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Q3 2024

Active Fixed Income Outlook: Back to the 1970s?

LGIM

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Back to the 1970s?

Colin Reedie
Head of Active Strategies

Geopolitical tensions, sticky inflation and ballooning government deficits. Sound familiar? Could the prospect of 1970s stagflation be gaining traction? And if so, what are the possible implications for fixed-income investors?

The myopic focus on the rate-cutting of the US Federal Reserve (Fed) and its ability to impact all asset classes ignores the multiple forces at work in today's financial markets. Combined, these drivers have the potential to affect both the path of growth and inflation. The result is that any high-conviction views held over the soft-landing narrative should be treated with an extreme degree of caution, in our view. Our investment mantra, as ever, remains 'prepare, don't predict'.

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A myriad of forces at work in financial markets

At face value, the forces themselves are easy enough to identify – the euphoria surrounding the growth of artificial intelligence (AI) and increased geopolitical tensions, not just in the Middle East, but in Russia/Ukraine and the South China Sea, are well documented. Global fiscal incontinence and the extent to which China can contribute to world economic growth are among the others.

We would argue that it is precisely because of the presence of these disruptive forces that investors are unable to accurately pinpoint where we are in the economic cycle. While no two economic cycles are the same, the ability to transpose asset allocation decisions onto a framework that points to an expansionary or recessionary phase has, for the most part, become null and void. Not having this framework deprives today's market participant from using a key part of the investor toolkit.

So, are we in a late cycle acceleration phase, driven by the forces that have made the post-pandemic world so interesting and challenging to navigate? Or are we at the beginning of a new cycle, an AI-driven investment boom that will be largely unaffected by the current level of interest rates? Both possibilities have profoundly different asset allocation outcomes.

The return of stagflation?

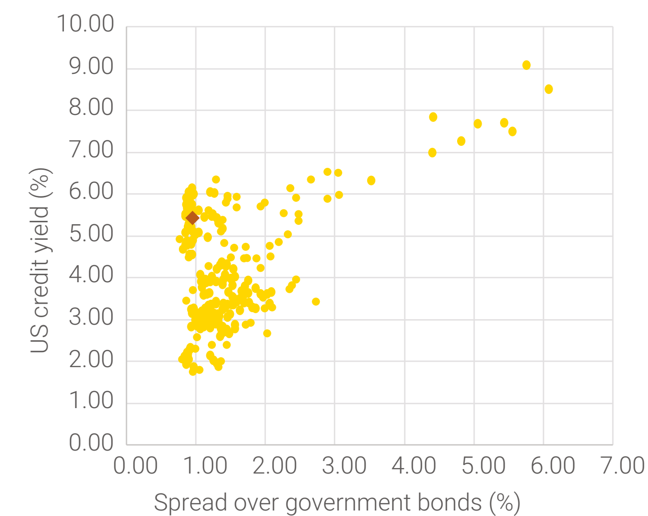
We believe the most interesting parallels for today's investor are to be found in the 1970s – an era characterised by high inflation and a cooling of economic growth. Back then, growth in US fiscal spending was prominent, fuelled by military costs related to the Vietnam War. The collapse of the Bretton Woods system in 1971 and the Arab-Israeli conflict of 1973 also contributed to further inflation and volatile growth.

While today's inflation rate is nowhere near that of the 1970s, the stickiness of service inflation is a problem. As is the cooling of global GDP. Corporate earnings growth continues to be seen mostly among an elite group of technology stocks, while rich valuations indicate that investors remain uncomfortably optimistic in their outlook.

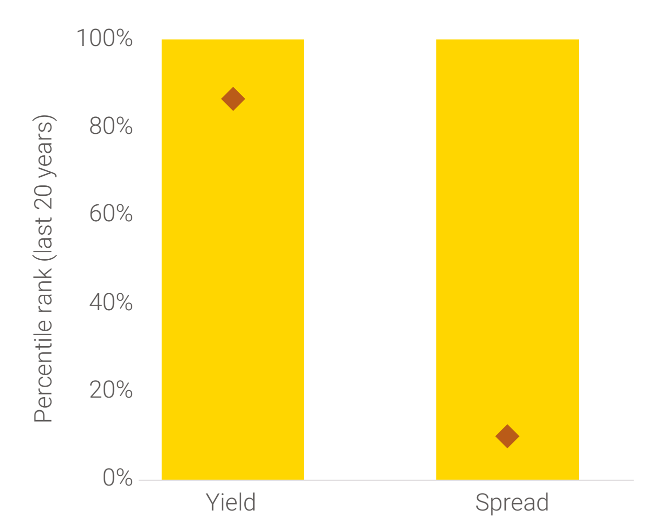
That level of optimism extends to the credit universe. While credit yields are high, their composition is unattractive, with spreads hovering near all-time tights. That scenario is fine if the US follows the path of a soft landing and perfect disinflation. If it continues to cool (we have seen tentative signs in new orders and US retail sales) then that could be problematic. How investors balance credit risk versus duration risk will, once again, be the key as we enter the second half of 2024.

