Gain now, pain later?

While we are comfortable being long credit and neutral on government bonds for now, increasing uncertainty around stronger growth, or higher inflation, makes us cautious for the second half of the year.

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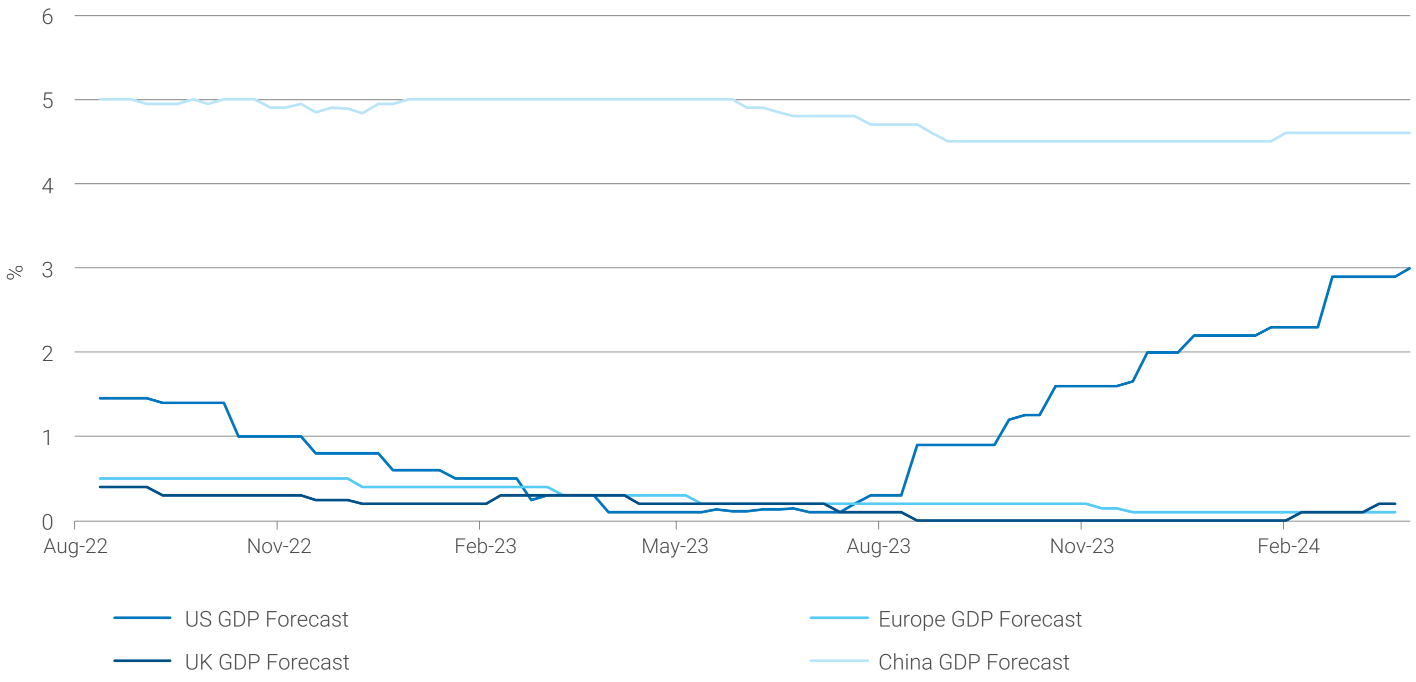
The US economy not only avoided a recession in 2023, it outperformed many major economies, delivering remarkable growth as well as falling inflation. The growth drivers have been well documented – excess savings, easy fiscal policy and an onshoring manufacturing boom, as well as a surprising resilience to higher bond yields. But, theoretically, strong growth coincides with higher, not lower inflation.

One explanation for the seemingly perfect soft landing has been the huge immigration wave that is top of the political agenda in this election year (the Congressional Budget Office estimated US net immigration last year of 3.3 million). As my colleague Tim Drayson wrote in a recent blog, normally it takes a recession to reduce wage pressure and ease recruitment difficulties. But this surge in potential workers helps explain how wages have been kept under control despite strong employment data.

