Macro Talking Points

Fixed Income Insights

Week of 20 January 2025

Author

Benoit Anne
Managing Director
Strategy and Insights Group

In brief

- **A major macro regime transition for 2025**
- **Risks to US market rates are no longer skewed to the downside**
- **Rosy versus gloomy, a different growth picture when you look at the US versus Europe**

From Goldilocks to Trumpilocks. Remember Goldilocks? That time when the market backdrop looked near perfect for both fixed income and equities? Well, it's gone. We're moving to a new macro regime, which Markets Insights have labelled Trumpilocks. To be clear, it's not all about Trump 2.0 and its impact, although that plays a big role. Besides Trump 2.0, a major consideration is that the US Federal Reserve has hit the brakes because of stronger-than-expected economic activity and slower progress towards disinflation. Under Trumpilocks, it's much harder to hold a high conviction call on being long duration, mainly because the inflation outlook is less supportive. There are also a number of risks that may reduce risk appetites, ranging from a potential trade war to geopolitics. Risky assets may continue to do well, but in addition to the risks above, there are also concerns over the market valuation landscape. Meanwhile on the fixed income front, we probably have lost the impetus of policy rate cuts as a key driver of fixed income expected returns, especially in the US. That is another key feature of Trumpilocks: the great bifurcation. The global monetary policy and macro outlook have become unsynchronized. From a fixed income perspective, the Eurozone remains in Goldilocks mode given the need for the ECB to go ahead with its policy easing. We believe this represents a fertile environment for a global active asset manager, as there should be plenty of relative value opportunities and dislocations in the period ahead. At the same time, we anticipate that macro volatility will remain elevated. Finally, from an equity/bond correlation standpoint, under Trumpilocks, fixed income should gradually regain its status as a portfolio diversifier, with the correlation expected to normalize lower.

The risk to rates is no longer substantially skewed to the downside. Listening to the latest fixed income strategy meeting held by our investment team last week, it's fair to say that the tactical case for being long duration is not as strong as it was just a few months ago. In fact, most fixed income portfolio managers have revised their market rate projections upwards. Additionally, the quant investment team rate forecast — which is based on curve slope and real yield modelling — takes a neutral view on market rates, supporting the notion that caution is probably needed on duration positioning in the period ahead. This week is going to be a heavy one on the US politics and policy fronts, and therefore a near-term spike in rate volatility appears likely. Overall, it seems that carry is going to play out as the primary driver of fixed income expected returns in the period ahead. Spread compression, in contrast, is unlikely to help in a major way given where spreads are. Finally, the earlier "cut and carry" Market Insights theme has now been overtaken by recent market developments, with the tactical case for duration becoming a bit more challenged.

This is not the end of the business cycle. In the US at least. At this point, recession risks are as low as they have been since May 2022, at least according to the Market Insights' business cycle indicator, which aggregates selected leading indicators for the US. In other words, the US economy is still going strong and behaves as if we're still in mid-cycle. If anything, the risk at this juncture is that the US economy may tip into overheating, which would likely undermine global risk appetite. Both Fed GDP nowcast projections (from the Atlanta and New York Fed) point to a remarkably healthy 3% growth estimate for Q4-2024.[1] If that were to materialize, it would be the third quarter in a row with GDP growth exceeding 3%. Impressive, but this begs the fundamental question whether the US has shifted to a structurally higher growth trajectory. If it does, this could be great news for risky and growth assets because by now, one should have expected some sort of slowdown. In contrast, the growth outlook for the eurozone is a lot gloomier, and the near-term dynamics are the exact opposite of what we see in the US. The risks in Europe are skewed to the downside, with most leading indicators going south. This reinforces the case for monetary policy divergence, with the ECB likely to remain aggressive throughout the year. From a fixed income perspective, we believe that the eurozone is a more compelling place to be.

Endnotes

[1] Source: Bloomberg, Atlanta and New York Fed. GDP nowcasts for the current quarter. Data as of 17 January 2025.

Source: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Bloomberg neither approves or endorses this material or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

The views expressed herein are those of the MFS Strategy and Insights Group within the MFS distribution unit and may differ from those of MFS portfolio managers and research analysts. These views are subject to change at any time and should not be construed as the Advisor's investment advice, as securities recommendations, or as an indication of trading intent on behalf of MFS. No forecasts can be guaranteed.

Diversification does not guarantee a profit or protect against a loss. Past performance is no guarantee of future results.