Insights
Fixed Income

February 2024

Bonds are Back

Where to Look, What to Do in 2024

Des Lawrence
Senior Investment Strategist
Investment Strategy & Research EMEA

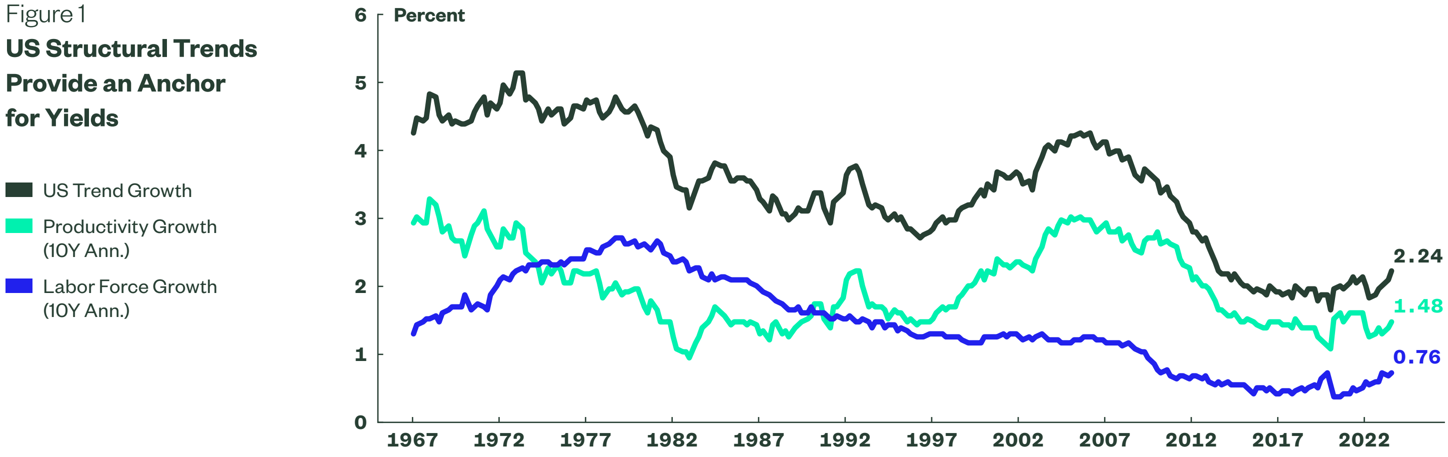
- Slowing growth and further disinflation will push central banks to cut rates aggressively.
- Structural trends in the labour force and productivity also favour lower yields.
- Expect a bullish steepening in yield curves.
- Embrace duration — US Treasuries will likely set the trend.
- Short-dated bonds offer a compelling alternative for those who remain cautious on duration in the near term.
- Cautious on credit (IG and HY) for now but EM debt warrants attention.

A Rare Synchrony

There are moments when the stars align particularly well for bond investors, moments when strong and complementary forces — cyclical and structural — strike a rare synchrony. These infrequent moments often deliver large gains relative to historic averages. For fixed income investors we may well be at such a pivotal point. On the cyclical side, three interrelated dynamics are in play: a slowing labour market and economy, rapidly cooling inflation and, as a consequence, real interest rates set at an overly restrictive level.

On the structural side, a more gradual, yet potent, dynamic is in motion: modest labour force expansion and waning productivity growth (see Figure 1) point to an economy whose safe operating speed or trend growth has declined. In the medium term this structural aspect will act as an anchor for long-dated sovereign yields in the US and elsewhere, while in the near term (i.e. the coming quarters) the cyclical forces get us moving towards the anchor point.

Figure 1
US Structural Trends Provide an Anchor for Yields



Source: State Street Global Advisors. As of 30 September 2023.

