Vontobel

Fixed Income Quarterly

Very balanced.
Very buoyant.
Very bold.

September 2024

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Fixed income steadies its footing

Dear readers,

Welcome to the first edition of the Vontobel Fixed Income Quarterly, a publication launched to guide investors through the waves of information and market developments that break upon us each quarter. In the same way that surfers do, investors too must continually assess a multitude of factors to find their footing amid ever-changing conditions. Purposely published off-cycle to allow time and space for contemplation, the Vontobel Fixed Income Quarterly ("Quarterly") aims to deliver easy-to-digest yet detailed insights into this asset class.

What can you expect in each edition? Our Fixed Income experts will address pertinent topics and explain what's driving risk appetite and assessments of relative value across the fixed income universe. Vontobel's Chief Economist Reto Cueni will also weigh in on the discussion, providing macro-level analysis and insight. And, like any evaluation worth its salt, our Quarterly will engage in an open discussion of the risks and challenges at hand. Should this frank debate appear too salty or cautious at times, do not be dismayed—in addition to my British humor, a keen eye for risk management is part and parcel of my role at the helm of Fixed Income and one of the hallmarks of good active management.

A return to normal?
As I write this editorial, I'm struck by the timing: it's hard to imagine a more striking contrast in the fortunes of fixed income as an asset class than that between the last quarter and the infamous period in 2022. As our slightly tongue-in-cheek cover title indicates, if fixed income was on TikTok, our hashtag could be "Very balanced. Very buoyant. Very bold" right now. That said, a furore did sweep through broader markets this July and early August, and though fixed income appears to have avoided the worst of it, several subsurface currents receive the attention they deserve in the pages to come.

One of our commitments with this Quarterly is to cut out the jargon and explain things simply. So, let's take a step back to explain that fixed income commentators typically only discuss the following three factors: credit, rates, and the relationship between the two. This is reflected in our publication, with a strong focus on credit and a special section dedicated to rates. While the third element can remain relatively unnoticed by many for large periods of time, it is not to be forgotten. Indeed, this relationship between credit and rates was instrumental in delivering fixed income's cataclysmic performance in 2022.

That year began with an unusual situation: credit spreads were at historically tight levels and rates across most major economies were at record lows, which made it unlikely that one factor could dampen increases of the other. This scenario has been described by some as the largest financial experiment in history; and it's hardly surprising that the comedown across fixed income has been so severe these last two years.

Key takeaways

1. The volatility seen in August is likely to be repeated.
2. Rate cuts by the US Federal Reserve will make cash and money markets less attractive.
3. Credit and rates are now likely negatively correlated.
4. Emerging market spreads currently have more value than developed market spreads.
5. Economic weakness in developed markets is likely insufficient to cause a default cycle.

By this June, however, fixed income appeared to have returned to a more "normal" footing. In such times it can be assumed that:

When the economy does badly:
– credit spreads should rise, signifying an increased likelihood that borrowers will default; and
– base rates should fall, signifying support from central banks for the economy and growth.

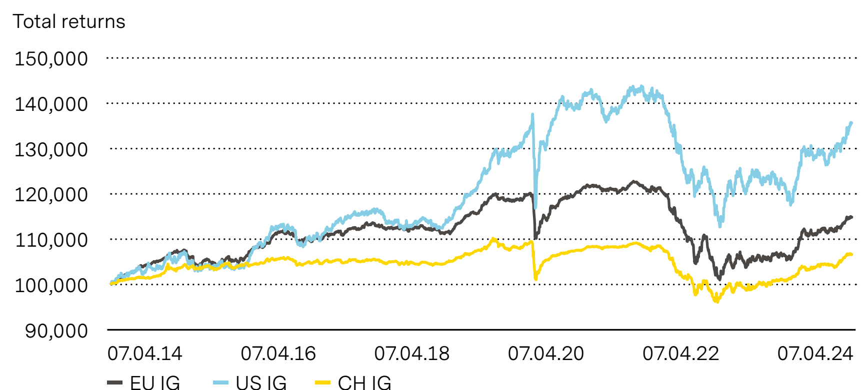
When the economy does well:
– credit spreads should tighten, signifying a decreased likelihood that borrowers will default; and
– base rates should rise, signifying attempts by central banks to avoid overheating and inflation.

