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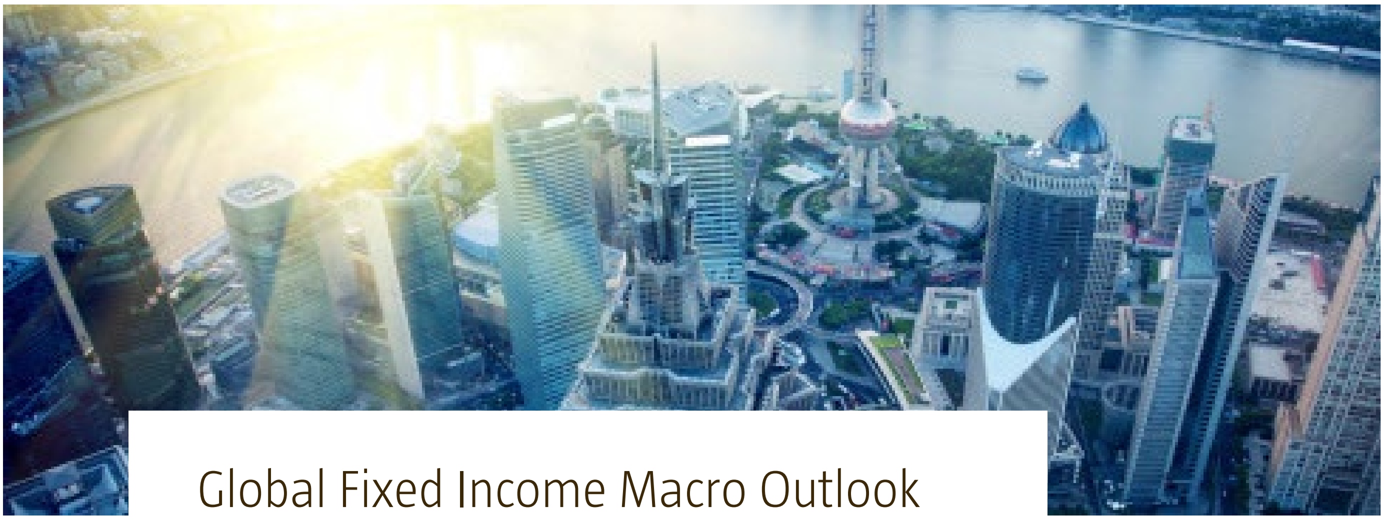

Global Fixed Income Macro Outlook

Recession investing

- Yield curves becoming more inverted, setting up big 2023 opportunities…
- …as recession probabilities rise for much of the G7
- GBP IG and EUR swap spreads show the rewards from recessionary levels

Summary

The coming recession
For all of 2022, we have focused on tighter monetary policy, discussing the dilemma faced by central banks (in 'Czech Mate') and their subsequent decision to prioritize the war on inflation (in 'The Inflation Game'). Since March 2022 we have highlighted that recession over the coming quarters is a probability rather than a risk. More recently, the market consensus has moved to that view.

Yet, while some markets are priced for recession, others are not. The historic volatility in fixed income in 2022 has unglued prior relationships, sending many cross-market, yield curve and cross-credit relationships to unusual levels (read: opportunities). Last quarter we laid out our thesis for how we expect fixed income markets to interact in our outlook called 'Twin Peaks'. There, we called for a turn lower in government bond yields and the resumption of 2022's overall trend wider in credit spreads. Our view is unchanged.

Since October, most government yields have finally turned lower – and we think some markets have put in a yield peak. Still, markets can be choppy, and there remains a

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large gap between the leading and lagging indicators of the US economy. We shouldn't assume a yield peak in every market.

Follow the leaders

The consensus may have joined us in expecting recession, but not all major voices on the debate have, including the US Treasury Secretary and a major US investment bank. Further, for those that do expect recession, almost all expect a mild contraction, without convincingly explaining why.

One reason for continued debate is that while leading and some contemporaneous indicators point to recession, such as open economy Purchasing Managers' Indices (PMIs), housing data, Institute of Supply Management (ISM) New Orders, and even the ISM itself now, the lagging data led by labor markets and inflation do not. As the laggards catch up with the leaders, market prices should shift. This looks to us a matter of time.

While the US labor market has not yet rolled over, it is clearly slowing – we have now had four consecutive non-farm payroll prints below 300,000, down from an average of over 440,000 in the first half of the year and over 560,000 in 2021. Further, weakness in the household survey could portend weakness in the establishment survey. The process of settling the recession debate is far more advanced in Europe and the UK where energy-related fragilities, and a real-terms shock for consumers make a hard landing recession our base case. Perhaps we should not be surprised that recessionary pricing has already arisen in parts of European and UK spread products – which gave attractive portfolio opportunities in the past few weeks – while it has not yet arrived in the US.

European and UK events are a reminder of the good news amid the economic gloom is that recessions provide opportunity in fixed income: first in government bonds, then in credit. As we highlighted just before the recent October yield peak, 2022 is already the worst year for fixed income total returns for years. There is scope for 2023 to see some reversal and, depending on entry points, we expect double-digit returns across several parts of the high quality fixed income spectrum.

Rates strategy

The recession we expect is different to the recessions of the past 35 years in that it is likely to occur with inflation substantially above target. While we have seen recessions with high headline CPI in their midst this century (e.g. summer 2008), the differences this time are sufficiently large that the roadmap and price actions of the recessions around the 1970s are more relevant. Yet even in the four recessions of the 1968-82 era, bond yields fell materially. Recessions by definition mean negative quarter/quarter real GDP, eventual central bank cuts and cyclical pullbacks in inflation. By March 2023, on current pricing, year-on-year oil price changes are set to be negative. We forecast close to zero inflation from US goods prices by June and our analysis suggests even rent price inflation will start to roll over later in H1 2023. Whatever happens to inflation over the *secular* horizon, 2023 should be a year where *cyclical* patterns dominate, leading to positive returns from high-quality government bonds.

