Macro Talking Points

Fixed Income Insights

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In brief

- **There is no strong conviction to be long duration, rightly so**
- **The stars are aligned again for EM local debt**
- **Analyzing fixed income volatility**

Staying close to home. In their recent fixed income strategy meeting, the MFS investment team underscored the need for caution regarding US duration, reflecting ongoing uncertainty and rate volatility. With recession risks declining and the Fed sitting on the sidelines, there are no strong drivers for rates to move substantially lower. In addition, the recent US sovereign rating downgrade will likely reinforce the upside risks to US rates and warrant a higher risk premium. With that in mind, the case for long US duration is not particularly compelling. Away from the US, long duration in the eurozone still makes sense from a strategic perspective. In the near term, however, our head of DM sovereign research, Peter Goves, suggests that some tactical prudence is needed given the recent downward move in Bund yields. Looking ahead, duration is unlikely to be a major driver of fixed income total returns. That role belongs to carry, which remains attractive, as well as potential alpha.

Going global by going local. There are times when it is appropriate to be prudent towards EM local currency debt. This is not one of them. The stars appear aligned for this exciting asset class, compliments of the new dollar cycle. EM local debt has returned almost 8.7% year to date, well above any other asset class in global fixed income, helped by the weakening USD.[1] Global drivers have turned supportive of EM local debt. To start, we have been reminded over the past few months of the merit of global diversification. By construct, EM local debt offers substantial country diversification. Indeed, the main point of reference, the JP Morgan GBI EM Diversified Index, includes 19 countries covering Asia, EMEA and Latam. More importantly, while the global macro environment remains critical for the asset class, local macro drivers, especially central bank policy and domestic inflation, tend to also have a major influence on local market performance. Meanwhile, the IMF forecasts that a global recession is unlikely, which is a positive development for global EM. In addition, China remains fully committed to pursuing a growth-supporting policy strategy, as exemplified by recent monetary policy action. The stabilization of China's growth outlook should also be viewed as a positive. Finally, EM inflation has now corrected to just 3.3%, which has helped boost the attractiveness of EM local yields on a real — *i.e.*, inflation-adjusted — basis.[2] The index yield currently stands at 6.2% for an implied real yield of just short of 3%.[3] By comparison, the US investor will collect a real yield below 2% in US Treasuries while the Bund's real yield is virtually zero at this juncture.[4] One of the major critiques we often hear about EM local debt is that it is a volatile asset class. It is by fixed income standards, due to the FX risk component. But with a volatility of about 10%, it remains well below that of equities. Overall, exposure to EM local debt makes sense these days for the fixed income investor whose profile can accommodate some EM currency risk.

A close look at fixed income volatility. Elevated macro volatility has been a major theme since the beginning of the year, so it is worth looking at what that means for fixed income. In the IG space, the main source of return volatility has been rate return volatility. Year to date, the annualized volatility of US IG rate return has been 5.7%, which is considerably more than the excess return volatility of 2.2% coming from credit exposure.[5] This is also true for EUR IG. The rate return volatility at 3.1% is virtually twice as high as the excess return volatility. Generally speaking, the longer the duration, the higher the rate volatility has been. Not really a surprise. In particular, the rate volatility for US taxable muni bonds, a long duration asset class, has reached 7.7% year to date. In HY, it is understandably the opposite. Excess return volatility is still higher than rate volatility. In particular, US HY excess return volatility now stands at 4.8% annualized versus 2.7% for the rate return component. The same story is true in EUR HY with the two volatilities being at 3.2% and 1.9% respectively. Of note, excess return volatility has remained contained, despite global market turbulence. Now looking at the US versus Europe, it is also worth pointing out that volatility in Europe has been considerably lower than across the pond. For instance, total return volatility of EUR IG has been only 2.5% versus 4.6% for US IG. Looking ahead, while the market backdrop may change quickly, for now de-risking in fixed income predominantly means reducing exposure to asset classes with higher rate volatility. In other words, the preferable volatility management combination has been exposure to asset classes with lower rate volatility and higher excess return volatility.

Endnotes

[1] Sources: Bloomberg, JP Morgan. EM local debt = GBI-EM Global Div index. Returns are gross and in USD. Data as of 16 May 2025.

[2] Source: EM inflation calculated using the GBI-EM div country weights. Monthly data as of March 2025.

[3] Source: Bloomberg, JP Morgan. GBI-EM global div yields. Data as of 16 May 2025.

[4] Sources: Bloomberg. Real yield for the US estimated as the UST 5y yield minus latest headline CPI. Data as of 16 May 2025.

[5] Sources: Bloomberg. In this section, the volatility is annualized, calculated based on monthly data from 31 Dec 2024 to 16 May 2025. US IG = Bloomberg US IG Corporate index. EUR IG = Bloomberg pan-European IG corp index. US HY = Bloomberg US HY index. EUR HY = Bloomberg pan-European HY index. US taxable munis = Bloomberg Bloomberg Taxable Muni US AGG Eligible. Rate return is estimated as the difference between Total return and Excess Return. Returns are gross and in USD (or EUR for Eur indices).