This explains how, under "normal" conditions, a negative correlation between rates and credit is created. Or, at a minimum, a dampening effect of one on the other occurs amid "normal" changes in regime. This effect is hardly perceptible over short periods but was well illustrated during the Covid crisis in 2020.

Strangely, it has been so long since fixed income was in its "normal" state that many participants now perceive conditions under the global zero interest-rate policy (ZIRP) regime that dominated the last decade and a half as "normal". Readers, let me remind you that they are not. Base rates for developed economies are not "normally" zero. Inflation is not "normally" zero. And fixed income is not "normally" sold based purely on return.

Chart 1: Historical total returns of the fixed income asset class

Total returns

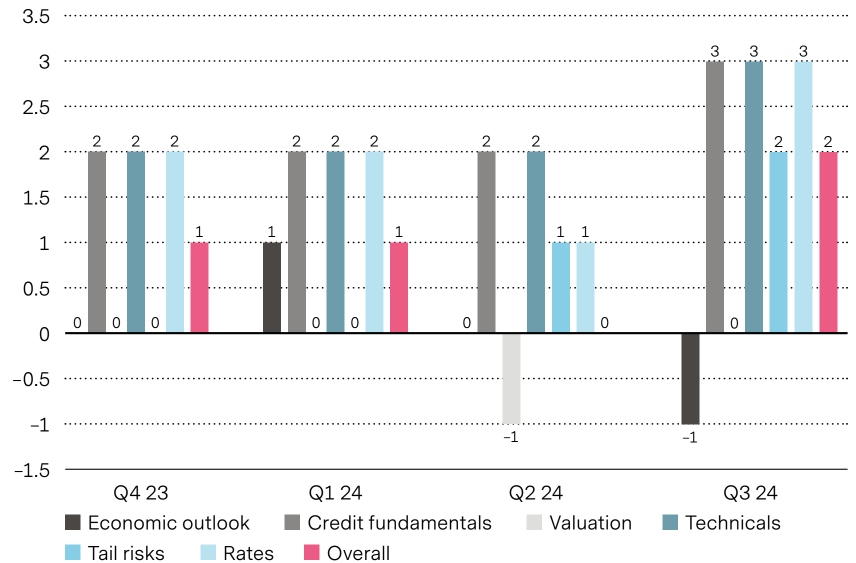


Source: Bloomberg and Vontobel, as of August 31, 2024.

An eye on the horizon
Having weathered the rough swells of the past two years (see Chart 1), I am delighted to tell you that we are pretty bullish about fixed income as an asset class right now. Our optimism is predicated on three fundamental tenets: fixed income's attractive return opportunities; our belief that the asset class is well positioned to navigate future tests, of which we expect several more; and our belief that, having refound its footing, fixed income is once again capable of providing the much-needed diversification from other, perhaps sexier, asset classes that it failed to deliver in 2022.

The pages that follow add more color to my optimistic statements, and I hope you enjoy reading them. Chart 2 shows the evolution of our recent risk appetite view; and the "scorecard" provides a snapshot of the evolution of our aggregate top-down view of fixed income as an asset class, with more detailed parameterization to be provided in coming quarters. In the meantime, we welcome all feedback on this new publication, which we plan to extend over time. In closing, I hope our new Quarterly becomes your go-to source for analysis of the most pertinent themes and market developments in the world of fixed income.

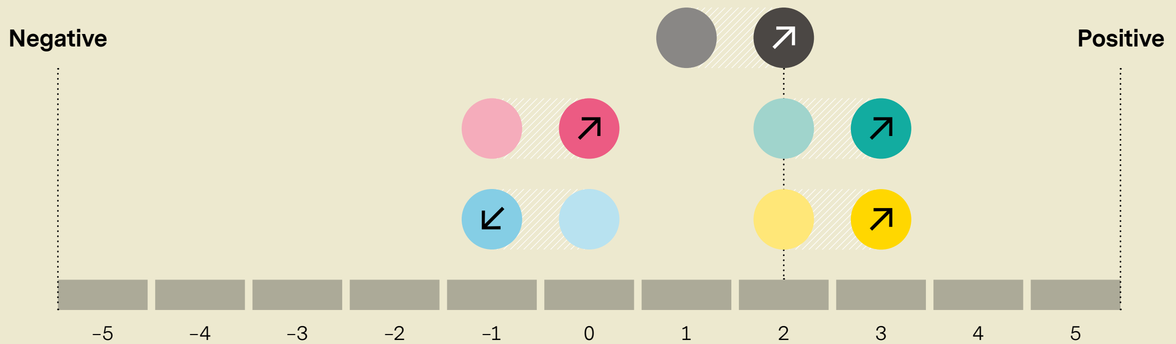
Chart 2: The evolution of Vontobel's risk appetite view on fixed income



Source: Vontobel, as of August 31, 2024.

