Macro Talking Points

Fixed Income Insights

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In brief

- **US exceptionalism, in reverse**
- **A look at recession pricing**
- **Fixed income valuation has improved substantially**
- **Client questions from last week's visit to the Nordics**

The wrong kind of US exceptionalism. What a difference a few weeks make. Not long ago, the United States had outperforming markets, stronger growth, large capital inflows and an appreciating currency. Fast forward a few weeks and the story has unraveled, with the pain mainly self-inflicted. At this juncture, the odds of a recession appear to be greater in the US than anywhere else, the dollar is weakening and the appetite for US equities has waned. Of course, the whole world has been subject to major financial contagion, and it feels like there is no place to hide in risky markets. At this point, it feels like a bit of panic in global markets. In comparison, the unwinding of the yen carry trade episode of last August and the Silicon Valley Bank blow up of March 2023 both feel like a spa retreat given the considerably higher level of market stress observed over the past few days. Looking ahead, we are going to need a catalyst to help settle the dust. In the near term, signals that there is a window for tariffs to be negotiated down would help, although there is little evidence that this is a likely scenario. Market Insights' search for a silver lining goes elsewhere. In order to avoid a recession in the US, we believe the government will have to shift gears and focus on a more growth-supporting policy agenda. If that happens soon, it could allay recession fears, thereby providing relief to the global markets. Separately, a "Trump put" cannot be ruled out if market pressure intensifies or if there is growing evidence that the economic cost of tariffs will be excessive. In the meantime, fixed income remains well positioned in the period ahead as an attractive de-risking asset class. The case for being long duration has strengthened considerably over the past week, reflecting the downside risk to growth and the growing expectations that global central banks may have to accelerate the pace of policy easing.

Is a US recession already priced in? It depends on where you look. The equity market basically says yes, fixed income markets, definitely not. Based on our calculations, we believe that an equity market correction of around 20% would be broadly consistent with a mild recession scenario. But credit spreads are well short of triggering a recession call. The data is not as good in high yield as it is in investment grade. Having said that, our HY investment team is of the view that spreads are still far away from pricing in elevated recession risks. Meanwhile in IG, spreads would likely have to break the 200 basis point level to signal a recession. So, which market is right, equity or fixed income? It is of course a tough call to make, but historically, equity markets have been known to more quickly price in worst-case outcomes.

Looking for a silver lining, the valuation picture. Compliments of the current global market stress, the valuation picture has improved considerably in global fixed income. While just a few weeks ago, most spreads were stretched, that's no longer the case. Looking at the absolute level of spreads relative to their own history, US HY valuation has swung back into moderately attractive territory. Similarly, US IG spreads have converged back to long-term fair value. Using one of the preferred valuation indicators of our quant investment team, the z-score of spreads per unit of excess return, US HY and US IG are the two most attractive asset classes from a valuation perspective at this point. More importantly, there is not a single fixed income asset class in overstretched territory anymore.

Client questions in the Nordics. We spent some time last week visiting our institutional clients in the Nordic countries. On the macro side, client questions centered around the impact of tariffs, the health of the US consumer and the probability of a recession. Clients also asked about how to interpret the severe drop in consumer sentiment. The dollar view was also heavily discussed, and what it means for a European investor. On markets, clients wanted to discuss the bond-equity correlation, our view on credit in the current market environment, including the case for HY exposure, fixed income valuation, and finally, sector allocation.

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