Credit yields are high, but composition is unattractive

Yields versus spreads



Percentile rank of yield and spreads



Source: LGIM, Bloomberg, as at 28 June 2024. Data is monthly yield-to-worst and OAS spread for US corporate credit over the 20 years to 30 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, you may not get back the amount you originally invested.

Outlook

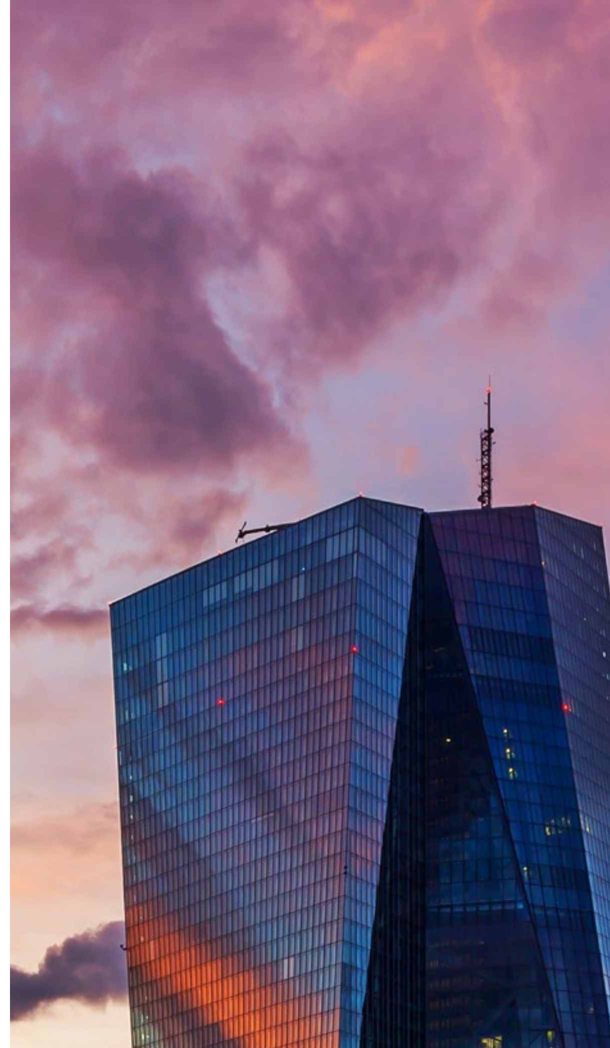
With valuations in credit and equities where they are, there's little room for manoeuvre if something goes wrong. All this comes against the backdrop of the impending US election and the possible return of Donald Trump to the White House. Should that happen, any questioning of the Fed's independence will not be good for term premia.

While uncertainty will inevitably increase as we get closer to the political event with the greatest global significance, we believe there are still pockets of value. For example, we prefer hard currency emerging market debt to high yield and investment grade. Looking at the curve, the shorter end feels safer for now, which means taking less duration risk. But if the burden of rising fiscal deficits persists, it will pay to stay as flexible and nimble as possible with regards to duration.