The Attraction of Sovereign

While the resilience of the US economy has surprised many of us in recent quarters, we expect a meaningful slowdown in global growth this coming year. The combination of that slowdown in output and a disinflation dynamic that has a bit further to run leads us to believe that sovereign fixed income — and US Treasuries in particular — offers investors an attractive proposition over the medium term. Returns will not come in neat portions quarter by quarter however, and we expect recent choppiness to continue as markets digest data revisions and outliers around an established softening trend. The US labour market is a good case in point: labour demand continues to slow — we see ample evidence of this — and while the occasional strong data point may be met with some angst and confusion it should not be read as a reversal of an overall weakening trend. Interestingly, even the Fed acknowledged recently that job gains "while still strong" had "moderated since earlier this year".

Furthermore, the welcome disinflation dynamic becomes more nuanced and market-specific from here. In the US for example the narrative will be less focused on the scale of disinflation and more about a rotation from headline to core. In the UK and across the Eurozone, we expect the disinflation trend to continue but at a much slower pace from here. Across Asia and the Pacific, declining inflation is also evident albeit at a more modest pace and through different channels. This ongoing inflation dynamic means that some of the world's major central banks have good cover to deliver significant rate cuts, even if their rhetoric remains somewhat ambivalent in the very near term.

At the time of writing much of this has been quickly and aggressively priced in to many short-term and long-term interest rate markets. It's not unusual for markets to reassess and give back some of those gains especially in light of the sheer scale and speed of the moves — in the last three months of 2023 yields plunged across most major government bond markets with a favourable spill-over into various other fixed-rate markets. We nonetheless believe that investors will still be rewarded in sovereign debt this coming year and, additionally, a potential correction in yields may offer an even more rewarding entry point before yields resume a downward trend in a more sustainable manner.