It's a very different growth picture for the rest of the developed world, with major economies such as Germany, the UK and Japan all flirting with recession. Emerging markets are a mixed picture, with India a notable outperformer, but China continues to face significant headwinds from the property sector.

LGIM

Figure 1: The US has seen significant upward growth forecast revisions in recent months



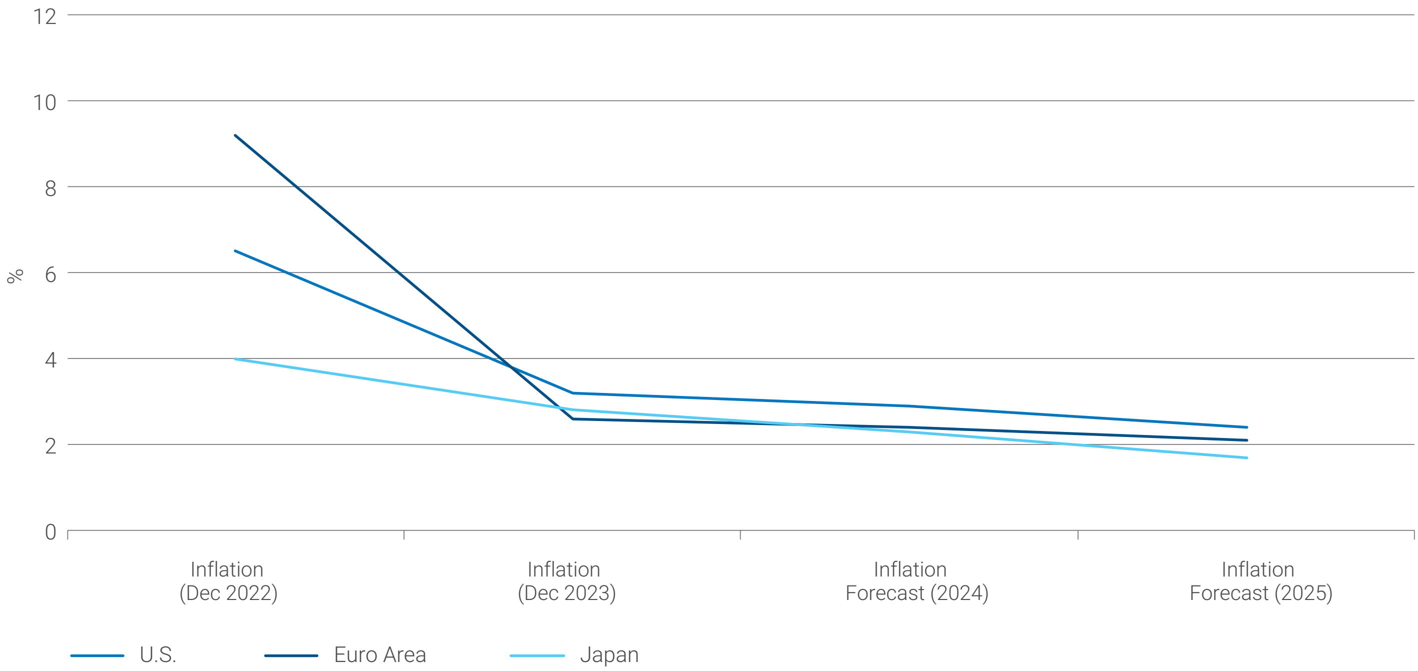
Source: LGIM, Bloomberg, as at 13 March 2024.

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Return of the Fed put

Despite this mixed economic growth, the global trend of falling inflation has been more consistent. This has allowed investors to expect easier monetary policy in the future, boosting equity and credit markets at the end of last year and in the first quarter of 2024.

Figure 2: The fall in headline inflation has been more consistent



Source: LGIM, Bloomberg, as at 13 March 2024.

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That said, recent data suggests there could be a problem developing – US inflation data has surprised to the upside at the start of 2024, causing bond yields to head higher, threatening a headwind for risky asset classes.