European credit: upping the quality

Marc Rovers
Head of European Credit

Lan Wu
European Credit Portfolio Manager



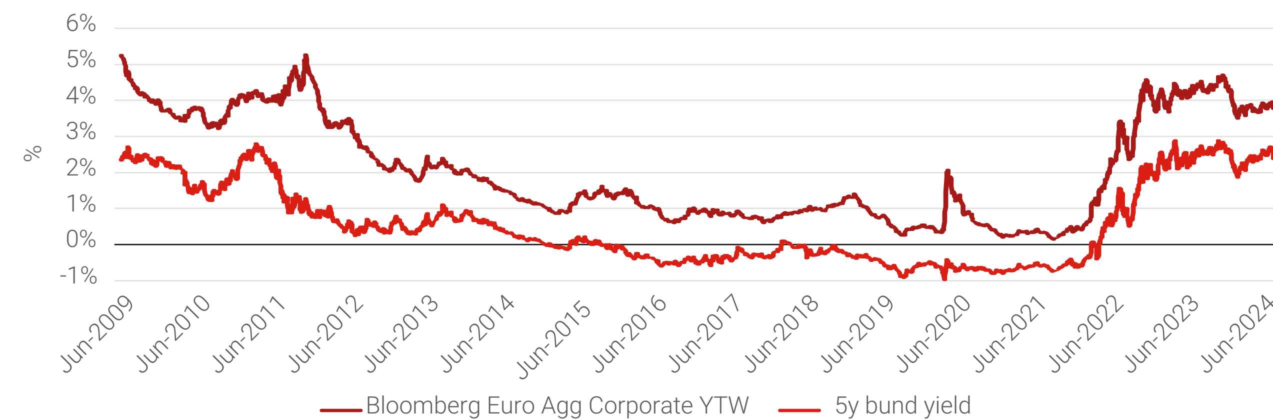
Against a backdrop of politically induced volatility in European credit markets and rich valuations, we continue to trade up to higher quality issuers.

The past: what just happened?

The European Central Bank (ECB) delivered its first quarter-point cut to 3.75% in June, but it fell short of promising any further reductions for the time being. That may have been because of the accompanying hawkish upgrade in both growth and inflation forecasts for the remainder of 2024. The central bank stressed the need for data-based decisions and for a meeting-by-meeting approach, thus limiting any forward guidance, which investors were hoping for.

Over the quarter, euro investment grade (IG) spreads continued to tighten, while all-in yields remained attractive, offering more than 100 basis points (bps) over the risk-free rate. While inflows into euro investment grade credit continued, issuance picked up, especially in reverse Yankee bonds (those issued by US companies denominated in a currency other than the dollar), as they were keen to tap the euro market and diversify funding sources.

Yields continue to look attractive historically



Source: Bloomberg as at 28 June 2024.
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The present: key themes

We believe European IG credit still looks attractive compared to history and alternatives in terms of spreads and yields when you look at the current percentiles*. At the same time, interest-rate risk is limited due to a duration of about 4.5 years. The latter point we believe is important as, with the spike in inflation over recent years and its sticky nature, with recent upside surprises to services inflation and wage negotiations, we remain humble in our ability to predict price increases and interest-rate trends.

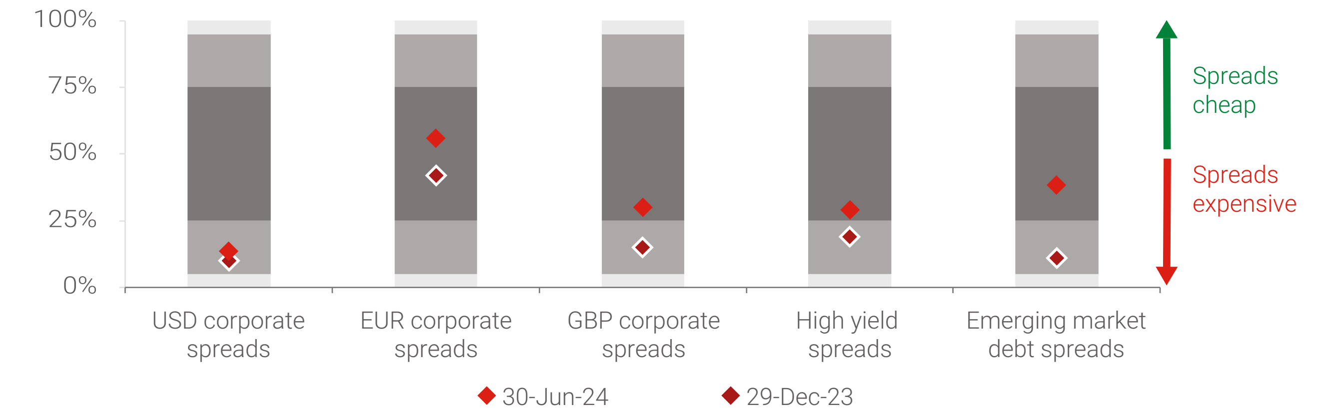
We maintain a more cautious stance on the back of the strong compression between higher and lower quality already seen in the first half of 2024. While we expect a supportive technical backdrop to continue for European IG credit, the premium offered on new issues has largely disappeared.

