one example: Inflation has dropped to 3.8%, and the central bank has cut rates in 50 bps increments so far. Real yields in Brazil have exceeded 600 bps lately, according to our specialists; real yields were not far behind in Mexico and were also attractive in South Africa, in the team's view.

Emerging Markets Currencies: A Weight Off

The turn in US Treasury yields is also expected to boost emerging markets currencies by weakening the US dollar over the next few months, according to our analysts.

In general, the dollar has been driven less by its status as a "safe-haven" reserve currency lately and has moved much more in sync with yields—softening as US yields fall and strengthening as they rise—a trend that our team expects to continue.

At the same time, many emerging markets currencies have been strong in their own right thanks to attractive real yields and generally cautious moves in rates—whether up or down—by their central banks, our team observed. In October, for example, currencies in Latin America showed surprising resilience, our analysts noted, with modest positive returns despite the obstacles of a strong dollar, rising US yields, sizzling US GDP growth, the onset of war between Israel and Hamas, and a sudden increase in energy prices.

Brazil, Mexico, and Colombia have been top performers, and our analysts expected that to continue in the months ahead. The team also saw potential opportunities in the currencies of Indonesia, South Africa, and Uruguay—a frontier country that has become active in the green economy and taken steps to be more investor friendly.

Overall, our currency team's outlook for emerging markets over the next 6–12 months is bright. They expected a growth rebound in China and the start of rate cuts from the Fed as economic activity slows there, likely keeping a wide growth differential of around 300 bps between emerging and developed economies. This would be a helpful backdrop for emerging markets in general, our team noted, and for currencies such as the Chinese yuan, the Thai baht, and the Korean won specifically.

Increased Treasury supply was a concern to the currency team, however, since it could push US yields higher. And as always, our analysts were closely watching global growth, which has historically been the main driver of emerging markets economies.
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Turning the Corner

The outlook for fixed income has finally brightened over the past month. The chances of more central bank rate hikes in the United States and Europe have dropped significantly, which means that the potential for losses on bonds due to rising rates has also diminished, in the view of our fixed income professionals.

For investors who stay focused on credit quality and understanding the risks, our bond teams see a land of opportunity.

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] 14 November 2023, Treasury Yields Fall as Soft CPI Boosts View Fed Done Raising Rates - Bloomberg Treasury yields in this Viewpoints are sourced from Bloomberg.

[2] St. Louis Federal Reserve, 9 November 2023. Commercial and Industrial Loans, All Commercial Banks (BUSLOANS) | FRED | St. Louis Fed (stlouisfed.org).

[3] Barron's, 9 November 2023. 30-Year Treasury Auction Breaks Bad, Sinks Stock Market - Barrons.

[4] China Treasuries lowest since 2009, 19 October 2023. Bloomberg. Watch China Sells Most US Treasuries, Stocks in Four Years - Bloomberg.

[5] Financial Times. FT—15 November. European Commission cuts growth forecast: European Commission cuts growth forecasts after 'challenging year'.

[6] Yields as of 20 November 2023 based on JP Morgan Emerging Market Bond Index Global (EMBIG) Investment Grade and JP Morgan EMBIG Diversified.

Important Information

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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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