As for portfolio construction, and how best to take advantage of better markets in due course, we continue to draw a distinction between the merits of yield curve versus duration strategies.

Yield curves versus duration strategies

As we have mentioned before, to be profitable with large-duration trades, you have to call not one but two things right: the cyclical outlook for growth, and the secular outlook for inflation. Yet for yield curves, the cyclical outlook dominates, because inflation premia exist across much of the yield curve, and the secular level of rates and inflation is in any case somewhat embedded in official rates. We do not mean to be blasé about the challenges of getting yield curve trades right (entry points are hard to time precisely); we just believe that valuations are easier to identify when a fixed income asset is dominated by cyclical mean reversion (yield curves) and is more insulated from secular uncertainty (duration). We think there is much more visibility in the data on the cyclical growth outlook, whereas we are humble about different scenarios in the secular inflation outlook.

It has been widely noticed that the US (and several other) yield curves are at their most inverted in 40 years. To be clear, this makes sense to us, as the inflation backdrop has necessitated a central bank response where rates are taken above estimated neutral levels. That in turn tends to lead to inverted curves, just as it did between 1968 and 1982. What always followed, however, was a cyclical mean reversion to positively sloped curves. We see no reason for that pattern to differ this time, particularly if growth stalls, leading central banks need to address the growth side of their mandates later in 2023 and 2024.

Market segmentation and cross-market opportunities

The second rates strategy we prefer over and above duration is cross-market. We detail the current opportunities that we see in the **Rates strategy** section. In brief, from an investment philosophy perspective, not all fixed income market players are able to look at, for instance, Australia versus the US. Not all have the liquidity or nimbleness to trade, for example, Sweden. And not all have the mandate flexibility to trade local emerging market (EM) debt such as Mexico, versus AAA/AA markets such as Canada. In the wake of central bank intervention in 2020-2021 followed by the volatility that has hit bond markets in 2022, many of these relationships are at two to three-decade extremes, creating attractive opportunities.

Fixed income asset allocation: finding recessionary prices

Our mantra for all of 2022 for US credit has been: "We do not yet think recession is priced into US investment grade and high yield spreads." Yet since our last quarterly, two markets have priced in recession: EUR swap spreads and GBP investment grade (IG) credit.

EUR swap spreads reached a wide of nearly +110 basis points (bps) in early October. On a weekly basis, this is above the wides seen during the 2020 Covid shock, the Eurozone Crisis in 2011-12, and the Global Financial Crisis (GFC) in 2007-08. EUR swap spreads have traded at recessionary levels since the Spring. Like any value-based opportunity, it takes time (in this case over two quarters) for value strategies to unlock their potential as spreads eventually retrace tighter. That requires patience. That tightening has now in part been delivered. There are some potential drivers of further tightening in 2023, for instance, primary government bond supply and QT.

In corporate credit, GBP IG reached an option-adjusted spread (OAS) of over +250 (on the ICE BofA Sterling Corporate Index) on 12 October amid extreme Gilt market volatility and concerns about leveraged liability-driven investing (LDI) structures. We do not buy distressed assets, but we like to buy good assets from distressed sellers. In October, many UK pension funds were highly distressed, and with our contrarian philosophy, we prefer to take the other side, as we recommended at the time in our article, 'Volatility strikes in the UK market'. Since then, GBP IG spreads have tightened by over 50bps. This episode illustrates a number of points about credit strategy which we don't think have gone away as we size up prospects for 2023:

- First, amid the fastest global tightening of monetary policy in 40 years, financial markets are fragile.
- Second, given those fragilities, credit investors can afford to be patient, as volatility is unlikely to be far away. Volatility creates accidents (opportunities for those not yet involved), usually when over-extended investors involuntarily become forced sellers.
- Third, areas that were previously widely believed by the consensus to be safe (UK (LDI) investing was routinely described as 'de-risking'), market structure vulnerabilities unearthed during volatility can surprise. Might the much vaunted 'Swiss finish' in post-GFC bank capital requirements be vulnerable? What else will we find when the proverbial tide goes out?
- Fourth, fixed income spread products are broadly correlated, but are far from synchronous. This means opportunities can arise in one market, without necessarily arising in others. When GBP IG spreads reached over 250bps, US IG was at barely 170bps. Little surprise then, that GBP IG has delivered over 1.5x the excess returns of USD IG since, at nearly +400bps. Broad surveillance, an open-minded global approach and nimble execution will all matter again in 2023.

Credit hasn't been the primary driver in 2022
2022 has been about rates, central banks and inflation. In the US, the credit OAS is not the bit of fixed income that has cheapened up by historic amounts. That leaves credit spread valuations more exposed, in relative terms, should volatility across fixed income sectors become equalized. For the interaction of policy and credit, we think there remains a heads-I-win-tails-you-lose proposition for defensive positions: either the US economy sinks into recession, or should the data remain resilient, the US Federal Reserve (Fed) will need to persist with rate hikes to slow it down and get on top of inflation. Neither outcome looks helpful for US credit spreads at an OAS in the 130s.