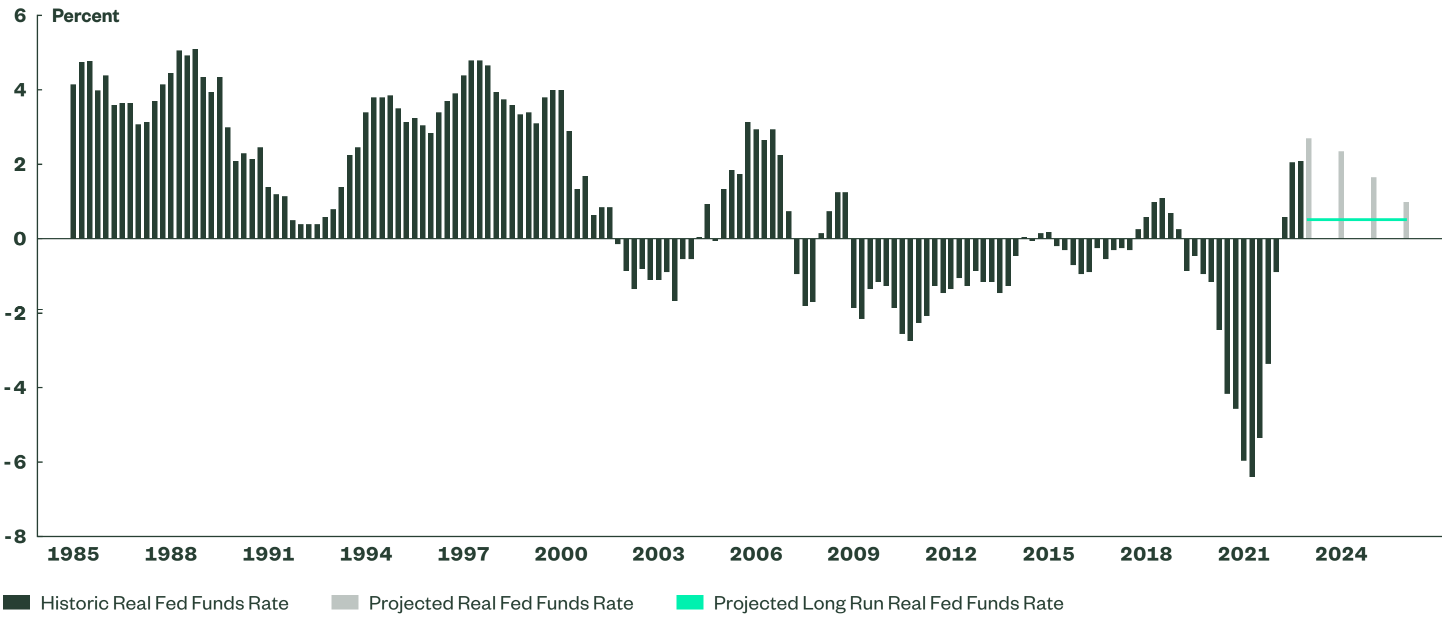
The Catalyst

As noted above there are a few dynamics in play on the cyclical front. The extent of the fall-off in economic activity and the pace at which inflation moderates are still subject to debate. However, the critical point for investors hinges around real interest rates — more specifically, what level and duration is sufficiently restrictive to restrain inflation without causing undue damage.

Currently the Fed's collective view[1] is that inflation[2] will fall from an estimated 2.8% at end 2023 to 2.4% by the end of this current year. Given their dot plot projections for the nominal Fed Funds rate that implies the real Fed Funds rate starts this year at 2.6% and ends at a still pretty restrictive 2.2%. Their projections see the real Fed Funds rate then falling to 1.5% and 0.9% by the end of 2025 and 2026 respectively. So how restrictive is that? The chart below provides some context on how the real rate has varied over previous economic cycles and the Fed's current projections for it out to end 2026.

Figure 2

Real Fed Funds Rate — Restrictive for Some Time to Come?



Source: State Street Global Advisors. As of 31 December 2023. Federal Reserve's Summary of Economic Projections, December 2023. Projected real Fed Funds rate data are inferred from projections for nominal rates and inflation.

It's clear that the Fed's response to a slowdown of any reasonable magnitude has been to reduce the real rate close to zero and in more recent times to bring it firmly into negative territory (the response during the pandemic was clearly exceptional). However, at this point the Fed is not only projecting real rates to remain significantly higher than its own long-run estimate of neutral (0.5%) but to remain quite restrictive for, quite literally, years to come despite clear evidence of inflation falling quickly and the economy slowing meaningfully. It also seems likely that the longer the Fed keeps rates this high for this long the more likely the ultimate need for negative real rates.

Sovereigns in the Spotlight

The value catalyst for Treasury investors can come about in a couple of ways. Either the Fed acquiesces and revises downwards its rate projections and/or tailors its inflation estimates or it sticks to its guns for longer and the economy most likely faces gratuitous damage in the form of needlessly higher unemployment and borrowing costs. The former supports Treasuries by removing uncertainty and policy error and while we certainly don't wish for the latter its implications for yields are arguably more favourable again.

