Macroeconomic Update

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Investors Embrace Disinflationary Soft Landing

In the last three months of 2023, we witnessed a remarkable market pivot. The U.S. 10-year Treasury yield surged to 5% in late October before plunging below 4% at the end of the year. In the space of two months, the market narrative has swung from expectation of further Federal Reserve (Fed) rate hikes and concerns about rising bond issuance to fully embracing a disinflationary soft-landing view.

At the start of the fourth quarter, our fixed income portfolios were overweight duration and benefited substantially from the sharp decline in bond yields. With inflation falling sharply and major developed market central banks about to embark on rate-cutting cycles, the macroeconomic environment is generally favorable for bonds. But the key question for us is: How much further can bond yields fall without a major growth scare or a recession?

The bottom line is that we are likely to go through a period of bond market consolidation with potential backups higher in yields. The more interesting opportunities for generating alpha could come from relative curve and cross-country positions instead of large directional bets on the U.S. 10-year yield.

In previous macroeconomic updates, we have frequently emphasized that the major macro developments over the past two years have reflected post-pandemic normalization dynamics rather than typical business cycle events. This normalization process is now well advanced with the U.S. economy settling back toward an equilibrium of around 2% real gross domestic product (GDP) growth and 2% inflation.

Potential Impact on Fed Policy and Treasury Curve

While these constructive developments should allow the Fed to normalize monetary policy, we do not expect a full return to the pre-COVID environment of the 2010s. In that decade, yields were suppressed by weak investment demand, post-Global Financial Crisis (GFC) debt deleveraging, investor risk aversion, and fiscal consolidation.

During the 2010s, nominal GDP growth averaged around 4%, while the federal funds rate averaged only 0.6%. In the future, we believe nominal economic growth of 4% is likely to be consistent with policy rates of 3% to 4%. Markets are already pricing in the expectation that the federal funds rate will return to the lower end of that range over the next two years and remain there in the medium term. Therefore, unless we have a major growth scare, the scope for further declines in bond yields is more limited.

Can the Fed cut rates well below 3% purely based on falling inflation? We see that as unlikely. It is possible that U.S. core inflation could undershoot the 2% target to the downside in 2024 as part of the post-pandemic normalization process, driven by a period of goods price deflation and of Consumer Price Index (CPI) rental inflation catching up to market measures of rent. However, if this potential development is accompanied by decent economic growth, the below-target inflation should be viewed as transitory and not a reflection of a future inflation trend.

If the Fed cuts policy rates to 3% in response to normalizing inflation, where should the 10-year yield trade? The long-term spread between the federal funds rate and the 10-year yield is about 100 basis points, so 4% is a reasonable starting point.

A Fed easing cycle that reinforces the expectation of an economic soft landing—and possible growth reacceleration in 2025—should lead to a steeper yield curve. In addition, at some point we may see a reemergence of bond supply concerns. The November 2023 Treasury refunding plan reduced the long-end issuance, providing short-term relief from upward pressure on the term premium. However, this relief is likely to be only temporary as the U.S. deficit trajectory will ultimately drive the medium-term bond supply outlook.

Macroeconomic Drivers

We started 2023 with most economists and investors expecting that the U.S. economy would be in a recession by now. The opposite is true today, with market expectations firmly in a soft-landing camp. Could the U.S. economy surprise yet again, this time with a period of weak growth and a rising unemployment rate?

The U.S. economy still faces some residual headwinds. Higher rates are gradually being passed into average consumer and business borrowing costs. Fiscal policy, which has played a significant role in U.S. economic resilience, is likely to be less supportive in 2024. Bank lending growth remains weak while commercial real estate markets remain under pressure. Lower-income households are experiencing significant increases in credit card and auto loan delinquencies.

At the same time, significant sources of U.S. economic resilience will likely remain in place. Both labor supply growth and productivity growth have been strong over the past 12 to 18 months, allowing inflation to normalize without a recession. Real consumer incomes should be supported by robust nominal wage income growth and falling inflation. The sharp easing in financial conditions in the past few months should boost housing demand and business capital expenditures (capex).

Overall, a U.S. economic soft landing seems like the most likely scenario, although this outcome is already reflected in current market expectations.

In addition, in 2024 we may see a somewhat better environment for the global goods sector. Since the fourth quarter of 2022, the global manufacturing PMI has moved sideways in an unusually tight range between 48 to 49. These readings have been consistent with a prolonged period of below-trend growth in global industrial production but short of a major cyclical downturn. In 2024, we could see somewhat stronger global industrial production growth. After a prolonged post-pandemic payback, real goods consumption is growing again. Companies have significantly reduced the post-pandemic inventory overhang. We also are seeing nascent signs of a global semiconductor up-cycle, driven by improving business and consumer electronics demand as well as artificial intelligence-related infrastructure investments.

Global Considerations

A key uncertainty going into 2024 is the trajectory of Chinese economic growth. Housing sector structural adjustment continues to be a significant drag on growth. Weakness in housing-related activities also is putting pressure on corporate and local government balance sheets. What is unclear is whether China's adjustment process worsens moderately in 2024 or if the economy can outperform uniformly negative market expectations. It is noteworthy that while most global equity markets rallied sharply in the last two months of 2023, Chinese equity markets did not participate in this rally.