Both developments, we believe, warrant a more cautious approach with regards to adding further risk and new names to portfolios.

In terms of positioning, we maintain our bias towards quality, without giving up too much carry in our portfolio, to maintain sufficient yield versus the benchmark. This has been done primarily by avoiding bonds that we believe are too expensive and carefully selecting debt in the lower-rated part of the market. We continue to reduce our exposure to banks due to the spread compression versus corporates, as described in our recent blog.

Within sectors, we are overweight defensive areas such as utilities, which are trading at a premium partly due to heavy issuance amid capital expenditure linked to the energy transition. By contrast, we have an underweight position in cyclical areas, especially the automotive sector, on account of the prevailing structural issues related to electrification and heightened tensions between Europe and China over tariffs within the electric vehicle market.

European credit: cheaper on a relative basis



Source: LGIM, Bloomberg, as at 15 May 2024. * Percentiles based on the number of monthly observations going back to 31 December 2006.
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, you may not get back the amount you originally invested.

What could go wrong?

Following the snap election called by President Macron, we anticipate that power wrangles between political parties will lead to headline risk and renewed bouts of volatility in financial markets.

Another potential headwind is a widening of credit spreads and a subsequent flight to safety, which may be exacerbated by the increasing popularity of the asset class.

Outlook

The dispersion between sectors and issuers, combined with political turmoil and economic uncertainty, offers opportunities for active management, in our view.

As Colin Reedie has already noted, while "two cycles are never the same", we continue to leverage top-down macroeconomic analysis and combine it with bottom-up research from the credit research team. This, we believe, can help us better understand where we are in the economic cycle, while keeping a close eye on valuations. It is this tried-and-tested process that helps us to select issuers and sectors which offer superior risk-return characteristics and to construct robust portfolios.

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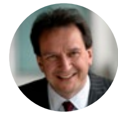
Global high yield... don't worry, be happy



Martin Reeves
Head of Global High Yield

Sophia Hunt
Fixed Income Product Specialist

Investors might prefer to focus on the yields on offer in the asset class, rather than worry about what, we believe, is the misplaced fear of defaults.

The past: what just happened?

The second quarter of 2024 registered positive returns across the globe in high yield. Emerging markets, once again, led the way, followed by Europe and the US. Credit spreads were broadly unchanged, and BB rated bonds outperformed single B rated bonds. Demand for the asset class persisted as fundamentals and global growth remained robust, and the yields on offer, standing at more than 7%,[1] continued to appeal to many investors.

From a sector perspective, our focus on the 'core' part of the economy remains, with an overweight exposure to the consumer, services and industrial sectors.

The present: reducing exposure in Europe

The strategy continues to target a higher income than the comparative benchmark, expressed through an overweight position in higher spread global names. Our view remains that spreads adequately compensate for the degree of credit risk undertaken (see outlook). From a regional perspective, we have started to reduce exposure in Europe, rotating back into the US, with emerging markets constituting our largest overweight position. From a sector perspective, our focus on the 'core' part of the economy remains, with an overweight exposure to the consumer, services and industrial sectors. Conversely, we have underweight positions in the global automotive, utilities and shipping sectors.

What could go wrong?

There are many known elections, but it's the unknown, snap elections that appear to cause the most concern. French parliamentary elections illustrated this, while focusing investor attention on imbalances, such as deficits and debt burdens.

As the first table on the right shows, France has one of the largest sovereign debts in Europe – along with Belgium and Italy. This has caused us to be more cautious on our positioning within Europe because downside risk doesn't yet seem reflected in high yield credit markets.

1. Source: HW00 ICE BofA Global High Yield index as at end June 2024, total returns, US$ hedged.

European Commission baseline forecasts

Countries	2024 deficit/GDP	2025 deficit/GDP	2034 debt/GDP
Belgium	4.4%	4.7%	119%
France	**5.3%**	**5.0%**	**139%**
Italy	4.4%	4.7%	168%
Hungary	5.4%	4.5%	78%
Malta	4.3%	3.9%	56%
Poland	5.1%	5.4%	85%
Slovakia	5.9%	5.4%	106%

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

Outlook

Although defaults have ticked up, they remain around historic averages. Going forward, we expect this to continue within an environment of decent global growth and expectations that central banks will likely begin cutting interest rates towards the end of 2024. Improving credit quality in the index supports this view.