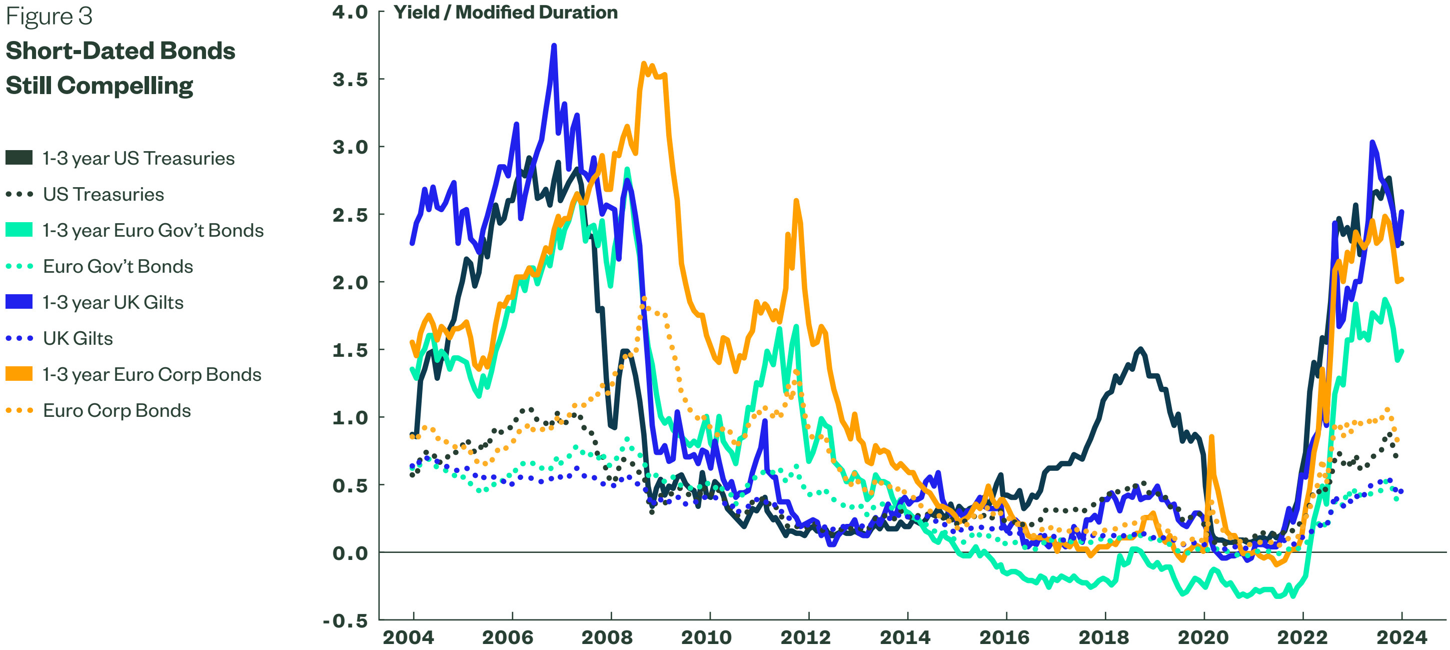
As noted the Fed sees core PCE inflation hitting 2.4% by the end of this year; we take a more constructive view and see it falling to 2.4% by mid-year and then lower into year end. Without trying to apply spurious precision, the extent to which realised inflation comes in below the Fed's estimates gives US Treasury investors more confidence in and a margin of safety on their exposure to US Treasuries.

At longer maturities there is typically a strong correlation between the performance of most major sovereign bond markets — indeed the performance of the Japanese 10-year yield in line with most other major markets in Q4 is a striking example when the Bank of Japan is embarking on a very different monetary course to others. It's a reminder that duration is often global, while policy rates are distinctly local. We believe the US Treasury market best captures our favourable view on duration but we are aware that other markets follow Treasuries very closely at times.

Nevertheless there are sound reasons for us to see things playing out slightly differently outside the United States. For example, while we expect the disinflationary trend to continue across many European countries the progress from here is likely to be a lot slower than the impressive pace of decline seen in recent months. Furthermore, wage inflation is still relatively elevated in both the UK and across the single currency bloc with clear implications for policy settings. Recent rhetoric from both the European Central Bank and the Bank of England alludes to rates coming to rest at a plateau for some time rather than a quick pivot to cutting mode. A combination of the above could mean that investors in European sovereign debt may wish to exercise some patience in the near term until they can discern more evidence of a tilt in central bank policy.

The other side of that same monetary policy coin is that European (and many other) investors have a compelling alternative if they remain cautious on duration in the near term. The dramatic rise in short-dated bond yields suggests that the risk-reward profile (yield per year of duration) across several European markets is at its most attractive level in a decade or more (see Figure 3).

Figure 3
Short-Dated Bonds Still Compelling



Source: State Street Global Advisors. As of 31 January 2024.

Credit Waits in the Wings

Although investment grade corporate credit has benefited from relatively solid fundamentals, we expect them to soften in the coming quarters as revenue growth fades in a slowing economy and margin pressures challenge bottom-line growth. Against that background, spreads — at average levels for euro issues and well below the average level seen over the past 20 years for US dollar and sterling issues — do not look inviting. A further point of caution arises in relation to the declining quality of the overall investment universe in US dollar, sterling, and euro corporate credit.

Although issuers of corporate debt have taken advantage of low yields in recent years it would be a mistake to believe that they are immune to market conditions given that significant amounts of debt are due to be refinanced in the coming years. There are a number of moving and interrelated parts — absolute sovereign yield levels, prevailing corporate spreads and the duration of any sizeable move in either.