For the interaction of rates and credit, we laid out our 'Twin Peaks' thesis in September. Market participants, it seems, have become so used to the idea that credit and rates can move in the same direction, with credit rallying when government bond yields fall, and credit selling off when rates are shocked higher, that from a behavioral finance perspective, they seem to have fallen under a Pavlovian spell. We think the assumption that only the co-movement of yields and spreads is possible is dangerous. It ignores history, where in recessions, yields fall and spreads widen. That applies both to recessions during low inflation regimes (1990-1, 2001, 2007-09, 2020), and those in high inflation regimes (1969-70, 1973-5, 1980, 1981-2). While it can take time for regimes to transition, we think historical evidence carries more weight than recency bias, and Pavlovian sentiment. We expect a shift to a greater emphasis on contracting earnings, credit downgrades, restructurings and defaults – the typical hallmarks of recession. Given the brevity and exogenous nature of the 2020 Covid shock, it is now 15 years since the last sustained recessionary bear market began in the US. We would not be surprised if institutional memories of recessionary patterns have dimmed. We would only point out that regime shifts in recessions usually come with an increase in volatility and not enough liquidity for those that want to get out to do so. We are looking forward to the recession investing opportunity that we expect this to bring.

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Macroeconomic and policy outlook

- Lagged monetary tightening effects challenge the 'mild-recession' consensus
- Soft landing unlikely to tame inflation sustainably
- Labor market downturn the eventual trigger for a central bank easing

Growth outlook: huge consensus for a mild recession

There seems to be a very large consensus among forecasters for either a soft landing or a mild recession across developed market (DM) economies. This view has recently been reinforced by four factors. First, there are growing signs of an end to China's dynamic zero-Covid strategy. Second, the winter energy outlook for Europe is less bleak, in part thanks to the fiscal support unleashed. Third, many believe that serious private sector spending and financial sector imbalances are absent this cycle. Finally, there are hopes that the Fed could quickly reverse its tightening course should US inflation have already peaked. Echoing the message from our two previous Quarterly Outlook publications, we remain in the camp that a soft landing or a mini-recession could prove too optimistic a view – for the following five reasons.

Five reasons for economic caution

First, the current policy tightening cycle has been relatively fast by the standards of the past 30 years. As Fed Chairman Jerome Powell recently reiterated, monetary policy still works with "long and variable lags". This means that even as interest rate changes work promptly to slow the housing market, as we have seen, the broader effects on the economy are largely yet to be felt. The relatively long time lag observed historically between yield curve inversion and the start of subsequent recessions corroborates this. Indeed, since the late 1960s, the time to US recession after an inversion of the 3-month 10-year Treasury curve – which materialized in October – has been five to 16 months, with a median of nine months.

Second, while the easing of China's Covid strategy coupled with infrastructure stimulus and the U-turn on property tightening have undoubtedly improved the near-term outlook for the Chinese economy, it does little to alter the view that it is hard to count on China to save the day. This is because the scale of the stimulus and backdrop appear more subdued than in prior cycles. Moreover, structural weaknesses in the local government financing vehicles sector pose clear downside risks. Covid easing policies will likely be much more beneficial to China's domestic services sector than to the global manufacturing cycle.

Third, while the winter energy outlook for Europe is indeed currently less bleak than had been feared, prompting upward revisions to GDP forecasts for Q4 2022 and Q1 2023, the shock to household real incomes still matches that seen in the early 1970s. This, coupled with the sharp tightening in financial conditions from European Central Bank (ECB) and Bank of England (BoE) monetary tightening, still implies a substantial risk of a harder consumer-led recession over the next 12 months – as in 1973-75. Importantly, the risk of energy rationing and/or a renewed rise in wholesale energy prices into next winter looms large, given the small size of the remaining Russian gas flows into the EU. This makes us challenge the H2 2023 growth rebound penciled in by the market consensus.

Fourth, on the lack of financial imbalances: US private sector credit creation and capex indeed looks less extended, given the current economic expansion is only 2.5 years old. But public sector borrowing has exploded higher, leaving overall economy-wide debt overhangs at record highs. Moreover, corporate debt to GDP is higher today than prior to any US recession in history because, unlike in prior recessions, there wasn't much deleveraging in 2020. Meanwhile in the crypto system, imbalances arguably don't appear to be hard to find.

Fifth, the still-high inflation backdrop probably raises the bar for DM central banks to reverse course quickly. While our central scenario envisages central banks to ease eventually in late 2023/2024, they will need to wait first to see that the inflation battle really has been won. Here we remain in the camp of the likes of Harvard University's Larry Summers who have argued that a soft landing would not sustainably tame inflation, as this requires much lower wage growth. And the latter seems hard to envisage without a rise in unemployment of at least 1 percentage point (ppt) – which in the current circumstances most probably entails a recession.

A lucky Beveridge?
There is a slim possibility of a moderation in wages-driven by a fall in job openings without a large simultaneous rise in unemployment. This thesis relies on market estimates of the Beveridge curve proving too pessimistic on the mismatch of skills across major Western economies. We think this is quite an optimistic take, and a variety of factors related to social issues, training, skills and immigration policies suggest a persistence of mismatches in many advanced economy labor markets.

Upside risks to the 2023 outlook include further supply-led disinflation and some sort of hoped-for truce between Ukraine and Russia that also results in lower energy prices across Europe. We would draw a distinction between a truce scenario on the military side, and a full reintegration of Russia into global commodity trade networks with the West. the latter is necessary for energy price normalization, and, despite the ongoing residual energy relationship between Russia and many EU countries, seems unlikely to us. Downside surprises could emerge from more severe financial accidents that typically occur after sharp US Fed tightening cycles.