On a final note, there are many myths about high yield that we would like to contest.

For now, we shall comment on what we believe to be the misplaced fear of defaults in the higher quality segment of the high yield universe (BB and B rated). As the below table shows, historic average one-year defaults are less than 1% for BB and around 3% for single B rated bonds. During periods of crisis, the default rate rarely rises above 7%, even for single B rated bonds. This explains why, if investors buy BB and B rated bonds and keep them for the average life of the bond (three to four years), they generally earn at least 75% of the yield on offer. Historically, the income received has more than offset mark-to-market volatility and losses due to defaults over the same period.

One-year average default rate for BB, B and CCC rated companies

Date of Peak	Period	BB			B			CCC-C		
		1yr default rate (%)	1 year later	2 years later	1yr default rate (%)	1 year later	2 years later	1yr default rate (%)	1 year later	2 years later
1933	1930s great depression	12%	3%	5%	16%	4%	4%	26%	17%	13%
1970	Bretton Woods collapse	4%	1%	0%	19%	0%	7%	50%	13%	38%
1990	"Black Monday" crash	4%	4%	0%	14%	13%	8%	45%	16%	15%
2001	"Dot com" crash	1%	2%	1%	9%	4%	3%	29%	27%	20%
2009	2008-9 financial crsis	2%	0%	0%	7%	0%	0%	26%	9%	6%
2016	US energy crisis	0%	1%	0%	2%	0%	1%	9%	8%	5%
2020	COVID-19 pandemic	1%	0%	0%	4%	1%	3%	13%	3%	4%
One year average (1920 - 2023)		1%			3%			11%		
LGIM 2024 estimate		<1%			<3%					

Exposure to bonds rated CCC and below very limited in LGIM strategy

Source: LGIM, Moody's default rates as at 31 December 2023. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Emerging market debt: all about the yield

Raza Agha
Head of EM Sovereign Strategy

Viraj Nadgir
Fixed Income Investment Specialist

Challenges for the asset class, in the form of unexpected election outcomes and volatility in US rates, have given way to relative calm in the second quarter.

The past: what just happened?

Persistent outflows, unexpected election outcomes in several countries, and volatility in US rates have all represented headwinds for emerging market (EM) debt. However, tighter spreads, except in Venezuela, and a recent rally in US Treasuries following the sell-off in April, contributed to positive total returns for the asset class across sovereigns and corporates this year. This rally in rates means that EM investment grade (IG) returns turned a corner in the second quarter and are flat for the year.

The high yield (HY) segment within EM has been the clear outperformer this year. The high yield sovereign index has seen gains of approximately 5.7%[2], while the high yield corporate index has risen by around 6.2%[3]. This outperformance is attributed to factors such as lower sensitivity to rates volatility compared to investment grade bonds, positive idiosyncratic developments in selected credits and stable macroeconomic fundamentals.

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The present: idiosyncratic stories drive returns

Sovereign high yield spreads, excluding Venezuela, tightened by c.50 basis points (bps) between January and May[4]. Much of this outperformance has come from lower rated/distressed sovereign credits, where idiosyncratic developments are driving returns. These credits, including Pakistan, Egypt and Argentina, have benefited from strong support from multilateral agencies such as the IMF and bilateral donors, which has anchored reform agendas.

Defaulted names like Zambia, Ghana and Sri Lanka have been helped by progress made towards completing their debt restructurings. Indeed, Zambia was the first to complete its Eurobond restructuring. Ghana and Sri Lanka do not seem far behind. A successful exit this year will help bring HY spreads further down. Hence, despite the year-to-date spread rally, we believe there is still value in this segment – current levels (707bps) look cheap compared to pre-COVID levels (c480bps)[5] as well as versus US high yield.

In corporates, too, the high yield segment has shown robust performance. Default rates within EM corporate high yield have significantly decreased to approximately 1% year-to-date, from a peak of 14% in 2022. While default rates have remained elevated in recent years, this has been primarily concentrated in Chinese real estate, Russia and Ukraine (c.80% - 90% contribution to total defaults in 2022 and 2023). Notably, China has taken nascent steps to support its property sector this year, which could reduce default rates. Meanwhile, on the technical side, the expected negative net financing for 2024, coupled with stable corporate fundamentals, should support spread compression.