As outlined above, the response of central banks to evolving disinflation will have a bearing on underlying sovereign yields: if central banks do not concede on the disinflation front and keep rates overly restrictive for some time there is a clear risk of a deeper slowdown which is likely to put upward pressure on spreads (which are already relatively low) although the likely ensuing fall in underlying sovereign yields would clearly be supportive. A more agile response from central banks would offer the best outcome with less damaging spread-widening and lower underlying yields. In any case, at current spread levels, we feel investors can afford to wait for better entry levels.

High Yield Fails to Convince

Despite the fourth quarter rally absolute yields (broad benchmark level) for sub-investment-grade debt are still substantially higher than their average over the past 10 years. While not an immediate problem, it does raise the spectre of borrowers having to issue debt at significantly higher coupons if yields are still elevated at the point of refinancing. High yield debt — given its typically shorter term to maturity — is usually more exposed to this risk than its investment grade counterpart. Euro-denominated debt, in particular, faces substantial refinancing needs two to three years out. Once again both the underlying yield and the spread determine the ultimate coupon at issue.

Similar to its investment grade counterpart, high yield debt has been trading at relatively compressed spreads. Default rates are currently quite modest but can only rise as our predicted slowdown bites in 2024. In that environment, we anticipate a rise in distress ratios and in average index-level spreads. Consequently, we do not consider high yield debt a compelling proposition at current spreads. In a scenario where central banks keep real rates overly restrictive greater spread widening could, if maintained for some time, start to feed into considerably higher refinancing cost for some issuers. In fact, investors in this higher income/risk segment are likely to be much better rewarded in Emerging Market Debt (hard currency) than high yield bonds in the coming quarters.

