Fixed Income Insights

Macro Talking Points

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In brief

- **We believe a Fed cut is coming. So what?**
- **One pillar of our fixed income team's investment process**
- **Client questions in Asia**

The Fed has its work cut out. We finally got there, with macro conditions now allowing the US Federal Reserve to initiate a much-anticipated easing cycle. But it may too soon for the Fed to take a victory lap. There is anxiety in the wake of the latest labor market developments. In other words, there is little room for further deterioration before the risk of a recession becomes a worry again. On the inflation front, the Fed deserves some credit, with the disinflation trajectory more established. More important, the central bank may have achieved what many considered to be Mission Impossible a year ago: engineering a soft landing. It is only the beginning of a long journey, but it is important to recognize this first cut as a supportive signal for fixed income while also acknowledging that the Fed has more work to do. The market anticipates that we may see a federal funds rate starting with a 3 in the future, but uncertainties remain. For this week, the market seems to be split between the chance of 25-basis-point move and a 50 bps move, with 36 bps of cuts priced in for now.[1] Our chief economist, Erik Weisman, leans towards a 25 bps cut this month (even as he thinks the Fed should go 50), but it looks like a close call. The 25 bps move sounds reasonable as the Fed may want to avoid engaging in a policy action that may be interpreted as a panic signal. Ultimately, what may matter is the steadiness of rate cuts ahead, and whether there will be the flexibility for more aggressive policy action if the macro backdrop takes a turn for the worse. Why is the first Fed rate cut such a big deal? To begin with, it will cause a drop in cash returns, which may help convince cautious investors to lower their cash allocations. In addition, a switch to easing typically sends a positive signal for global risk appetite, unless it is associated with a severe growth shock. Overall, fixed income is well positioned in the period ahead, both from a duration and total return perspective, as long as the landing is indeed soft.

When top-down meets bottom-up. One of the pillars of the fixed income team's investment process is to leverage the breadth of its research platform and extract potential bottom-up signals that may help complement the team's top-down macro analysis. With that in mind, the investment team regularly discusses these micro versus macro themes. Sometimes, the bottom-up and top-down views are consistent, and sometimes they offer a different perspective, simply because our credit analysts may be able to detect a trend at the firm or sector level that may not be visible through the lens of the macro data yet. Whether the bottom-up signals confirm or differ from the top-down, the process remains valuable. It includes detailed insights on the health of the consumer, the hiring and lay-off developments at the corporate level or the appetite of firms for capex. Overall, generating a strong and resilient alpha stream can appear daunting for an active asset manager, but leveraging the signals from the bottom-up research process and contrasting that with the macro signals is an important piece of MFS' alpha puzzle.

Client questions in Asia. I spent a couple of days last week seeing our institutional clients in Taiwan. Here were the key discussion topics: On the macro side, the main questions revolved around the rate view, including the market pricing of future policy easing, the prevailing macro scenario (hard landing versus soft landing) and the various macro regimes. Other questions related to inflation risks, the outlook for emerging markets and the view on China. On the fixed income front, the key questions were about the view on duration, the best opportunities in fixed income across sectors, the curve view, what the optimal curve positioning is and the outlook for private credit, especially in the context of declining rates. Finally, the US election and its impact on market was a major item on the agenda, including the implications for the global environment, the impact for fiscal policy, the risks for the Treasury market and the USD.

Endnotes

[1] Source: Bloomberg. Based on federal funds futures. Data as of 13 Sept. 2024.

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