

Global fixed income: the struggle to decouple

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We have struggled throughout the year to decouple short-term interest rate expectations from moves in global energy markets and this month has been no different.

Authors

The last month has been a difficult one for fixed income markets. A potent cocktail for weakness in global bonds has been created by the recent upward move in energy prices, coupled with comments from several central banks.

These comments came most notably from US Federal Reserve (Fed) chair Kevin Warsh at the Jackson Hole symposium, but also subsequently from the Bank of Canada, the Reserve Bank of Australia and the European Central Bank (ECB) – all suggesting their patience for above-target inflation is reaching its limit. The impact has been most acute at the short end of the yield curve (0-5 years) that are most directly linked to central bank policy action.

It is clear the persistence of the inflation shock and the growing intolerance towards it from policymakers has shifted bond markets in a more hawkish direction. With this in mind, we have increased our probabilities of our "too hot" scenario - where the Fed raises rates 3+ times – to 35% this month. Our modal outcome is our "warming up" scenario (now 50%) - a more modest adjustment with a couple of hikes from the Fed, and we significantly downgrade the chances of the Fed not tightening at all – in our parlance, "just right" - to 15%.

Our scenarios – reflecting a warmer macro backdrop

We are of the view that moderate tightening is needed by the Fed. We don't see the inflation problem as out of control - the overshoot is modest, wages remain benign, and broadly inflation expectations remain well-anchored - but we think some restriction is merited to curb demand. The Fed delivered the 16 September rate hike we and the market expected, given latest inflation data.

All else equal, an engaged central bank dealing with the inflation problem is relatively positive for longer-dated bonds as inflation-fighting credibility is restored. However, this comes at the expense of higher shorter maturity yields. The yield curve has flattened aggressively in recent weeks as the odds of Fed tightening have increased, and while tactically a pause from this fierce move wouldn't be a surprise, we believe strategically this global flattening trend has legs.

Outside of the US, the main story has been the sharp repricing higher of energy prices, and this has shown up no more starkly than in European fixed income markets. It has been by far the dominant factor in the recent repricing higher of UK, German and other eurozone markets.

We are turning more cautious on European growth as a result. Although we don't believe the outlook is catastrophic, higher energy prices will hurt both the manufacturing sector and consumer real incomes if they remain at these elevated levels.

This weaker growth outlook, in combination with a market pricing a further three hikes for the ECB from here (having already delivered two), means that strategically eurozone bond valuations are now

beginning to look attractive. But this has been a falling-knife market. Unless and until we see some stability - as the bare minimum- or a clear peak in energy prices, it is hard to call a short-term top in eurozone yields.

In other words, having largely avoided them in recent months, German Bunds are back on our radar but we're not quite ready to pull the trigger yet. On the other hand, we remain cautious on the UK and have downgraded gilts to negative. The Bank of England has maintained a dovish disposition, given the lack of second round effects, but this feels increasingly vulnerable to the same bout of energy shock intolerance we are witnessing from its peers.

Turning to asset allocation, we have struggled with corporate bond valuations for a number of months. By almost any metric, credit spreads (the premium paid to investors to take additional credit risk) are tight. Very tight. But with a positive macro backdrop, we maintained a neutral stance despite these unattractive valuations. However, with signs the macro backdrop, especially in Europe, may become more difficult due to tighter monetary policy and the energy impact on real incomes, we believe it is now appropriate to downgrade corporate bonds globally - both investment grade and high-yield – to negative.

We remain more positive on emerging market hard currency bonds, especially Hungary, while also seeing opportunities in US agency mortgage-backed securities.

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