2. Source: Bloomberg as at 19 June 2024.
3. Source: Bloomberg as at 19 June 2024.
4. Source: Bloomberg as at 31 May 2024.
5. Source: Bloomberg as at 31 May 2024.

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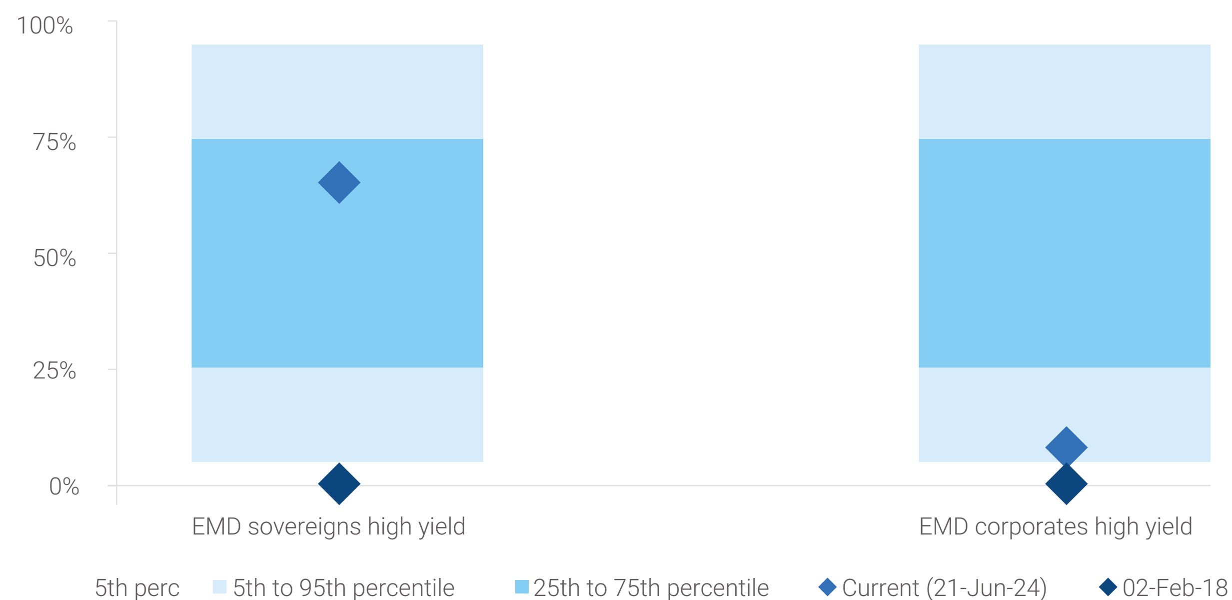
EMD high yield – spread percentile analysis



Source: Bloomberg as at 21 June 2024.
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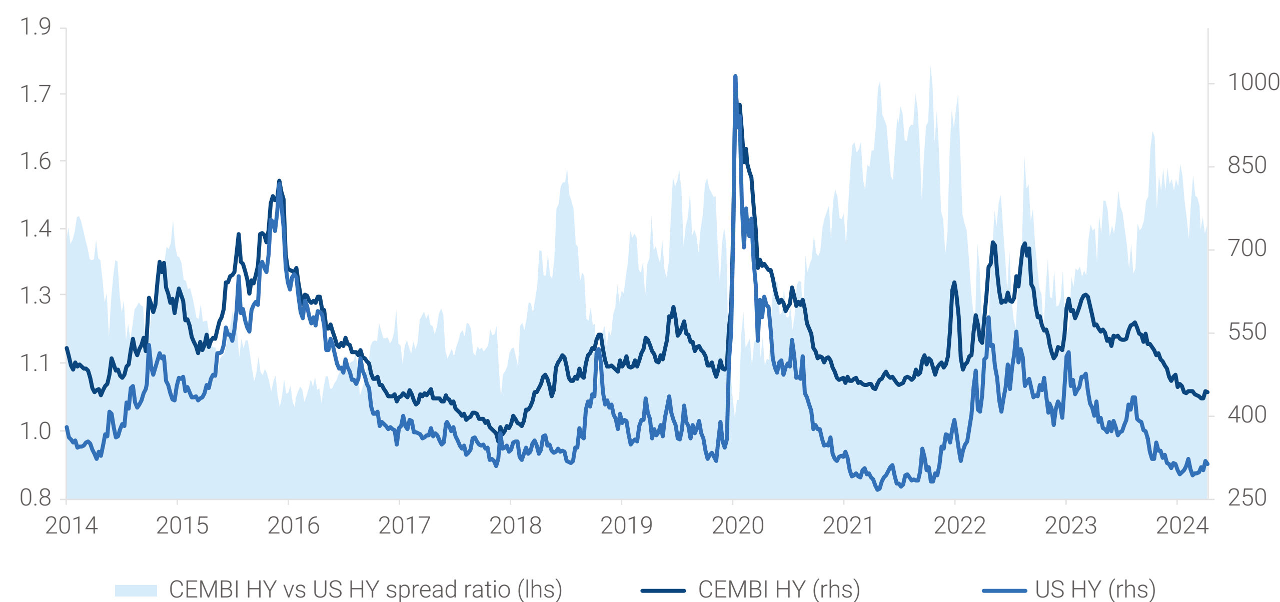
More generous than most: EMD corporate high yield versus US high yield



