# Macro Talking Points

Fixed Income Insights

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## In brief

- **US inflation surprised to the upside. So what?**
- **EUR IG fundamentals remain satisfactory despite a tough macro environment**
- **It is hard to see the dollar weaken considerably in the near term**

**Be careful of SID: seasonal inflation disorder.** The January US inflation print produced a bad surprise, but the story may not be as bad as it looked last month. This is mainly because of the "January effect" and other one-off developments, which may suggest that next month's number may be more constructive. In particular, the supercore services prices (core services excluding housing) spiked in a dramatic way last month, but that shock is unlikely to be persistent. On a more positive note, it is worth flagging that housing inflation was fairly contained in January, a sign that the long-awaited downward adjustment in rents may finally be happening. More importantly, the outlook for the inflation measure that matters the most for the US Federal Reserve, the core PCE, seems to be a bit more favorable. SID or not, the reality is that the inflation backdrop is clearly not as supportive as it was just a few months ago. Our chief economist Erik Weisman is of the view that the 2025 Fed cuts may be priced out by the market. With that in mind, he has turned a lot more cautious on US duration given the scarcity of macro drivers that would help push rates lower. Ultimately, the Fed may cut its policy rate further this year, but the timing of the next move has become uncertain. Overall, we believe that duration is unlikely to actively contribute to US fixed income expected returns in the period ahead.

**Macro-fundamentals versus asset class fundamentals.** In principle, macro and asset class fundamentals should move together most of the time. But that is not necessarily the case. In fact, an interesting case for observation is EUR IG fundamentals. The latest data available, as of Q3 2024, were still quite robust despite a macro backdrop that had turned increasingly challenging in the eurozone. We believe that it is unlikely that economic growth in Europe will make it to above 1% this year, which places the region in the lackluster category. Looking at the latest J.P. Morgan data on credit fundamentals, EUR IG's strength mainly comes from solid EBITDA margins and adequate leverage.[1] However, one caveat is that the fundamentals for EUR HY look to have taken a turn for the worse, suggesting that HY fundamentals tend to be more sensitive to macro conditions than IG. To be clear, it is always a dangerous game to generalize about HY given the significant dispersion of fundamentals from one sector to another, and even from one corporate to another. Overall, we believe that EUR IG remains well supported by satisfactory fundamentals. In addition, it may be worth noting that ongoing ECB easing, together with adequate valuation and robust technicals, continue to work in favor of the asset class.

**The dollar is king.** Is the dollar strong? Very. Looking at the Fed trade-weighted nominal broad index, which is the most relevant nominal indicator for the dollar, the USD currently trades just 1.25% short of its highest value since 1973.[2] That historical high was printed on 13 January of this year. In other words, it is fair to say that the new macro regime, which Market Insights has dubbed "Trumpilocks," is characterized by a strong dollar environment. No surprise there: The US grows faster than everybody else, the Fed cuts by less than everybody else and the US government has threatened (almost) everybody else with tariffs. In other words, the strong dollar is the result of US macro-outperformance combined with the impact of Trump 2.0 policies. It is interesting to note that the USD has strengthened by twice as much against the other developed market currencies since the US election than it has against EM currencies during the same period. In real terms — after the adjustment for inflation differentials — the USD currently trades at a level that is 20% higher than its long-term average (since 2000).[3] So unless we believe that the US has experienced a substantial shift in structural productivity and long-term growth potential, the basic conclusion is that the dollar is overvalued. It does not mean that the dollar is set to decline, however, at least probably not in the near term. Having said that, there are nonetheless two tactical risks for the dollar. First, being long dollar is the consensus and has become a crowded trade. This means that the technicals are no longer supportive. In addition, when looking at the short-term rate differentials against the euro — in real terms — the signal, which historically had a significant influence on where the dollar would trade, is not as supportive as it used to be. However, these two near-term risks may not be enough to bring the USD down overall. A persistently strong dollar may represent a challenge for non-USD assets, and navigating FX volatility is likely to be one of the many challenges facing fixed income investors with a global mandate.

## Endnotes

[1] Sources: J.P. Morgan, EUR HG fundamentals, as of Q3-2024.

[2] Sources: Bloomberg, Fed. Fed trade-weighted nominal broad index. Data as of 7 February 2025.

[3] Sources: Bloomberg, Fed. Fed trade-weighted real broad index. Monthly data. Data as of end January 2025.

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