Macro Talking Points

Fixed Income Insights

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In brief

- **There are two potential reasons to favor EUR Credit: tactical and strategic**
- **US HY remains well positioned**
- **Market focus will likely center on communication and expectation management during this week's FOMC meeting**

EUR credit as a strategic asset class. First, before discussing the strategic considerations, it's worth stressing that the tactical case for exposure to European Investment Grade remains strong. Our investment team continues to favor exposure to European fixed income over the US in their global fixed income strategies. This is mainly because the case for being tactically long duration in Europe is compelling as the European Central Bank will likely deliver multiple rate cuts in the period ahead. Current market pricing suggests that the ECB will cut by just short of 100 basis points over the next year, but there is a strong possibility that they will ease their policy rate even more, helping promote market rate compression in the process.[1] Besides the favorable long duration environment, EUR credit fundamentals remain robust despite the challenging growth backdrop in the region. Finally, EUR IG is supported by its attractive valuation, especially on a relative value basis against its peers, and by strong technicals, including healthy inflows into the asset class. But EUR Credit has a lot more to offer than just a tactical appeal. Indeed, EUR Credit is also a highly relevant asset class in strategic asset allocations. For a start, EUR IG is an interesting de-risking asset class option given its attractive defensive characteristics. Specifically, the volatility of EUR IG total returns is markedly lower than that of US IG returns, suggesting that EUR IG tends to be less risky. In addition, EUR IG offers diversification benefits relative to US IG, be it from a sector allocation standpoint or a country of risk exposure. Finally, EUR credit has produced compelling risk-adjusted returns over the long term. Looking back at historical performance in global fixed income, EUR IG stands out as one of the most attractive asset classes from a risk-adjusted return perspective. Overall, EUR IG has surfaced as an attractive strategic asset class for the global fixed income investor with a long-time horizon. However, investors should also be mindful of potential risks, such as economic uncertainty, liquidity constrains, and changes in central bank policy, all of which could influence performance.

The market backdrop remains broadly supportive for high yield. There aren't many red flags for US high yield at the moment. In fact, quite the contrary. Talking to HY portfolio manager Mike Skatrud, on balance there are reasons to believe that HY may continue to perform well in the period ahead. The macro performance in the US remains robust, which means that a broad-based default shock is unlikely. Meanwhile, the all-in yield valuation is attractive. Of course, spreads may appear fairly tight, but our HY team doesn't rule out further spread tightening, given the supportive combination of positive market drivers, including the macro, the fundamentals, valuation and even technicals. On the other hand, the key risk ahead for HY would be a recession in the US, but we can probably all agree at this point that this risk is as low as it's been for a while. At an index yield of about 7.2%, HY break-even yields are particularly attractive.[2] Yields would have to rise by some 240 bps over the next year for an expected negative price return that would more than offset the carry, pushing the total return into negative territory. We think that this is a fairly high bar.

The opposite of watching the paint dry. Just because the US Federal Reserve is likely to do nothing on the policy front this week, doesn't mean it will be a boring FOMC. With the Fed widely expected to keep rates on hold, Chief Economist Erik Weisman suggests that market participants may focus on Chair Jerome Powell's remarks, which could influence volatility. Managing communication risks has been a challenge for the Fed in the past, so it will be interesting to see how the rationale for this mini-policy pause is explained. There are still many questions on investors' minds and, overall, we would argue that the uncertainty over the Fed policy outlook is quite elevated at this juncture. Will the Fed Chair signal that a future rate cut, which is only partially priced in for the March meeting, is still very much on the table? Or are we now at a policy inflection point, with the risk that the Fed may have completed its easing cycle? Will the Fed Chair comment on the prospective policy agenda from the White House and its impact on monetary policy? These are some of the pressing questions. More fundamentally, there is still the issue of where the so-called neutral rate is, given the recent growth performance and productivity dynamics. It is entirely possible that the neutral rate may have shifted upward, which would mean that the current policy stance is not as restrictive as it was perceived initially. This is a difficult but important question as it determines how much policy room for further easing the Fed has. Moving on to rates pricing and curve positioning, under the assumption that the Fed will deliver its pause with a dovish undertone, the front end of the yield curve appears to offer somewhat better value than the long end. Overall, at this week's FOMC, communication, expectation management and policy signals all have the potential to trigger significant rate volatility in the near term.

Endnotes

[1] Source: Bloomberg. Based on forward cash curve. Data as of 24 Jan. 2025.

[2] Sources: Bloomberg. Bloomberg US HY index. Data as of 24 Jan. 2025.

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