However, after the most recent US Federal Reserve (Fed) policy meeting, Chair Jerome Powell suggested this could be down to seasonal dynamics as some businesses focus on price changes at the start of the year, leading to an exaggerated inflation hit. The implication being that recent upward price surprises could be a statistical anomaly and won't derail the Fed's determination to cut rates in the coming months. Investors cheered the return of the 'Fed put', meaning that the Fed could be relied upon to ease policy and support equity prices if they suffered a wobble.

But inflation is notoriously hard to forecast, even for well-resourced central banks. Perhaps policymakers in Europe can be reasonably confident that stagnating economic growth should eventually bring inflation back to target, but the Fed should be worried that above trend growth might even lead to a reacceleration of prices. In other words, Europe is undergoing a bumpy landing, but the US might not be landing at all.

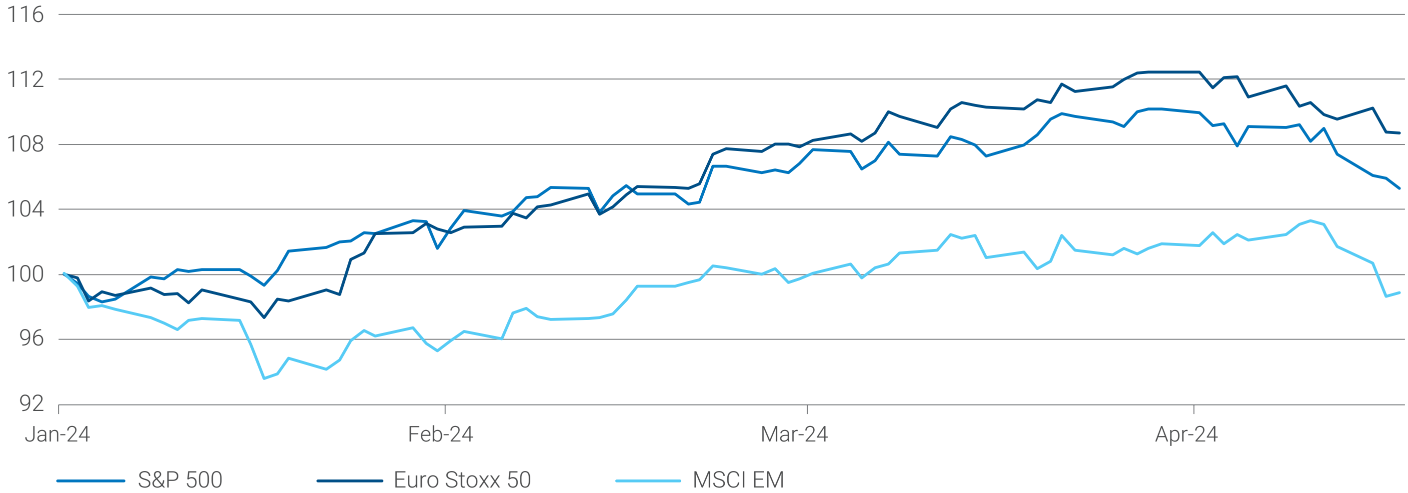
Glass half full

Thus far, investors have focused on the positives rather than the risks:

- Strong US economic growth should boost earnings
- The increase in inflation should prove temporary allowing the Fed to still eventually cut rates
- Elsewhere, weak growth will eventually turn around as central banks ease policy

So, 2024 has seen the combination of higher bond yields as rate cuts are postponed, but equity and credit markets have still been resilient.

Figure 3: Equities have had a strong start to 2024



Source: LGIM, Eikon, rebased to 100 at the start of 2024, as at 17 April 2024.

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Bond beauty in the eye of the beholder

Equity market strength is easier to explain, driven by the 'magnificent seven' stocks in the US, and hope in the AI productivity revolution more broadly. Ultimately, there is no upside limit for equities as long as investors are prepared to pay for the prospect of future earnings growth.

High-beta credit has been swept up by this equity market strength, with high yield bonds and emerging market credit both benefiting from the risk-on environment, as well as the positive outlook for corporate earnings.

