JULY 2024

QUARTERLY FIXED INCOME OUTLOOK
Q3 2024

ECONOMIC OUTLOOK

Global

The second quarter saw a mixture of news on inflation, with some instances of headline rates unexpectedly rising, and leading to markets reassessing the potential and timetable for rate cuts ahead. Core inflation rates have tended to continue to ease, but frequently, at a more gradual rate. Data on economic growth remains mostly modest, with many leading indicators appearing to flatten or even decline slightly. Few are indicating any significantly acceleration in activity is imminent. There was a raft of elections in some key emerging markets and anticipation of what the outcomes may bring in France, the UK, and to some extent, the US in November.

US

Some key forward-looking indicators of the US economy showed signs of a moderation in activity. Though the Institute of Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) initially rose above 50 for the first time since late 2022, it slipped back below that level later. Meanwhile, the labour market remained robust, adding more than 750,000 new jobs in the period. Inflation data was mixed. Headline inflation rose to 3.3% but the core rate continued to ease lower, reaching 3.4%, The Personal Consumption Expenditure Price Index, the Fed's preferred inflation measure, followed a similar trend to headline CPI, rising slightly overall. The Michigan Consumer Sentiment index showed that confidence fell back in each of the three months. There was no change of interest rate policy from the Fed and the window of opportunity for the policymakers to act before the elections in November is narrowing.

Eurozone

The European Central Bank (ECB) reduced rates by 0.25% in June, in what was a widely anticipated move, taking the refinancing rate to 4.25%. The ECB also later signalled that further rate reductions will be dependent on the path of economic data. This was despite headline inflation becoming stuck around 2.5% and the core measure risen slightly, back to 2.9%. GDP growth was 0.3% for Q1 2024 and some of the key forward-looking indicators have been improving. The ZEW Economic Sentiment Index has continued to climb, reaching 51.3, its highest level for three years. However, not all indicators have been showing the same positive picture. Beyond the economic and monetary policy concerns, political volatility has increased in the region, which may indicate a potentially turbulent period ahead.

UK

The UK was the first major developed economy to see inflation rate fall back to the central bank's target rate, reaching 2.0% at the headline level. Core inflation also continued to decline, reaching 3.5%. However, wage growth remains around 6% year-on-year. The Bank of England kept rates unchanged at 5.25% throughout the quarter, but the market now believes there will be a cut at the next policy meeting on 1 August. The UK economy grew by 0.6% in Q1 2024, rebounding from its short-lived recession in 2023. The GfK Consumer Confidence Barometer continued to improve slowly. The move came despite there being a sharp increase in the number of people claiming unemployment benefit in May.

Emerging markets (EM)

China's economic growth was surprisingly stronger in Q1, driven by the external sector but domestic demand has remained below trend and the drag from the property sector and weakening household and business confidence remain key issues. Prices for newly build house declined -3.9% year-on-year according to the National Bureau of Statistics of China, while inflation has been stable at 0.3% recently. The People's Bank of China retained the one-year and five-year Loan Prime rates at 3.45% and 3.95% respectively. In other emerging markets, Brazil's central bank eased policy by a further 0.25%, although the inflation rate stalled just below 4%. Elsewhere, elections dominated. In India, Prime Minister Narendra Modi secured another term, but without an outright majority for his BJP party alone. Claudia Sheinbaum will succeed of President Andres Manuel Lopez Obrador, in Mexico in October. The central bank retained interest rates at 11.0%. The African National Congress lost its majority for the first time in 30 years in South Africa and will now have to govern in coalition. Turkey's inflation rate continued to creep higher, reaching 75%, but the central bank kept rates steady at 50%.

ASSET CLASS OUTLOOK

Investment grade credit

Although spreads have tightened back to long-term average levels, investment grade credit continues to offer yields comparable to the long-term returns associated with equity markets. The risk of a US recession appears to have receded, and the economic outlook appears benign, with activity accelerating from subdued levels and interest rate cuts on the horizon. This leaves us constructive on the asset class despite the level of spreads, and we would seek to add to exposures on any material spread weakness. We are observing increasing levels of demand from institutional and retail investors looking to lock in absolute yields, and this is creating a positive environment for issuance in the H1 2024. Cross market opportunities also remain, and we believe European markets offer greater value.