—
Andrew Jackson
Head of Fixed Income,
Vontobel

Scorecard



Source: Vontobel, August 31, 2024.

Economic outlook

Move to –1 from 0

The latest US figures have increased the probability of a US hard landing, although the probability of a soft landing is still greater than fifty percent in the US and other economies show lower probabilities of hitting macro-economic road bumps.

Credit fundamentals

Move to 3 from 2

Despite the interest coverage ratio headwinds, corporates have continued to deliver strong results and an ability to refinance their debt. Leverage levels and debt maturity walls look historically very positive for this point in a cycle.

Valuations

Move to 0 from –1

Credit spreads have tightened rapidly post the August sell-off. Most credit spreads are back inside historical averages and close to near term highs. The exception is within emerging markets and banks where credit spreads still offer good value.

Technicals

Move to 3 from 2

Fixed income technicals look robust and are likely to be further supported by shifts in market participant allocations away from cash and money market instruments as rates decline.

Tail risks

Move to 2 from 1

August's wash out has materially reduced tail risks as investors have noticed once again that risk assets can indeed have risk. The establishment of the negative correlation between rates and credit further reduces the medium-term tail risks in fixed income. Tail risks remain in terms of geopolitics and equity valuations.

All eyes are focused on the rates horizon

With growth rates varying across key economic regions, investors are observing how the changing tides in the US labor market and the actions of central banks will impact the economic swell.

Reto Cueni, PhD
Chief Economist,
Vontobel

Daniel Karnaus
Portfolio Manager,
Fixed Income,
Vontobel

Key global economic regions are growing at varying speeds, with Europe, and particularly Germany, slowly recovering from a phase of significant weakness that started late 2022, China muddling through a recovery, and the US boasting 3 percent (annualized) GDP growth in the second quarter. This disparity is mirrored in our global interest rate outlook. There have been significant differences in the timing of central banks' rate cuts: the Swiss National Bank (SNB) initiated cuts in March, followed by Sweden's Riksbank in May, and the Canadian and the European Central Bank (ECB) in June; the US Federal Reserve (the Fed) is only now seriously considering its first rate cut, while the Japanese Central Bank (BOJ) has actually increased interest rates.

Japan's rate hike and its effect on currency markets and the so-called yen-carry-trade, coupled with weaker-than-anticipated US labor market and industrial production data, rattled financial markets in August. Consequently, rate cuts in the US are now widely expected by the end of 2024. Several Federal Reserve committee members already pushed for a July rate cut, according to Fed minutes. However, a significant market downturn was needed to convince Chair Jerome Powell, who stated at the Jackson Hole symposium in late August "The time has come for policy to adjust". His following remark, "We do not seek or welcome further cooling in labor market conditions," signals a shift towards normalizing monetary policy, not just easing restrictions like the ECB.

75

The number of basis points it's estimated the Fed will cut this year.

For the first time in six months, the market is forecasting more US rates cuts than we are: while we predict three cuts by year-end, the market expects four. We believe a significant slowdown in US economic growth in the new year, driven by a weaker labor market affecting consumer sentiment, will prompt the Fed to further lower key rates. We project interest rates will decline to 3.5 percent by summer 2025, implying another four additional cuts. However, before the labor market could show a more significant increase in unemployment, it first had to transition from excessive job growth post-Covid lockdowns to a balanced job-to-applicant ratio, which we believe occurred in the third quarter, as shown in Chart 1.

However, if we witness a harsh deterioration of the economic situation in the US and the Fed cuts rates more than currently anticipated to stave off a severe slowdown, bond markets are likely to rally, even if it's too late to avert a recession, as shown in Chart 2.

Across the Atlantic, the Eurozone's economic growth was notably more subdued than the US in 2023 and the first half of 2024, due to the energy shock and uncertainties triggered by the Russian invasion, and weak demand from China. Thus, it was not surprising when the ECB eased its policy rates by 25 basis points in June, well ahead of the Fed's yet to be announced rate cut, despite stronger-than-expected wage growth in the first quarter.