Source: Bloomberg as at 21 June 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, you may not get back the amount you originally invested.

What could go wrong?

Given where sovereign and corporate balance sheets are, reflected in stable/improving ratings, the risks remain focused on global macroeconomic data. Recent weaker-than-expected US inflation and macro data supported the view the US Federal Reserve (Fed) will be able to deliver cuts later this year. This has reduced rates volatility somewhat, although markets remain sensitive to data surprises.

Although the supportive macroeconomic backdrop and ratings and technicals picture imply good prospects for carry over the summer, the focus will shift quickly thereafter to US elections. That complicates the picture for the impact Fed cuts could have. Cuts will help duration, but September is close to the November elections. The risk is that any rally in rates will be short-lived, given the likelihood that both presidential hopefuls will be in full swing on their policy agendas. With the current US debt/deficit levels, this could rattle rate markets. This suggests that the performance of high yield – less sensitive to rate moves – will remain a key return driver for EM credit.

Outlook

Global credit is vulnerable to geopolitical developments, and uncertainties continue. The Russia-Ukraine conflict is now in its third year with little clarity on a resolution. The Middle East conflict also continues, with material risks that it could escalate on Israel's border with Lebanon. Markets, however, appear somewhat complacent towards escalation risks, suggesting knee-jerk reactions could be significant. Hence, we continue to monitor both conflicts closely.

Finally, what will also be supportive for sovereigns and corporates is the yield on offer for both – high single to low double-digits. This means it will take significant spread widening from current levels to offset the carry on offer. As such, we believe the high yield segment is on course to post total positive returns in the second half, building on its already impressive performance.

Research and Active Engagement: credit upgrades dominate

Madeleine King
Head of Research and Active Engagement

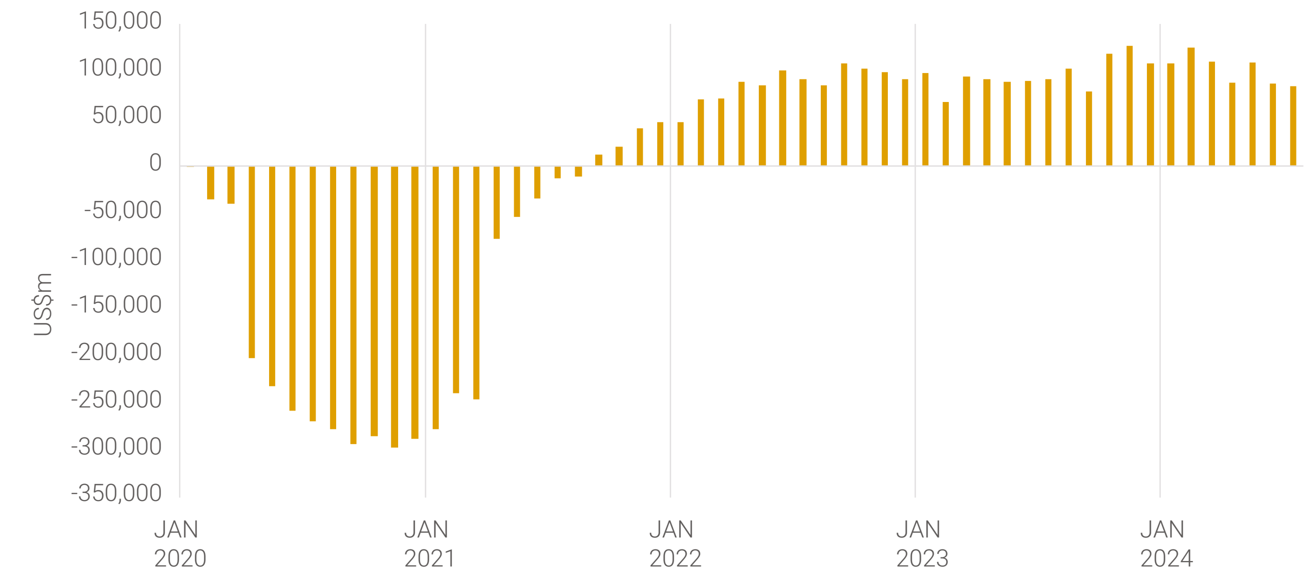
Assuming the soft-landing narrative continues, we are likely to see credit upgrades outweigh downgrades over the next one to two years.