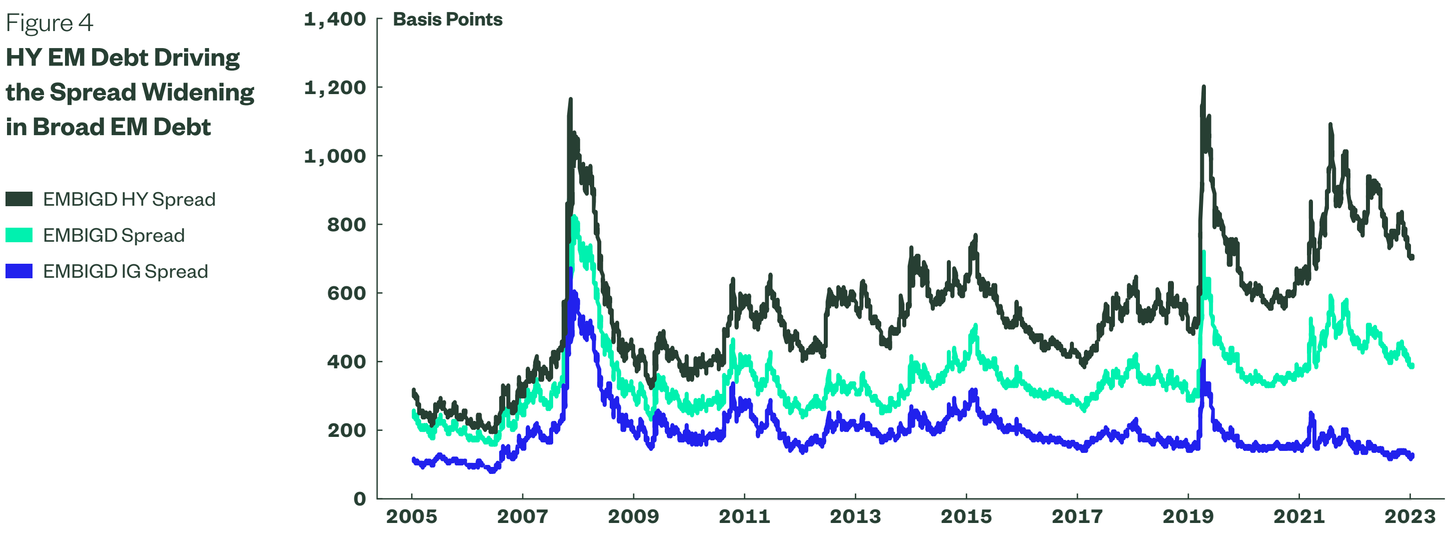
Emerging Market Debt Commands Attention

Against a backdrop of heightened volatility and uncertainty, hard currency emerging market sovereign debt currently looks attractive in light of the spreads on offer. With spreads in the high yield subsegment trading well above their long-term average, markets have already priced in most credit events (see Figure 4). Credit quality has shifted as the credit rating composition of indexes has changed. In high yield, the proportion of the lowest-rated credits has increased as countries have defaulted, restructured their debt, and been downgraded. In investment grade, by contrast, the proportion of the highest-rated credits has grown largely due to the addition of highly rated Gulf countries that have been large issuers of debt, resulting in a quality upgrade. Moreover, in the absence of a US recession, spreads have the potential to tighten further. There is also additional upside possible from a rally in Treasuries as outlined above.

On the other hand, the picture for emerging market local currency debt (EMD LC) has become a lot more complex. Firstly, emerging market monetary policy has decoupled from the Fed, so the differential between the yield on EMD LC and US Treasuries is around the lowest it has been in 15 years.

Next, the strong US dollar is clouding the short-term outlook — not only because of its direct impact on emerging market currency returns, but also indirectly because of its impact on emerging market inflation. However, real yields have now turned positive for some of the largest constituents in the broader EMD LC Index, and even though this is still below US Treasuries, it offers a pick-up versus the euro area.

Figure 4
HY EM Debt Driving the Spread Widening in Broad EM Debt



Source: State Street Global Advisors. As of 29 December 2023.

The 2024 Game Plan

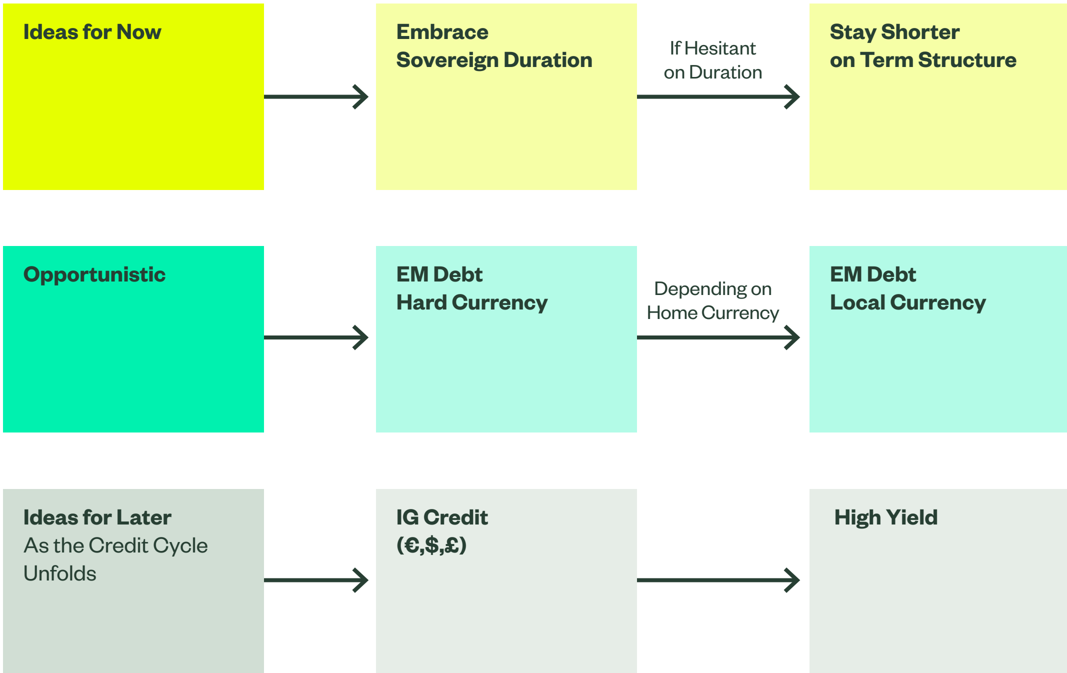
As the impressive resilience of the US economy fades in 2024, we believe that **sovereign fixed income** offers investors a rewarding opportunity. The significant improvement in the inflation environment will be the likely catalyst as central banks witness just how restrictive real policy rates have become.