Inflation: set to moderate, but watch core and wages

Headline inflation across many DM economies seems to have finally turned the corner, helped by falls in oil, wheat and fertilizer prices. If recession transpires, commodity prices should weaken further – albeit moderated by any China post-Covid re-opening. Conversely, a renewed rise in wholesale gas and electricity prices due to a cold snap or a gas deficit next winter could slow this process in Europe.

'... the pace of wage growth, adjusted for productivity, will likely prove crucial for determining where core inflation ultimately lands'

The descent in core inflation however is has been more gradual, and there are short-term upside risks. In the US, the rental component is still exerting upward pressure on the core CPI rate (currently: 6.3%), while in the Eurozone it is mainly indirect effects of earlier rises in food and energy price inflation that are keeping core Harmonized Index of Consumer Prices (HICP) inflation (currently: 5.0%) elevated.

Over the coming six months, we expect core inflation to come down more in the US than in Europe, helped by goods deflation. Even so, as pointed out by one of our guest speakers, Matt Luzzetti from Deutsche Bank, US core *PCE* inflation – the Fed's preferred core reading – might retreat at a slower pace in 2023, thanks to the much higher PCE basket weight of health care included in that index, which is rising.

The pace of wage growth, adjusted for productivity, will likely prove crucial, in our opinion, for determining where core inflation ultimately lands. As such, a worsening of labor market conditions seems a pivotal trigger for a pause in or reversal of central bank policy tightening. For now, we see little sign of a convincing easing of wage pressures in the US (and UK), supporting the case for further monetary tightening. In the Eurozone, wage pressures have clearly built in the wake of high realized inflation, especially in North-western European countries. Ultimately however, we think Eurozone wages are likely to remain relatively more contained than in the US and the UK – assuming the ECB continues its tightening path.

Geographic diversity
In China and parts of Asia, inflation pressures have remained more subdued, due to a smaller price impact from logistics disruptions, more forceful government price intervention and cyclical reasons. Nevertheless, food price-led rises in inflation have forced Asian central banks into tightening action, and in China, economic re-opening should lift the currently depressed core inflation rate of just 0.6% year/year. Meanwhile in Japan, where underlying inflation pressure has remained subdued, earlier yen weakness is boosting imported inflation, suggesting that over time, Japan may still be affected by the global inflation wave.

Cheer up!
Still, while the outlook for inflation has diverse geographic and bottom-up components, relative to the historic upward inflation shocks of 2021-22, there are three positive signs to consider for 2023. Focusing on US CPI, we see visibility of moderation in oil, goods, and in due course, rents.

Oil prices, and therefore gasoline, could be in deflation by the end of March 2023, given prices in March 2022 of up to USD 130/barrel. That, and the 50%-plus inflation we saw in oil-related CPI components earlier in 2022, is a high bar to beat. Second, goods prices also rose at double-digit rates in 2021 as excess pandemic fiscal spending saw outsized US demand for goods, exacerbated, by the supply bottlenecks and sharp rise in freight costs. Now, freight rates are plummeting, helping the ongoing disinflation in goods. Finally, on rents, our analysis suggests the near-term upward pressure is time-limited and rental inflation should moderate from Q2 2023.

All in all, while the inflation outlook remains complex, these three large disinflationary (and even deflationary) cyclical trends look set to dominate in 2023, regardless of which way the secular debate on inflation settles in the years beyond.

Fiscal and monetary policy: time-constrained

In the US, the Democrats seem keen on negotiating a new fiscal package worth as much as 0.8% of GDP before Christmas. However, even if they succeed, this is unlikely to steer the US fiscal impulse – which measures the change in incremental support – out of negative territory. GOP and Democrat cooperation is also needed to avoid a government shutdown and a default/debt ceiling confrontation in mid-2023. Meanwhile, in China, the stance of fiscal policy remains more expansionary, even though this comes at a cost in the form of a further weakening of local government finances.

In the UK and the Eurozone, fresh fiscal support in the wake of the energy crisis is being rolled out to aid household and companies' energy costs. Together with ongoing support from the NextGenerationEU (NGEU) recovery fund, this should keep the European fiscal impulse in positive territory in the near term. Still, the overall effect here is moderate as much of the help on energy is funded by withdrawing money from the corporate sector (rather than by fresh borrowing). If the energy support is not extended into next winter, the fiscal impulse is set to turn negative by H2 2023.

In any case, we believe fiscal policy cannot provide the game-changer for growth in 2023 that it did in 2020. Fiscal largesse on a grand scale (as in 2020) is hard to fund without quantitative easing (QE), and not only is QE unlikely with inflation far above target, most major central banks are weighing up quantitative tightening (QT) instead.

The fiercest pace of hikes looks behind us

For now, the heavy lifting in terms of monetary tightening across developed and emerging markets is still being done via interest rate increases. There is some hope on the visibility to the end of hiking cycles as the hiking increments across many DMs, including the US and Eurozone, are moderating, as rates policy turns more restrictive. The latter is evidenced by ever deeper inversions of many DM yield curves. We agree with markets that, on a risk-weighted basis, terminal rates of around 5% and 3%, are likely in the US and the Eurozone, respectively. But we suspect the BoE will struggle to get near the 4.5% area that is currently discounted. In Japan, as in China, a rate hike seems unlikely, although we expect the Bank of Japan (BoJ) to widen the band at which it allows the 10-year yield to move around its 0% target under its yield-curve control (YCC) policy by April 2023.

