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

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

The bottom line for us is that we are likely to go for a period of bond market consolidation, with some potential back ups higher in yields. And the more interesting investment opportunities for us could really come from relative curve and cross-country positions instead of large directional-bent bets on the U.S. 10-year yield.

In previous macroeconomic updates, we frequently emphasized that the major macro developments over the past two years have reflected the post-pandemic normalization dynamics, rather than what would be a typical business cycle. 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.

We believe that nominal GDP growth of 4% in the medium term is going to be consistent with policy rates of somewhere between 3% to 4%. And after the recent move in bond yields, markets are already reflecting this expectation that the federal funds rate will return to around 3% over the next two years and remain that in the medium term. So, unless we have a major growth scare or potentially a recession, to us, the scope for further significant declines in bond yields from here are much more limited.

Another way of looking at this is by comparing the current 10-year yield with where the Fed policy rate is. And as you can see on the chart that I'm showing, the spread between the 10-year yield and the federal funds rate is currently very depressed, and it's rarely been more inverted than it is today. In a world where the Fed cuts rates to 3% in response to normalizing inflation, where should we expect the 10-year yield to trade?

You could see from the chart that the long-term spread between the federal funds rate and the 10-year yield is about 100 basis points. So that's probably a reasonable starting point, which would imply a 10-year yield expectation of around 4% — where we are today.

If we see a Fed easing cycle that reinforces the expectation of an economic soft landing, ultimately, that should lead to a steeper yield curve. In addition, at some point, we may see a sort of reemergence of bond supply concerns that we experienced in the third and early fourth quarter of last year. While the November Treasury refunding plan reduced the long-end issuance and provided some short-term relief from the upward pressure on term premium, this relief could end up being temporary as it's ultimately the trajectory of U.S. fiscal deficits that will drive the medium-term bond supply outlook.

We started last year with most economists and investors expecting that the U.S. economy would be in recession by now. The opposite is true today with market expectations now firmly in the soft-landing camp. So could we see a situation where the U.S. economy surprises yet again, but this time with a period of weak growth and rising unemployment rates?

It's true that the U.S. economy still faces some significant 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 this year. And then if you look at bank lending growth, it remains very weak while commercial real estate markets remain under pressure. And that pressure is likely to get worse going forward.

But at the same time, there are some really important sources of U.S. economic resilience that are likely to remain in place. Both labor supply and productivity growth have been very strong over the past 12 to 18 months, allowing inflation to normalize without a recession. Going forward, we would expect some slowdown in labor supply and productivity growth, but not necessarily in a way that would push the economy in a recession. At the same time, real consumer incomes should be supported by decent nominal wage growth and falling inflation. And then finally, we've had a sharp easing in financial conditions in the past few months, which on the margin, should support housing demand and business investment.

Overall, a U.S. economic soft landing seems like the more likely scenario, although this outcome is really already reflected in current market expectations. In summary, our positioning is really based on the view that U.S. 10-year yields may not fall much further and the bond market consolidates in response to inflation and monetary policy normalization. Hence, we see the potential for more interesting investment opportunities through yield curve tilts and potentially looking at cross-country positioning as well.
One investment area that we continue to like is local currency bonds in Latin America. These bond markets still offer historically attractive nominal and real yields. And here's a chart that shows the real yield for Mexico, which even after the recent rally, remains very elevated. If you look across Latin America, we are generally seeing decent economic growth, falling inflation, and very positive balance of payments dynamics. On top of that, the Fed's monetary easing cycle should allow LatAm central banks to gradually normalize very elevated policy rates, which should support returns for these bond markets going forward.