This slight decoupling of the ECB's interest rate policy from the US interest rate trajectory is likely to persist for the rest of the year, albeit with different signs. We anticipate the ECB will continue to gradually ease its monetary policy in both September and December, primarily based on the ECB's tracker predicting a decrease in wage pressure next year.

We believe the ECB will not see a need to adjust key interest rates this year beyond a gradual easing of its currently contractionary policy stance, given its slightly raised inflation expectations in recent forecasts. Only in the new year, with the anticipated economic slowdown and decreasing inflation pressure, do we foresee room for further rate cuts towards 2.75 to 2.5 percent. Conversely, the Fed is likely to "normalize" its key interest rates later but more significantly, narrowing the difference in key rates. This aligns with our expectations of converging growth rates between the US and EU economies.

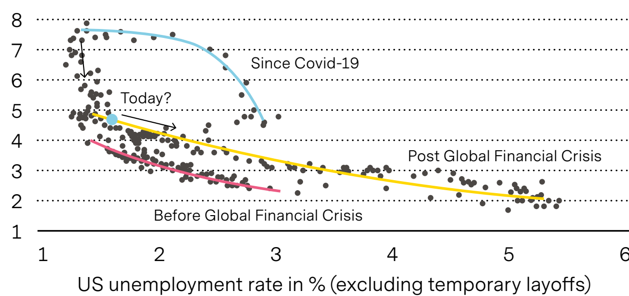
In Switzerland, following the SNB's second key interest rate cut in June, another decrease is likely in September. Despite the first cut, the franc has gained strength, even without further ECB rate cuts. Increased political uncertainty and ongoing growth weakness are bolstering the franc against the euro. Additionally, leading indicators like the Purchasing Managers' Index (PMI) and the Swiss Business Cycle Index of the Swiss Economic Institute (the KOF index) continued to decline, and inflation was weaker than expected. Overall, the SNB is likely to reach its provisional terminal rate in September.

Even more decoupled from US monetary policy than the ECB, the BOJ seized the opportunity in March to end the phase of negative interest rates—becoming the last central bank in the world to do so—due to unexpectedly high wage settlements at leading companies ("shunto"). Despite a foreseeable less restrictive US monetary policy, the BOJ doubled down with another 15 basis point rate hike in July. Unlike its first rate hike in March, the BOJ appeared hawkish, stating that if the outlook for economic activity and prices presented in the July Outlook Report materializes, it will continue to raise the policy interest rate and adjust the degree of monetary accommodation. Since the wage settlements ("shunto") mentioned above turned out significantly higher than last year, we see good chances of Japanese inflation solidifying next year. We therefore consider a further rate hike in December to 0.5 percent very likely.

Converging but still asynchronous growth in the global economy and macro volatility is increasing price volatility in the bond markets and thus in interest rates. Major central banks also appear torn between significantly lower inflation, increasingly weaker growth in the US but relatively robust labor markets, and the weak effects (so far) of higher interest rates on the real economy. However, the recent market corrections due to weaker US economic data suggest that bonds in particular could benefit from the tense and probably too rosy-looking stock market this year.

Chart 1: The US labor market is approaching an important pivot point

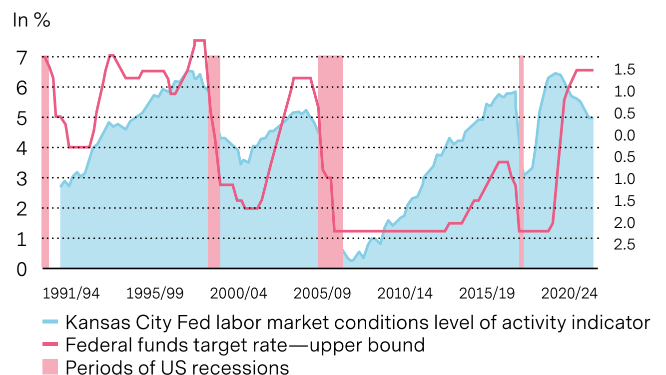
US job opening rate in % (1 month lag)



Source: BLS, LSEG, Vontobel, as of September 6, 2024.