But lower-beta investment grade credit market strength is harder to justify as credit spreads are hitting levels that have historically proved difficult to break through.

Figure 4: Credit spreads are close to their historical tights

Source: Bloomberg, as at 21 March 2024.

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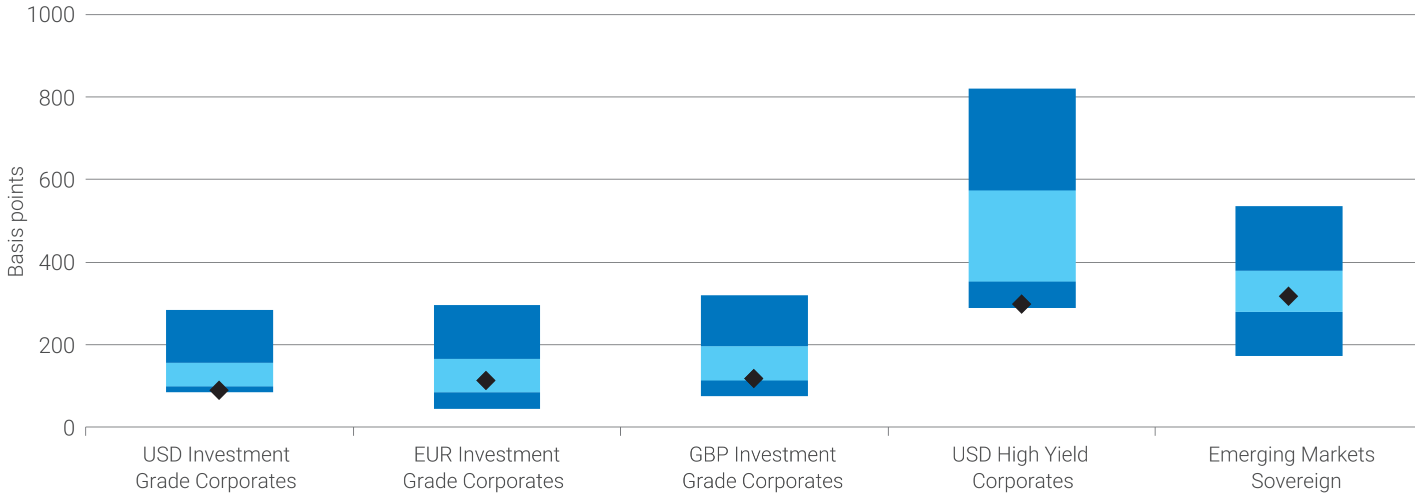
An important reason why credit markets have been so strong this year is because investors have focused more on yields than spreads. Figures 5. and 6. show current valuations in a historical perspective for both spreads and yields. While spreads indeed look rich, yields are closer to the historical average.

Figure 5: Credit spreads are historically expensive



Source: LGIM, Bloomberg, Barclays, historical ranges from January 2003, current level 1 April 2024.