Across EM, central banks in Latin America (Latam) are closest to being done – led by the Brazilian central bank – while Asian central banks in particular still have some more work to do. Although markets have priced in a significant reversal of tight monetary policy across Eastern Europe next year, we are not so sure whether this can be delivered given underlying wage pressures, especially in Hungary.

QT or not QT: that is the question

Many G10 central banks, including the Bank of Canada (BoC), Swedish Central Bank (Riksbank) and the Fed, continue to tighten monetary policy via reductions in their government bond holdings (QT). This is done primarily via only *partially* reinvesting proceeds from maturing bonds. The Royal Bank of New Zealand (RBNZ) and BoE have gone further and commenced with active bond sales. Highlighting its outlier Western status, the ECB continues to fully reinvest maturing bonds held under the Asset Purchase Program (APP) and Pandemic Emergency Purchase Program (PEPP) – with some flexibility in the latter to support EGB spreads. However, in December the ECB is likely to pave the way for a gradual reduction in APP holdings from late Q1/early Q2 2023 onwards.

Yet all is not what it seems. The BoE is now actively selling Gilts on the one hand – implementing Monetary Policy Committee (MPC) policy) – yet was forced to *buy* Gilts since our last Quarterly Outlook for liquidity and financial stability reasons, implementing Financial Policy Committee (FPC) policy. Similarly, while the ECB hopes to embrace QT one day, it has been forced this year to create the Transmission Protection Instrument (TPI) to promise to buy bonds to counter fragmentation at the Eurozone country level.

Even the Fed may have to address declining liquidity in the Treasury and mortgage-backed securities (MBS) markets, a worrying development which has begun to attract the attention of the likes of the BIS. Financial stability and monetary policy mandates appear increasingly at odds with each other. This may translate into bouts of ongoing rates volatility – as seen most dramatically in the UK in the autumn – followed by decisive FPC-type action and falling volatility thereafter.

Rates strategy

- Rates peak is getting more convincing
- Many cross-market relationships are at 20-year extremes…
- …while once-in-40-year opportunities are building on the curve

Some yield peaks are probably in

Chances are growing that we have seen the peak in yields for this cycle in several markets and tenor points. Part of this is mathematical. Yields for 30year Gilts topped 5% in late September, for the first time in 20 years, yet recently traded as low as 3.20%. Is another 180bps yield rise possible? Polish 10-year government bond yields recently fell from nearly 9% to below 6.5%. Evidently, there is a lot more to the Global Aggregate universe than where the over-watched and more market-efficient 10-year US Treasury yield trades, which currently sits 'only' 70bps below its highs. To be clear, we do not expect a synchronous peak in all bond markets at once. As a result, cross-market opportunities have sprung up: both these, and the yield curve offer larger and better risk-adjusted opportunities in our view than outright duration.

Progress on three duration metrics

Still, as duration is the question we almost always receive, let us start there. If our macroeconomic and policy outlook proves to be correct, there should be more clarity on terminal rates levels for this cycle – a key factor for the level of interest rates, curvature and volatility. Over recent months, substantial progress has been made on the three metrics that we see as signals for a forthcoming rates peak.

First, the curve inversion between the yields of two-year and 10-year Treasury bonds, known as 2s10s. While the 2s10s US Treasury curve has become ever more inverted since July, having briefly inverted back in the Spring, the German Bund curve ticked this box in early November. Many other curves also broke the zero line either recently again (like UK Gilts) or several months ago. While there can be volatility in the short-term, bond yields tend to peak cyclically soon after curve inversions: since 1980 the peak in the 10-year US Treasury yield has occurred within a range of -1 to +7 months after 2s10 inverted. In the late 60s-70s 10-year yield peaks typically occurred a few months prior to inversion.

The second metric is 2-year yields diving below official rates. The UK Gilt curve briefly experienced this in November. The same thing happened in Mexico, while in Brazil the 2-year BLTN yield is already well below the SELIC rate. For most major markets, this yield spread is still positive. However, that is likely to change very soon. If the Fed and ECB both hike by 50bps in their December meetings, the 2-year yield will probably end up at or below official rates in both Treasuries and Bunds.

The third metric, which we have highlighted through much of 2022 is the progress of the tightening cycle reaching the second to last rate hike. In our central scenario, both the Fed and ECB will deliver their last rate hikes for this cycle in March. This implies that their February meetings would bring the penultimate hikes. Over a 40-year period, the second last hike has been, on average, the time to buy bonds for the cyclical fall in yields. While risks for this view are still skewed towards a later, rather than an earlier end to the hiking cycle, the level of uncertainty around the timing and level of the last hike is probably lower than it was a few months ago.

Further, the way the second-last-hike rule of thumb plays out this cycle may be slightly different, with the bond rally possibly starting sooner. In prior cycles (e.g. 2004-06), the Fed hiked rates in equal increments for the entire cycle. That is not the case this time around, with hikes initially accelerating towards large 75bps clips, as central banks had to catch up to inflation trends – and now, the hike sizes look set to moderate. The reduction in increments gives investors better visibility on anticipating the level at which Fed Funds might peak. While many investors have incorrectly over-emphasized hopes of a forthcoming Fed peak for much of the past nine months, relying on hopes of a 'pivot' with which we have not concurred, at some point the tightening cycle will eventually end, History shows that major rate hiking cycles always do, and as Milton Friedman pointed out, they are frequently followed by recessions. What has changed is that the bullish side of the argument is now supported by official guidance of falling increments.

Gradual approach and cross-market implementation

As 2022 has progressed, we have moved overall portfolio duration from underweight to neutral, and then to a small long position since the start of Q4. We have been gradual, however, in scaling into this position because, as with any value strategy, there is a risk of being too early. Specifically, the risks around how long the Fed will need to keep hiking mean we are adopting three techniques to protect portfolios from changing their stances too early.