Chart 2: Labor market conditions suggest a less restrictive stance from the Fed

In %



Upgrades and high yields drive surging demand for credit

Strong fundamentals, improving credit quality, and a surging appetite for both investment grade and high yield across the asset class.

Investment grade

—
Mondher Bettaieb-Loriot
Head of Corporate Bonds,
Portfolio Manager,
Vontobel

—
Christian Hantel
Portfolio Manager,
Global Corporate Bonds,
Vontobel

3.5 ×

Average subscription rates for new IG corporate bonds.

Global investment grade (IG) credit has been enjoying a strong improvement in credit quality, in particular since the 2023 fiscal year. Post-Covid, the appetite for large M&A transactions has been muted. Many companies have been prudent about spending their high cash balances, focusing more on improving their credit metrics, such as leverage or interest coverage. Rating agencies have honored this effort with a number of upgrades across bond types, particularly within IG. This trend has continued in 2024 and is expected to result in several additional rating upgrades in future quarters.

Chart 1 illustrates the rating upgrades within the IG category (from BBB to A), with a split by financials and non-financials. With fewer BBB-rated companies, the credit quality of IG indices has improved. This favorable credit trend reduces the likelihood of downgrades and improves the quality of underlying investments in corporate bonds.

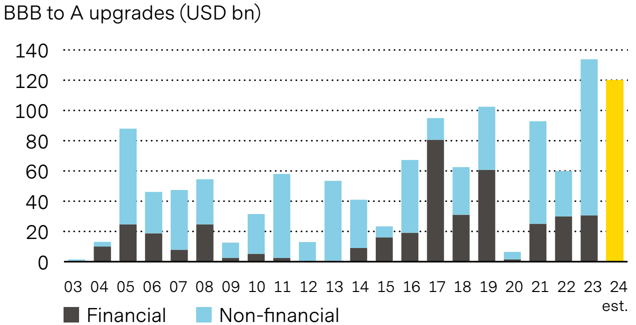
Looking closer at the reporting season for the first half of 2024, this positive momentum has been broadly confirmed: Most S&P 500 companies, as a proxy for US IG, have exceeded earnings estimates, driven by solid profit margins. Only a few companies have disappointed during the reporting season so far or guided for a weaker outlook, a good reminder that name selection remains key when picking issuers and bonds in IG.

On top of solid fundamentals, IG corporate bond investors are also benefiting from attractive yields and good recent returns in fixed income. European IG corporate bonds, for instance, are yielding around 4 percent – significantly more than in the past decade. This increase has attracted strong demand year-to-date, as investors recognize the benefits of higher government yields and attractive credit spreads, resulting in greater long-term income. Historically, credit spread fluctuations have had minimal impact on long-term returns, making coupon income a key driver of steady returns.

An illustrative example can be seen in recent senior preferred bonds issued by one major European bank, where their coupons have increased to just over 4.0 percent for a medium-term maturity, compared to coupons of around 1 percent for bonds brought to market in the period 2018 – 2020. This represents a major step-up.

It is therefore no surprise that in 2024 investor appetite has surged, with new IG corporate bonds seeing average subscription rates of 3.5 times. The overall market environment remains very carry-friendly, with solid corporate credit fundamentals and refinancing risks abating as companies successfully push out maturities. Default rates are likely to finish in the lower forecast range for this year.

Chart 1: BBB to A upgrades reached record highs
BBB to A upgrades (USD bn)



Source: Barclays, Vontobel, June 30, 2024.