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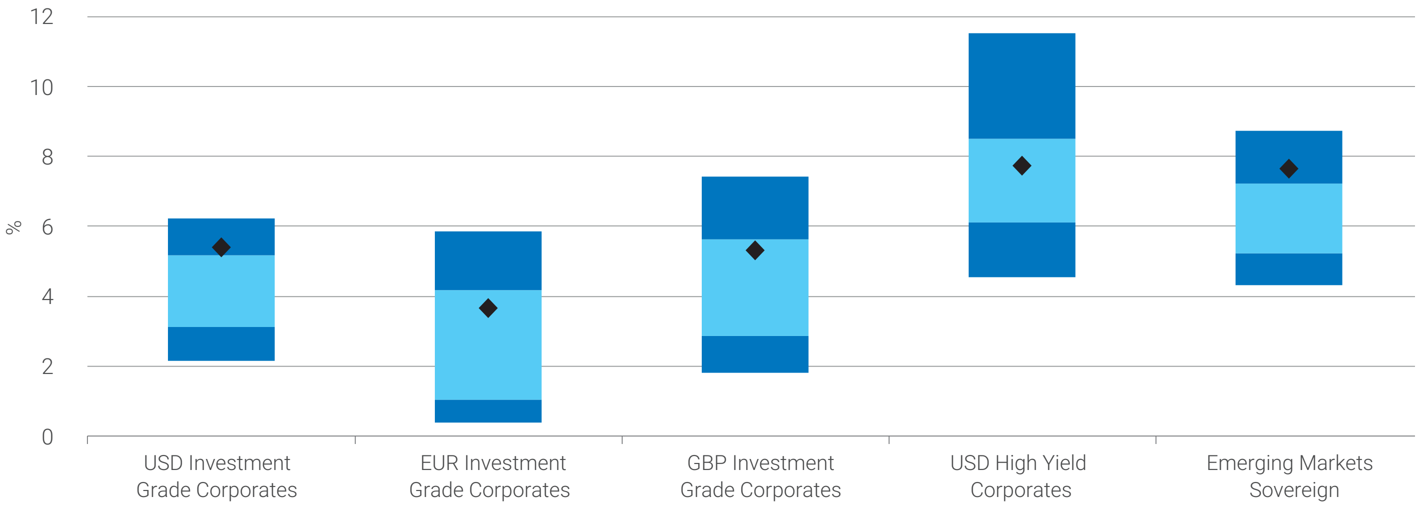
Figure 6: Yields appear more attractive

Current diamond versus both 5% - 95% and inter-quartile range, index yields



Source: LGIM, Bloomberg, Barclays, historical ranges from January 2003, current level 1 April 2024.

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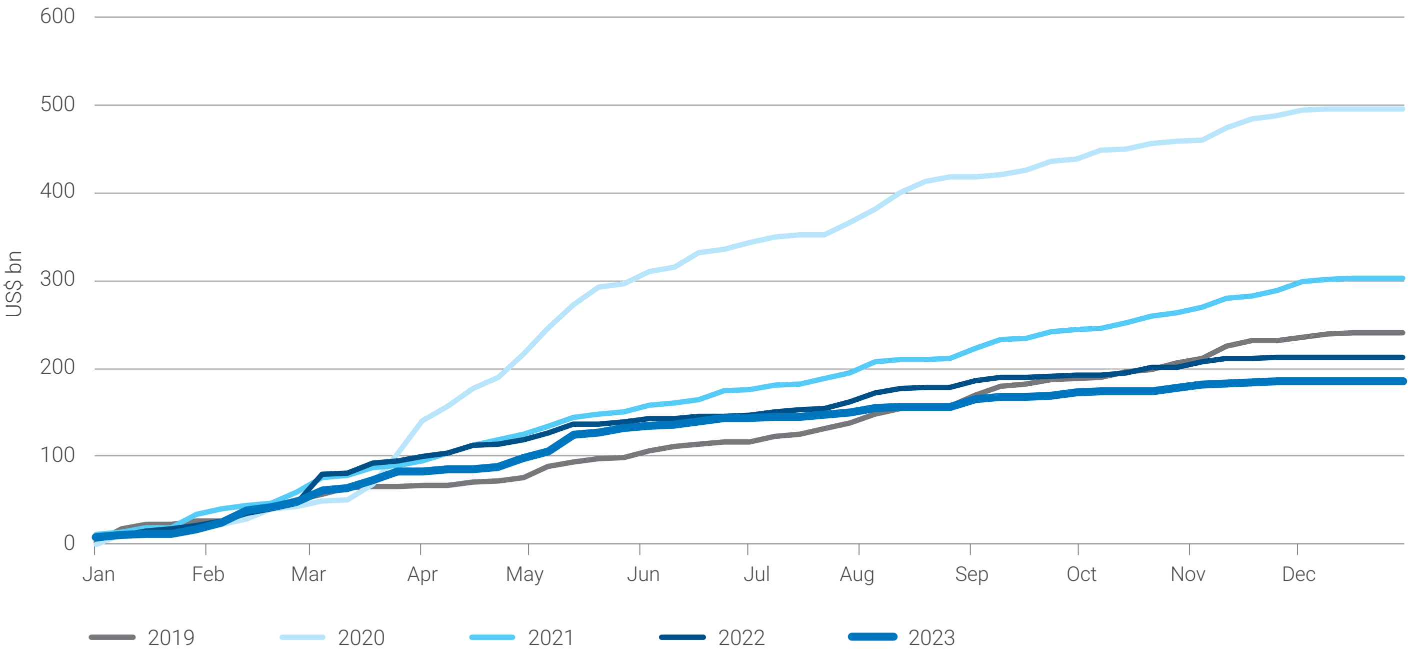
Up until the recent spike, yields have generally trended lower for many years, with the period just before the COVID-19 pandemic even witnessing trillions of dollars of negative yielding bonds. Investors who have therefore been starved of yield for a prolonged period are now feasting. This might be pension investors who are locking in high yields to close a funding gap, or individual annuity buyers who can now guarantee an attractive income through retirement. Insurance companies are also looking to secure elevated yields to back various products.