High yield credit

Global high yield continues to benefit from a strong technical backdrop. Supply is dominated by refinancing activity, but demand from investors seeking to lock in high absolute yields is stronger. Inflows to the asset class are being bolstered by reinvestment of principal payments from called bonds and high coupons. With the first rate cut occurring in the eurozone, and the Fed expected to follow later in 2024, we believe investor demand is likely to remain strong, from both institutional and retail investors. At the same time, a combination of resilient growth, better than expected earnings, and improved capital market access mean defaults are running at lower levels than anticipated and we see no material signs of stress in the wider market. Many companies we invest in are continuing to address 2025 and 2026 maturities and extending their capital structure, providing opportunities to invest in higher coupon issues.

Emerging market debt

There are no major changes to our macro views. Investment grade credit continues to be affected by poor valuations, but even though spreads have widened recently, the move has not been sufficient to change our viewpoint. High yield sovereigns appear to offer more value, but the opportunities there are currently more idiosyncratic, in a number of concentrated distressed issuers, such as Ghana, Ecuador and Argentina. Local currency markets appear to offer more opportunity following the recent increase in yields. In this part of the market, there has also been some idiosyncratic moves, arising from the effects of recent elections in South Africa and Mexico. We view EM corporates positively as we believe they still offer attractive value in general, with a preference for high yield over investment grade where, as in developed markets, valuations appear quite tight. In currencies, we have a small preference for EM over the USD.

Structured credit / Secured finance

So far, 2024 has performed as we expected, with strong investment returns for secured/structured markets, driven by spread tightening but also healthy levels of income. At this stage, we see the theme of strong income continuing over the rest of the year. Resilient growth, still tight labour markets and an expectation of lower interest rates ahead, continue to provide a strong backdrop. Robust demand for the asset class combined with tighter spreads is encouraging issuers to come back to the market and we see that many deals are oversubscribed, even for lower grade tranches. With spreads still wide relative to similarly rated corporate credits we expect demand to remain high. We continue to favour issues with seniority in the capital structure and robust transaction structures that divert cashflow in the event of underperformance, and strong underwriting and servicing policies, all of which have the ability to insulate investors if the economy weakens. We are seeing the market at the historical tights for several sectors but the relative value versus corporate equivalents remains attractive in our view, so we believe that valuations are likely to be well supported even if the likelihood of meaningful tightening has diminished. Best performing assets continue to be those generally in the bottom part of the IG capital structure as tranches are heavily oversubscribed by investors targeting short dated high-quality yield.

Municipal bonds

Although the Fed has pushed back the expected start of the easing cycle, with rate cuts remaining on the horizon, we believe this will provide an anchor for municipal bond markets. We expect inflows to accelerate once the easing cycle starts, as investors move quickly to lock in rates. From a sector perspective we maintain a bias toward essential service revenue bonds (water/sewerage, electric utilities) that we believe offer attractive yields and with solid credit fundamentals. Against this, we are underweight state and local general obligation (GO) issues, which tend to trade at tighter spreads, but where revenues are more vulnerable to a slowdown in growth. Opportunities in sectors such as airports and toll roads remain. Idiosyncratic buying opportunities across all sectors and quality ranges mean there is plenty of scope to add value via stock selection. Given the shape of the yield curve, we believe maturities beyond 10-years should offer a favourable income and return profile in a declining rate environment.

Currencies

In currencies, the USD may be poised for a decline in the short term but approaching the US election, market volatility is likely to increase. The outlook for rate cuts is reasonable but not yet obvious. This environment will challenge a hypothesis of a weaker USD. However, we continue to favour a lower USD against the JPY. We believe the Bank of Japan and the country's Ministry of Finance would prefer to have a stronger yen, as that will help keep inflation under control. However, they would like to avoid having to increase rates too quickly, as that will increase the cost of debt, which is large as a proportion of GDP. Additionally, there are opportunities in non-USD crosses, such as the NOK versus the SEK. The Norges Bank has been clear about the need for a stronger currency to combat inflation, while the Riksbank is cutting rates and is less concerned about currency weakness. To us, this divergence creates a compelling trade.

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