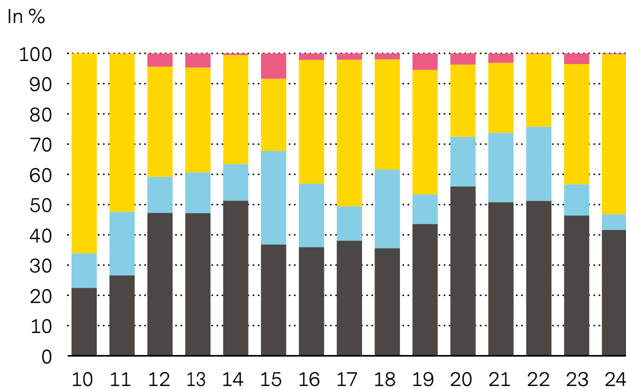
High yield

—
Stella Ma
Portfolio Manager,
Global High Yield,
Vontobel

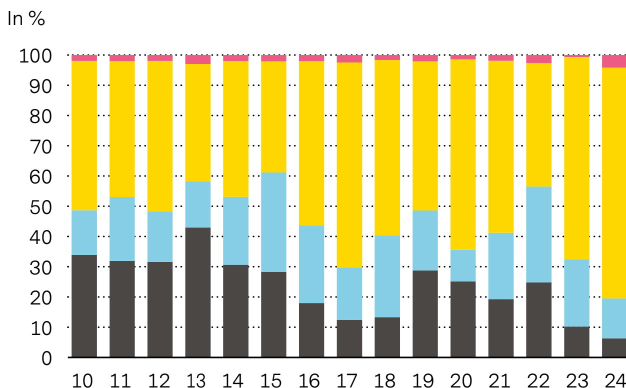
High yield (HY) investors are benefiting from positive technicals in the asset class, which we expect to continue in the next few quarters. The face value of the US HY market shrank from USD 1.5 trillion to USD 1.3 trillion and the European HY market shrank from EUR 610 billion to EUR 490 billion over the last two years due to low primary issuance. This relative scarcity of bonds, coupled with stable demand in the asset class, provides a positive backdrop for HY bonds. In addition, higher all-in yields have incentivized companies to refinance debt using alternative financial instruments, or more simply, with cash on the balance sheet. New issues in the asset class this year saw healthy demand with the oversubscription ratio in the 4 to 5 times ballpark for high yield companies. This ability to refinance and push out debt maturities provides both fundamental and technical support to the asset class.

Chart 2: Issuance has a heavy skew towards refinancing, away from M&A and recapitalization

EUR HY UoP
In %



USD HY UoP
In %



General corporate purposes
Refinancing
M&A
Recapitalization

Source: Goldman Sachs, Vontobel as of July 31, 2024.

Issuers within global HY are proactively addressing the maturity walls in 2025 and 2026. This is most evident when we look at the mix of primary issuance year-to-date in 2024, where a significant portion of the primary issuance has been used for refinancing rather than for releveraging transactions such as M&A and recapitalizations. Chart 2 illustrates the mix of proceeds over time in the US and Europe. In the USD HY market, over 73 percent of issuance year-to-date has been earmarked for refinancing, the highest share on record, and a strong indicator that USD HY issuers are actively managing their maturity walls as opposed to releveraging their balance sheets. Similarly, the share of EUR HY issuance earmarked for M&A or recapitalizations is at its all-time lowest level so far this year.

Last 12-month default rates are running at 1.8 percent for US HY and 2.6 percent for European HY bonds, respectively. We expect default rates to remain low over the next 12 months for the following reasons:

1. HY companies are actively addressing the 2025 and 2026 maturity wall.
2. The average credit fundamentals of HY companies remain solid even though dispersions are increasing.
3. The overall credit quality of the HY market in terms of ratings profile has improved over time. The BB segment currently contributes to 58 percent of the global HY universe, up from 48 percent a decade ago. The single B and CCC segments have shrunk in relative terms.

CH bonds

—
Gregor Kapferer
Portfolio Manager, CHF Bonds,
Vontobel

After a quiet Northern Hemisphere summer, we expect an increase in new issuance and secondary market activity in the Swiss bond market as domestic and foreign issuers from various sectors become active. Despite the lull, the market showed strong performance in July and August, with a 1.51 percent return. Yields on 10-year Swiss government bonds fell to 0.48 percent by the end of August, close to the lowest level in two years. While stable demand limits upside potential, we expect a retracement in September driven by new supply, with yields gradually moving higher. High inflation in services, particularly rents, may continue to pressure the Consumer Price Index. Appreciation pressure on the Swiss franc, driven by geopolitical unrest, is increasing pressure on the SNB for further rate cuts. However, we believe market expectations for rate cuts are exaggerated. The Swiss bond market remains attractive, especially given global uncertainties and the safe-haven status of the franc. Swiss bonds should benefit from stable demand.

A buoyant outlook despite the stormy seas

Emerging markets fixed income delivered positive returns through the recent market turbulence: In an impressive show of resilience, EM bonds outperformed global equities in the sell-off and through the recovery experienced in August.