First, despite the recent bond rally, we expect to be longer in duration only by late Q1 2023. Scaling into value positions avoids unnecessary market-timing risks, and means that when long-term strategic opportunities materialize, they can be approached and implemented in a way that is appropriately long-term and strategic.

Second, we think many cross-market opportunities are much more asymmetrically attractive right now. For example, front end UK 2-year swaps still yield more than 200bps over Schatz. Despite the recovery in Gilts since early October, this spread is still otherwise near its widest since euro inception in 1999. US 5-year yields have traded unusually wide compared to Canadian 5-years. Australian 2-year yields are a full 125bps below US 2-years, a level not seen since the early years of Reagan's presidency. In sum, there is less need to take heroic and more risky directional outright duration bets when world bond markets are teaming with cross-market anomalies. If you believe in market segmentation, but view the US Treasury market as relatively efficient, it's fair to say that duration risk adds sigma; cross-market offers alpha.

'Duration risk adds sigma; cross-market offers alpha'

From here, markets that we prefer either stand out in relative valuation (UK, US) and, or in the progress made towards the metrics discussed above (Mexico). Markets that have experienced no, or a slower tightening cycle (Japan) and, or for which we expect inflation to be more sticky (Germany) are our preferred underweights. Yet the biggest long-term opportunity in our view is in yield curves.

Yield curve strategy
As we have said many times, yield curves are cyclically mean reverting over time. That maxim holds for both high inflation regimes (for example 1965-82), periods of inflation moderation (1982 to the mid-1990s), or low inflation (mid-1990s to 2020). That in turn means that excessively inverted yield curves are eventually very likely to dis-invert and re-steepen. At some point in the next couple of quarters, recent moves in yield curves into the most inverted territory in 40 years are likely to reach an inflection point, in our view. We may not yet be done on the inversion trend at present, but we expect a turn in H1 2023.
We therefore recommend using further deep inversions in the US Treasury curve to scale into steepening positions – a trade that we think should alone make 100+bps of alpha, while acknowledging the risk of short term mark-to-market losses when building the position. The deeper the inversion goes, the more mark-to-market we may face in the near term, but that also then means even more historic levels of asymmetry which in turn suggests a larger position should be built. Given this greater long-term return, from a larger position at more deeply inverted levels, then somewhat counterintuitively, to maximize profits over a strategic horizon, we hope to lose more in the short term.

Beware of mean reversion assumptions in duration
By contrast, we would argue that long-term mean reversion valuation anchors for duration are largely illusory. It is just about mathematically true that the 10-year US Treasury yield has mean reverted over the past 60 years around an average yield level of 6%. However, a valuation-based strategy of going long duration at yields above 6% and short at yields below them has hardly been successful. First there is the crushing mark-to-market risk in duration: yields reached nearly 16% in 1982 and little above 0% in 2022! Second, there is investment horizon: it took nearly a quarter of a century for yields to get sustainably back down below 6% after 1972, and it is nearly a quarter of a century since the 10-year was last at 6%. If there is mean reversion around the average, we would argue the degree of mark-to-market risk and the time horizons involved are both far outside the tolerance of mainstream institutional and wholesale clients. We have not yet met anyone in the fund management industry who is happy to see a position trade offside for a generation!

We find it intriguing then that so many fixed income mandates and managers sign up to putting duration strategies first in their hierarchical list of active strategies, given these symmetric risks. We have a far stronger ordinal preference for risk-adjusted propositions in yield curve, and cross-market strategy.

In portfolios, we have been transitioning from flatteners to steepeners as 2022 has progressed. In the US, having taken profits on flatteners in Q2 2022, we initiated a small 2s10s steepener strategy in Q3. We have started to add to this in Q4, using a disciplined value-based approach.. In the Eurozone, we still have a flattening stance in Italy (see periphery section), but in AAA/AA EUR markets we have recently switched from a 2s10s flattening stance to a 10s30s steepening policy as 30-year Buxl yields trade below the 10-year. An inverted 10s30s curve only tends to happen at this point in the cycle. It could yet invert some more, but it is a phenomenon we expect to see only over a minority of the economic cycle overall. In Australia, where the curve is not inverted yet, flattening positions are still our preferred stance, offering a complimentary portfolio offset to the larger US steepening position we now have.

Fixed income asset allocation

- EUR swap spreads and GBP IG briefly priced in recession this Autumn
- For all other DM credit markets, that process looks ahead of us…
- …as the outlook transitions to earnings contraction, downgrades and defaults

Credit markets: a choppy bear market so far

Credit spreads have carved out a broad range in the past six months, revisiting the tighter end (around the high +130s OAS on USD IG) in May, mid-August and early December, while testing the wider end (around +170) in early July and mid-October. This back and forth has been the story of 2022: the Volatility Index (VIX) has risen above 30 no fewer than seven times (in January, February, March, April, May, June, September and October) while it eased close to 20 a further six times (in January, February, March, April, August and early December). At the same time, both excess and total returns have been decidedly negative, with US IG spreads nearly 50bps wider on the year and high yield (HY) over 150bps wider. The net result has been a choppy bear market, as we forecast this time last year. With fresh wides seen in USD IG since our last quarterly, but at levels much tighter than typically seen in recessions, we are far from convinced that this recessionary bear market is over.

'Corporate debt to GDP, now at 77%, has never stood higher on the eve of a recession'

For a bear market to fully run its course, several processes have to occur. Ahead of our Quarterly Outlook meetings, we have analyzed these thoroughly, across fundamentals, market factors and valuations, to seek to understand how far through the bear market we might be.