The past: what just happened?

Since we emerged from the COVID-19 pandemic, the fundamental quality of global credit markets has – on average – been on a consistently improving path. There was an initial rapid bounce back, followed by a more gradual, prolonged period of recovery.

Many originally investment grade (IG) companies that tipped into high yield (HY) territory during the pandemic (so-called fallen angels) subsequently recovered and made it back into IG indices in 2022 and 2023. Indeed, the trend of elevated rising stars has continued this year, hitting a post-COVID peak in February 2024 on a 12-month rolling basis.

On the up: net fallen angels (negative) to rising stars (positive)



Source: LGIM, BAML as at 30 June 2024.
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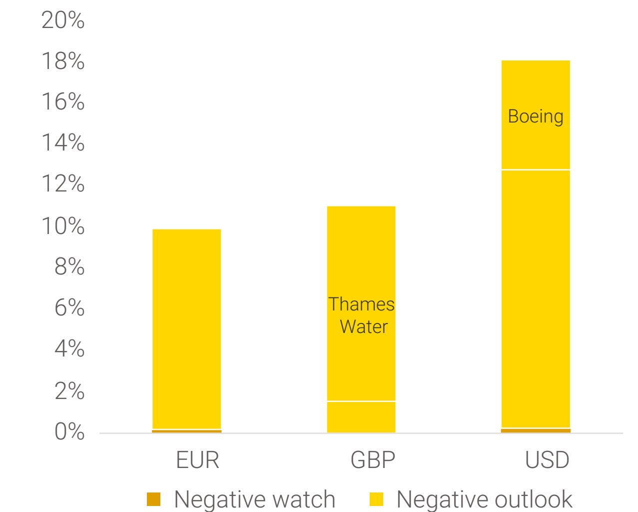
The present: idiosyncratic situations, not widespread downgrades

Analysing the percentage of BBB- bonds on negative outlook or watch (a common measure of credit downgrade risk) suggests that risk has recently picked up for global IG corporates, driven by negative outlooks on some large cap structures in the US. However, the largest of these are idiosyncratic situations suggesting that, unlike in previous waves of credit deterioration, sector-wide downgrades are not a significant risk.

Negative outlooks for US large cap companies are increasing



LGIM, Bloomberg as at 30 June 2024. Note: Figures are based on the constituents of the Bloomberg USD/EUR/GBP Corp 1% Issuer Capped index. **Past performance is not a guide to the future. The value of any 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. For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.**

That said, over the next 12-18 months, our analysts are predicting more fallen angels than at any point since COVID-19. We still expect these to be slightly outweighed by rising stars, so there will probably be marginally improving credit quality on average.

What could go wrong?

In order to witness a more systematic deterioration in credit quality, we think a broad-based economic downturn would be needed. Our regular stress tests of the global credit investment universe suggest that over $350bn of IG bonds are vulnerable to downgrades in the event of a global recession.

To put this figure in context, this would be a slightly more benign outcome for bondholders than either the global financial crisis or the pandemic.

Outlook

Assuming that our base case of a soft landing remains intact, the bottom-up analysis conducted by our global research team concludes that we will continue to see more upgrades than downgrades over the next one to two years. That said, we expect this to be a bumpy ride and we believe the biggest improvements are behind us and will moderate from here.

Moreover, at compressed spread levels, the margin of error for IG investors is lower than usual. We believe avoiding problem credits is the best way to add alpha in a market environment such as this one, making single name selection more important than ever.

Contact us

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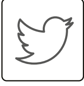

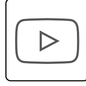

Key risks

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