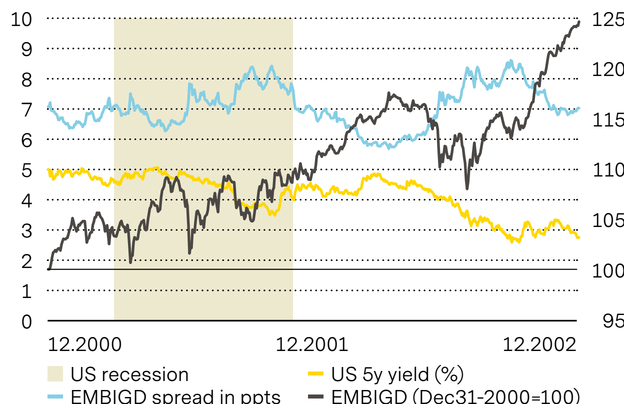
Hard currency

—

Carlos de Sousa
Emerging Market Debt Strategist,
Portfolio Manager,
Vontobel

Steady fundamentals underpin EM hard currency, which can perform well in most scenarios. As we highlighted earlier in the year, 2024's significant tightening of EM spreads occurred on the back of improving fundamentals and easing global financing conditions. This allowed HY issuers to regain market access and drastically reduced default risk. As such risk recedes, EM corporate default rates are expected to maintain their steady decline, while those for developed market corporates are expected to rise amid an ongoing slowdown in the developed world. Given the most recently reported results (for non-distressed corporates), the fundamentals for EM corporates remain strong and justify further spread tightening before year end. Similarly, fundamentals in the sovereign space have also continued to improve: Paraguay and Azerbaijan obtained their first investment-grade ratings and even niche HY issuers like Cameroon successfully issued Eurobonds during what's normally considered a Northern Hemisphere summer lull.

Chart 1: EM hard-currency sovereign bonds performed well through 2001 despite the US recession



Source: Bloomberg and Vontobel calculations, as of August 20, 2024.

Valuations are more attractive now: In early August, a brief market panic triggered by two developed market events—an unexpectedly hawkish rate hike by the BOJ and a quicker than anticipated slowdown in the US labor market—temporarily widened credit spreads in EM. However, lower US Treasury yields are likely to reduce refinancing costs for EMs in the future. These events created a window of opportunity for investors, leading to more attractive EM valuations, while the outlook for the overall asset class is unlikely to be impacted negatively. While most of the spread movement has already been reversed, these events have left plenty of idiosyncratic opportunities for active investors, as they often result in movements that don't sufficiently differentiate between individual issuers.

We believe the resilience of EM bonds is likely to continue: In our baseline of a US soft landing, we expect US Treasury yields to continue to decline over the next two years. Markets may have overshot the pricing of short-term interest rates, but they are likely correct on the medium-term outlook. This implies that even if EM spreads widen amid persistent macroeconomic uncertainty, borrowing costs for EM issuers are unlikely to rise, unless there is a big crisis, and total returns should remain positive.

When considering the risk of a US recession, the 2020 pandemic sell-off or the global financial crisis may come to mind as investors tend to place too much emphasis on recent events—a behavior known as recency bias. But these were exceptional crises that we believe are not a realistic guide to the near future. If a US recession does materialize in the next year, we anticipate it to be similar to the shallow 2001 or 1990/91 recessions.

With the caveat that EM fixed income has evolved significantly in the last 20 years, it is still instructive to look at the performance of the Emerging Market Bond Index

Global (EMBIG) in 2001 – 2002, a period of gradually falling US interest rates and a mild recession. The Argentine default took place in 2001, when Argentina comprised 11 percent of the index vs. less than 2 percent today. During this turbulent time, however, the index delivered a 9.7 percent total return in 2001 despite rising EM spreads, and 13.7 percent in 2002 (see Chart 1).

Elevated risk-free rates have resulted in ongoing outflows from EM fixed income, with USD 15 billion leaving the asset class in the first eight months of the year. Fortunately, such high risk-free are already declining and flows into EM should return in the near term. In this context, we expect high single-digit total returns in the next twelve months for EM hard-currency bonds (sovereigns and corporates at the index level) in our baseline, and low but positive returns even if a more significant recession hits.