Fundamentals

In each of the last four recessions (1990-91, 2001, 2007-9, 2020), trailing 12 month speculative grade default rates have risen to at least 8%, and in all bar the most recent have headed well over 10%. Even in 2016 (not a recession year), defaults rose above 5%. Today default rates are at just 1.5%. That suggests it is very early days in the default cycle. Now credit spreads tend to peak before default rates peak because markets anticipate them: default rates peaked first in 2002, but we view that as an exception. So, how far through the default cycle and at what sort of levels of default do we need to progress before seeing a credit spread peak on average? The answer – on average – is 4-6% and two-thirds of the way through the entire default cycle, from the low in defaults to the peak. That timeline means default rates need to triple from here until the bear market is over.

One argument for a milder recession, and a milder default rate, is that there has been limited corporate re-leveraging this cycle. One aspect of that is true: it has only been 2.5 years since the last recession. Despite a healthy nominal growth rate in corporate debt this cycle of 6-8%, as per the Fed's Z.1 accounts, corporates have not had time to add on more than around USD 1.7 trillion of debt since mid-2020. In the last expansion they added on USD 5 trillion. The problem is the stock of debt has continued to rise.

Worse, unlike in prior recessions, there was no deleveraging in 2020 as the extraordinary monetary and fiscal help during the unusual Covid shutdown recession meant the normal processes of defaults followed by several years of deleveraging was short-circuited. In actual fact, corporate debt grew in Q1 2020 at an astonishing USD 3 trillion annualized pace. The outstanding stock of total US business debt is therefore poised to top USD 20 trillion for the first time ever. In 2007, it only reached USD 10 trillion and in 2000, after all the releveraging excesses of the 1990s, reached (a now rather sepia-tinged) USD 6 trillion. Of course nominal GDP growth has also risen, yet in ratio terms, US corporate debt to GDP, now at 77%, has never stood higher on the eve of a recession.

A second argument for a mild experience is that HY default rates were lower in the 1970s than in the late 1980s, 1090s and 2000s. That narrow fact is true, but only because the original issue high yield market did not begin in earnest until the mid-1980s! if one looks at BBB default rates, they were higher in the recessions of the 1970s than in the late 1940s, 1950s, 1960s, and even over the past decade. On a quality-adjusted basis, high inflation periods therefore are not only not a cure all, but they have seen higher defaults.

The reason for the tough credit loss record in inflationary times is earnings. If one looks at the worst seven earnings downturns in the past 70 years of National Bureau of Economic Research (NBER) recession data, four of the worst seven occurred in the high inflation period of 1968-82. Put simply, when inflation goes up, the three major corporate costs of wages, interest rates and raw materials (commodities and the like) go up. As demand falls, revenues come off before inflation– which is a lagging indicator – has a chance to come down too. The idea that high inflationary recessions see some of the worst earnings and defaults is far from market consensus today.

So, what of the recent market bounce? We analyzed corporate lending conditions versus credit spreads. In both the Fed and ECB surveys, bank corporate lending conditions are unambiguously getting harsher, giving clear cyclicality to the trend away from the fickle twists and turns of the latest few weeks' market performance.

Market factors

Many market factors in early December look significantly better than in early October when rates and equity volatility were high, the UK pension system was at serious risk of entering a spiral of forced selling, concerns were raised about a potential global spillover, and price action was starting to become gappy. Still the same 'it feels better' observation could be said of early August, when similarly, a temporary period of spread tightening and retracement had been enjoyed.

It's very important to be aware that bear market bounces are absolutely normal during a multi-year move wider in credit spreads. We have seen three in 2022, occurring in March, in late June to early August, and over the past several weeks. None have been as large or long as in August 2001, October 2001 to January 2002, or April to June 2008. Indeed, the rolling bear market of 1998 to 2002 saw no fewer than six bear market bounces. i.e. a spread tightening of at least 10bps over a period of 10 days from the recent spread peak. There could quite easily be another three to go this cycle.

This is reflected in fund flows where inflows recently returned. We note there were sharp fund inflows in December 2021, January 2022, July 2022 and early August 2022. None of them portended anything about future price action. They were merely contemporaneous indicators of a fleeting more positive market mood, each of which faded. It should come as no surprise that, analyzing historical flow data, there were six such inflows in 2000-02 which also all faded. We do not think the weather vane of fund flows offers a credible forward-looking investment thesis.

Of more concern have been trends in both primary and secondary liquidity. In primary markets, credit supply in 2022 has been anemic, on a par with the Global Financial Crisis in US, European and GBP HY. The paltry USD 17 billion in US bonds rated as CCCs in the year to end-November for example is the lowest total since 2008-09. That suggests a rolling credit crunch. EUR HY is at less than USD 6 billion equivalent, versus USD 82 billion last year, and less than the primary volumes seen right back in 2000. GBP HY has not even managed USD 1 billion. Evidently, refinancing risks (and therefore restructurings and defaults) are real heading into recession in 2023.

In secondary liquidity, we note the dramatic reduction in liquidity measures in US Treasuries and MBS. According to JP Morgan (JPM), market depth has declined 60% in the US Treasury market over the past year. According to the BIS, leveraged investors and small retail investors have now become the main buyers of MBS, just at the same time that the Fed has stepped up QT. That suggests more volatility going forward in their opinion. With the two major higher quality Fixed Income markets in the US (Treasuries and AAA/Aaa MBS) under some liquidity strain, it's not outlandish to suggest that liquidity premia in corporates should be wider heading into a recession.