Eurozone growth disappointed in 2023, with the region continuing to experience below-trend GDP growth while avoiding an outright recession. Eurozone GDP growth has been held back by a combination of an aggressive European Central Bank (ECB) tightening cycle, subdued global goods demand, and the residual impact of the 2022 energy market shock. In addition, fiscal policy has been much less growth supportive in the euro area than in the U.S. The sharp decline in eurozone core inflation in recent months should allow the ECB to reverse some of its policy tightening. Lower inflation will boost real household incomes and support consumption. Finally, the euro area economy would benefit from a potential improvement in the global manufacturing cycle.

We expect the Bank of Japan (BOJ) to finally start policy rate normalization in the coming months. A regime change has occured in Japanese inflation dynamics, and current monetary settings are clearly no longer appropriate. Japan is the only major economy where real bond yields today are lower than before the pandemic. The longer the BOJ waits to start its policy adjustment, the faster it may need to move in the future. Given the number of false starts since 2000, investors are understandably reluctant to price in a meaningful policy tightening cycle. However, the current inflation regime is very different from anything we have seen in the last 25 to 30 years.

A U.S. economic soft landing creates an environment that allows the BOJ to raise policy rates at a time when the Fed is expected to ease. While the narrowing of relative policy rate spreads will put upward pressure on the yen (JPY), the currency remains far away from its fair value. Therefore, the risk of currency appreciation should not be a major concern for the BOJ.

Finally, moving into the second half of 2024, markets will increasingly focus on U.S. elections. As many political analysts have highlighted, this election cycle is likely to be extremely unpredictable and polarizing, particularly if Donald Trump is the Republican nominee. The outcome of both the presidential and congressional elections could have major implications for fiscal and international trade policy settings. Investors will likely demand higher risk premiums across a range of asset markets as we approach November.

Strategy Implications

With inflation falling sharply and major developed market central banks about to embark on rate-cutting cycles, the macro environment is generally favorable for bonds. However, after the sharp rally in the last two months of 2023, the risk-reward tradeoff for bonds is clearly less compelling.

U.S. real bond yields are still attractive relative to U.S. equity yields. However, that is more a reflection of elevated U.S. equity market valuations rather than the absolute cheapness of the domestic bond market.

We continue to favor a steeper U.S. yield curve from a medium-term perspective. We would expect the curve to steepen in either a soft landing or a recession scenario.

For the past six months, we have been overweight UK bonds on the back of attractive valuations versus other G10 markets and have believed that UK inflation dynamics were not that different from other major developed economies. That view has largely played out as we expected, and the relative valuation case for gilts is now somewhat less compelling.

We have a medium-term bearish view on the U.S. dollar (USD). The dollar is expensive on a range of valuation measures. Over the past 18 months, the USD has been supported by expansionary fiscal policy and aggressive monetary tightening. Looking forward, the key question for currencies centers around the prospect of continued U.S. growth outperformance. At least part of the recent U.S. growth outperformance has come from exceptionally stimulative fiscal policy compared with other G10 economies. In 2024, we anticipate a deceleration in U.S. fiscal support, which combined with Fed rate cuts, could lead to USD weakness. In addition, we believe medium-term U.S. debt dynamics are a negative headwind for the dollar.

Even after a strong performance in 2023, we still like select Latam currencies, including the Mexican peso (MXN), Brazilian real (BRL), and Colombian peso (COP). These currencies offer a combination of reasonable valuations, attractive real yields, and positive balance of payments dynamics. We think 2024 could be more favorable for Australian dollar (AUD) and Norwegian krone (NOK), given attractive valuations, potential for stronger global goods demand, and expectation that both the Reserve Bank of Australia and Norges Bank are likely to be much slower in cutting rates than the Fed. Finally, we are bullish on JPY, expecting relative policy spread convergence going forward.

We also continue to like Latam local currency bonds, excluding Chile, which still offer historically attractive nominal and real yields. The Fed monetary easing cycle should allow Latam central banks to gradually normalize still elevated policy rates.

Finally, we still have a large overweight position in U.S. agency mortgage-backed securities (MBS). While MBS spreads have tightened significantly in the past few months, they remain attractive, particularly compared with investment grade bond spreads.

In summary, our positioning centers on the view that yields may not fall much further as the bond market consolidates in response to inflation and monetary policy normalization. Hence, we see the potential for more interesting opportunities across fixed income sectors and through active, relative yield curve and cross-country positioning. Foreign currency dispersions may also provide opportunities and the potential for mean reversion in the wake of U.S. growth exceptionalism, dollar strength, and Fed policy all beginning to normalize.

Index Definitions: The **Consumer Price Index** (CPI) is used to measure the change in the out-of-pocket expenditures of all urban households for a particular set of goods and services. In terms of its coverage, the CPI measures the cost of spending made directly by households for the items in its basket, with the notable exception that it also includes a measure of the rents that homeowners implicitly pay instead of renting their home. The CPI is constructed by the Bureau of Labor Statistics and is released around the middle of each month, with a one-month publication lag.

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