Local currency

—

Carlos de Sousa
Emerging Market Debt Strategist,
Portfolio Manager,
Vontobel

EM local bonds returned a stellar 12.7 percent in 2023 (in USD) but lost 2.6 percent in the first seven months of 2024 amid a strong dollar, concerns about fiscal discipline in Brazil, and the prospect of post-election institutional deterioration in Mexico. August brought a rapid bounceback, with the asset class delivering a 3.1 percent return in a single month despite market turbulence and the unwinding of JPY-funded carry trades. While Brazil and Mexico's issues persist, investors are shifting their focus to US events that are weakening the dollar and therefore boosting EM local assets. EM local bond prices rallied in August although to a lesser extent than US Treasuries, thus creating a wider interest rate differential that could favor EM local returns in the short term.

The US presidential race, now tighter with Kamala Harris surging in the polls, is influencing the US dollar's appeal. A lower probability of a Trump presidency reduces its appeal for two economic reasons: taxes and tariffs. Trump has promised to extend the corporate tax cuts he introduced during his first presidency, which increased competitiveness and attracted capital flows from corporations and resulted in a stronger dollar. Harris, on the other hand, has promised that "the wealthiest Americans and largest corporations will pay their fair share".

If elected again, Trump would impose more tariffs on China, and potentially on the rest of the world. A country facing higher tariffs will see its currency weakened by market forces to compensate for lower competitiveness. This was evident in the Chinese yuan during the 2018 trade wars. We expect the US-China rivalry to continue regardless of the outcome of the election, though it is likely to be less disruptive under Harris. Taxes and tariffs point towards a stronger dollar if Trump wins. If Harris continues to rise, so will the sentiment towards EM amid prospects of a weaker dollar.

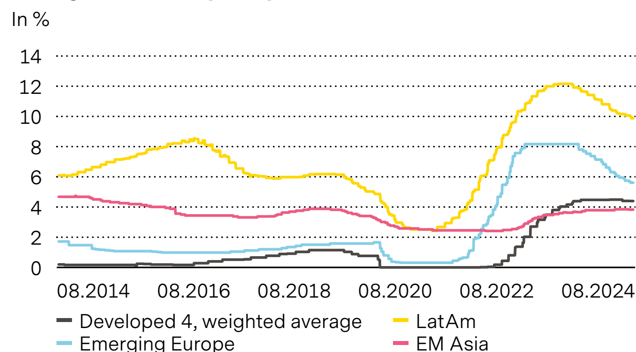
Can we stay in the middle of the so-called US 'dollar smile'? Currencies strengthen when their economies are doing well and vice versa, but the US dollar also strengthens in times of crisis on safe haven flows due to its reserve currency status. The dollar remained strong after the Covid pandemic on the back of strong US growth. A hard landing would imply dollar strength on safe haven flows. But in our soft-landing baseline, we could move towards the middle of the smile: weaker US growth and a weaker dollar. Should this occur, it would be a game changer for sentiment towards EM local currency, and we would expect double-digit returns to ensue.

Real rates remain high in EM amid orderly disinflation: many major EM central banks hiked rates faster and more aggressively than their DM counterparts in 2021 and 2022 after the pandemic and cut rates earlier starting in 2023 (see Chart 2). These rate cuts contributed (with +4.4 percent) towards the double-digit returns achieved in 2023.

Many EM central banks paused through 2024, others continued to cut but more cautiously, waiting for the Fed. With Fed cuts anticipated to finally start in September, some EM central banks will resume their rate-cutting cycles, which should boost returns. Active investors are likely to find plenty of idiosyncratic opportunities since cycles will be much less synchronized, as not all countries have been equally successful in their fight against inflation.

Chart 2: EM central bank policy rates— taking the lead in post-pandemic monetary cycles

In %



Source: Macrobond and Vontobel calculations as of August 20, 2024.

13.4 % & 12.2 %

YTD total returns by USD EM sovereign and EM corporate bonds.

Investment implications

1. We believe that the negative correlation we expect between rates and credit meaningfully reduces downside risk to fixed income. As a result, our risk appetite is increased to the highest level to date in 2024. Fixed income currently looks like a very attractive return-for-risk asset class.

2. Credit spreads have retraced the vast majority of their widening, but yields remain attractive. We advocate moving further out in maturity in order to take advantage of shifts in yield curves.

3. European and US banks have weathered the storm well and maintain very strong capital ratios, AT1s and other hybrid capital instruments offer meaningful relative value.

4. In our view, opportunities to rapidly recycle risk are likely to recur—therefore we believe maintaining good levels of liquidity and staying nimble will reward active managers.

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