In addition, some corporate bond issuers are put off by these high yields, particularly when it comes to locking in such yields via long-dated bonds, which are exactly the type of bonds that yield-hungry investors are interested in. This supply-demand imbalance is therefore supporting credit valuations even as spreads head to their historic tights.

Figure 7: Cumulative long-dated US credit issuance was relatively low in 2023



Source: LGIM, as at 18 March 2024.

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When could this change?

It's not obvious what will change this dynamic in the very near term. Investors are buoyed by attractive yields, but also the prospect of the Fed cutting rates later in the year. However, the Fed will have to turn rhetorical support into actual rate cuts or else investors may lose confidence.

In our view, the most likely risk to the supportive backdrop is that US inflation and growth continues to surprise to the upside, forcing the Fed to abandon rate cuts altogether (and perhaps even think of hikes). Such a scenario is already catching the attention of government bond investors, with option markets suggesting a 50% chance of no cuts by the Fed in 2024.

Figure 8: Markets already pricing in a high chance of 'no landing'

Source: LGIM, Bloomberg, as at 17 April 2024.

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Yield-sensitive credit investors could change their behaviour under these circumstances – if rates are going up again, why lock in today's levels when they might be more attractive tomorrow? Also, issuers might be more inclined to come to the market given the fear of rising yields. There could also be more companies looking to raise money in the bond markets should aggressive corporate activity accompany such strong economic growth such as debt-funded M&A or leveraged buyouts.

To mitigate this risk, investors might wish to overweight shorter-duration, lower-rated credit such as high yield bonds, or simply look to underweight government bond duration to hedge credit exposure.

Long and variable lags

The opposite scenario is that the US economy finally succumbs to tight monetary policy, with recession predictions proving too early rather than wrong. This seems unlikely, but monetary policy famously acts with long and variable lags, and the post-pandemic world has been anything but predictable. Recession fears would usually lead to lower government bond yields and higher credit risk, suggesting investors should hold positions opposite to those described above – underweight high yield bonds and overweight government bonds.

Over the longer term, we think high government bond yields will eventually cause the US economy to slow, as already experienced by the rest of the developed world. The recent inflation upward surprises, plus robust US economic growth suggest this isn't happening yet, but once growth slows, we believe investors will price in more Fed rate cuts and bond yields should fall. We therefore have a structural bias to be long US government bond yields, expressed via real yields (i.e., after stripping out inflation).

Figure 9: Elevated real yields should eventually slow US economic growth

Source: LGIM, Bloomberg, as at 13 March 2024.

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So how have we positioned the fixed income portfolios? We have a tactical, near-term view, as well as a longer-term positioning bias.

As long as investors remain confident that Fed rate cuts have been delayed rather than abandoned, we are comfortable being long credit as we think the strong supply-demand imbalance is likely to persist. We are neutral government bond yields, given elevated US inflation and economic growth.

However, we think that uncertainty should grow as we head into the summer. We don't know which of the two risks we have described will dominate, but we are worried that the current benign backdrop for credit will be tested. Our outlook therefore becomes more cautious in the second half of the year. We are also more positive on government bond duration over that time horizon, in line with our structural view that current elevated real yields should prove unsustainable.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

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