The **US Treasury** market is probably best placed to capture this prospect. The picture varies by region and country, the short end of several sovereign debt markets also presents a compelling yield-duration profile for those investors unwilling to embrace duration more fully.

A slowing economy and advancing credit cycle will present challenges to corporate income and balance sheets. Therefore, we expect that there will be more rewarding entry levels for credit investors in the coming quarters.

There are attractive spread opportunities in **hard currency emerging market debt**, assuming a hard landing is avoided. The picture for **local currency emerging market debt** is more nuanced but still offers attractive pick-up potential for eurozone investors.

Figure 5
How to Play It



An ESG allocation can be considered as part of your investing strategy.

Source: State Street Global Advisors.

Endnotes

1 Summary of Economic Projections, December 13, 2023.

2 Personal Consumption Expenditures (PCE) inflation.

About State Street Global Advisors

State Street Global Advisors serves governments, institutions and financial advisors with a rigorous approach, breadth of capabilities and belief that good stewardship is good investing for the long term. Pioneers in index, ETF, and ESG investing and the world's fourth-largest asset manager*, we are always inventing new ways to invest.

* Pensions & Investments Research Center, as of December 31, 2022.

ssga.com

Marketing Communication
For Investment Professional Use Only

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM branch is regulated by the Financial Services Regulatory Authority (FSRA).
This document is intended for Professional Clients or Market Counterparties only as defined by the FSRA and no other person should act upon it. State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O. Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 185, 1170 Brussels, Belgium. T: +32 2 663 2036. State Street Global Advisors Belgium is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Europe Limited, France Branch ("State Street Global Advisors France") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors France is registered in France with company number RCS Nanterre 899 183 289, and its office is located at Coeur Défense — Tour A — La Défense 4, 33e étage, 100, Esplanade du Général de Gaulle, 92 931 Paris La Défense Cedex, France. T: +33 1 44 45 40 00. F: +33 1 44 45 41 92. **Germany:** State Street Global Advisors Europe Limited, Branch in Germany, Brienner Strasse 59, D-80333 Munich, Germany ("State Street Global Advisors Germany"). T: +49 (0)89 55878 400. State Street Global Advisors Germany is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Europe Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 49934. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Europe Limited, Italy Branch ("State Street Global Advisors Italy") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Italy is registered in Italy with company number 11871450968 — REA: 2628603 and VAT number 11871450968, and its office is located at Via Ferrante Aporti, 10 - 20125 Milan, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building 7th floor, Herikerbergweg 29, 1101 CN Amsterdam, Netherlands. T: +31 20 7181 000. State Street Global Advisors Netherlands is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **South Africa:** State Street Global Advisors Limited is regulated by the Financial Sector Conduct Authority in South Africa under license number 42670. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

Important Information

Investing involves risk including the risk of loss of principal.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent.

The information provided does not constitute investment advice as such term is defined under the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell any investment. It does not take into account any investor's or potential investor's particular investment objectives, strategies, tax status, risk appetite or investment horizon. If you require investment advice you should consult your tax and financial or other professional advisor.

All information is from SSGA unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Investing in high yield fixed income securities, otherwise known as "junk bonds", is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

The views expressed in this material are the views of Des Lawrence through the period ended January 2024 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

The returns on a portfolio of securities which exclude companies that do not meet the portfolio's specified ESG criteria may trail the returns on a portfolio of securities which include such companies. A portfolio's ESG criteria may result in the portfolio investing in industry sectors or securities which underperform the market as a whole.

This communication is directed at professional clients (this includes eligible counterparties as defined by the appropriate EU regulator) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

ID1966350-6370796.1.1.GBL.INST 0124
Exp. Date: 31/01/2025