Valuations: tighter than average into a recession

Recessions typically mean a USD IG OAS somewhere wider than +200bps. For various reasons, we don't expect the +400bps levels of 2020 or the +600bps levels of 2008, but even in 2002, which saw the mildest credit sell-off in the mildest of the past three recessions, spreads reached north of +270bps. At that point, as the recent UK LDI crisis or the March 2020 underperformance of US credit showed, all sorts of bear market processes can kick in, with involuntary sellers at distressed levels, once fragile conditions are exposed. While IG spreads in the mid-200s are attractive in our view – a disciplined rule we used to implement the overweight in GBP IG in October – one should be prepared for spreads to go substantially wider, at least until central bank financial stability departments decide to call a halt to proceedings.

We could be wrong. We respect that recession may not happen, but we view this as a minority scenario. In any case, the spread gain from the current high 130s OAS is asymmetrically smaller. Worse, the starting point today, almost incredulously, is tighter than the long-term market average OAS of mid-150s over the past 25 years.

For balance, there are two brighter stories to highlight, of which the second at least provides a bit more comfort.

The first is on HY prices. The average US Single B price is around 88c in the dollar, with the interest rate component in particular reducing the current value of low-coupon bonds from the 2020 and 2021 vintages before yields rose significantly. The thinking is that this gives less room to default. This is true at the margin. But it is also true that recovery rates are cyclical. The prices achieved for disposing of assets and liquidating companies in a recession is not the same as during a boom. If recovery rates fall by more than 12c versus cycle averages, the price gain from buying at 88c is wiped out. Further, the percentage fall in a high yield bond from 88c to 40c if we are generous on recovery rates and take a rounded through-cycle average is still -54.5%. It is true that -54.5% is better than -60%, but if you pick the wrong bonds, who's up for that trade?

The second is in dispersion in high yield. Low-quality bonds typically underperform less low-quality bonds into and during a recession, both within the CCC segment, and across the broader HY spectrum. In CCCs, dispersion (measured as the proportion of face value marked outside +/-400bps of that rating's sub-index level) looks around 75% done, based on how dispersed the indices tend to become at recessionary peaks. At the broad HY level, dispersion looks around two thirds done. The fly in the ointment here is that much of the divergence between BB and CCC spreads has been caused by BB outperformance, whereas into recessions, it is supposed to be outright CCC widening that occurs. CCC spreads are currently at only +1100 OAS, whereas they often hit +2000 in recessions. So unless there are some compositional quirks this time around – to which we defer to our HY colleagues – there seems to be plenty of room for credit damage into the upcoming default cycle.

We make no changes to either of our big picture asset allocation assumptions, as laid out in our previous quarterly. First, we expect a government bond yield peak before a credit spread peak. Second, if the last three recessionary bear markets are anything to go by, spreads typically only peak when central banks buy bonds (or threaten to buy bonds) in size. We are more optimistic on the prospects for FPC-type intervention rather than QE. The Bank of England FPC's first major intervention since its inception post-GFC has been enough to turn around GBP IG spreads. But we do not think the UK has enough global weight for that move to have turned around the entire global credit cycle.

Until the inflationary backdrop has improved materially – and in the eyes of the Fed sustainably – we think the bar for intervention is higher than at any time in the recent few decades. In the UK, the initial conditions for intervention included the perceived risk of the failure of the entire defined benefit (DB) pension system and forced selling of Gilts to unfinanceable levels. That's some bar.

Peripheral bonds: a gradual deterioration

Peripheral bonds have held up very well over the past quarter amidst the recent bounce in risk assets. The spread of the 10-year Italian government bond versus Germany, at around 180-190bps, is at the low end of our expected band.

In the end, the proposed 2023 budget of the new right-wing government did not rock the boat, with a projected deficit of around 4.5%, showing no material deviation from the proposed plans by Mario Draghi. That said, energy subsidies are only budgeted for Q1 of next year. If these need to be extended, which seems likely, this could mean a sizeable increase in the deficit number. The Q1 subsidy amounts to around EUR 20 billion, so a three-quarter extension, even in a reduced format, could mean an additional hit to the deficit of around 2-3% of GDP.

The debt-to-GDP ratio looks on track to dip below 150%, though, but this is mainly due to high inflation and (so far) limited wage agreements. This could well prove to be a one-off, as we expect inflation to fall in 2023. Debt servicing costs are already at elevated levels and will rise further in coming years. Nominal interest rates have moved up sharply and the Italian Treasury has issued much more inflation-linked bonds in recent years. Running debt-to-GDP of over 130% was feasible in an era of negative rates and QE. With debt-to-GDP now 20 ppt higher post-Covid, should nominal yields settle nearer 5%, debt sustainability is more questionable.

With 10-year BTP yields reaching 4.8% since our last quarterly and interest rate volatility still high, we think the coast is far from clear. Although all looks relatively calm for now, not much needs to happen before BTP spreads will move on a widening trajectory again. As industrial disputes in the UK have shown, wages will need to keep up to avoid a flareup of social unrest. We thus maintain our cautious stance.

Have some bonds

The Q1 supply calendar will be huge across countries in Europe. The net cash requirements (gross issuance minus redemptions minus change in QE holdings) are expected to amount to EUR 295 billion, a record since the start of the Eurozone and EUR 200 billion above what was needed in 2022. If the ECB would decide upon full (passive) QT (not our base case), total supply could amount to as much as EUR 420 billion. Debt management agents will need to compete with each other for the marginal investor, meaning large new issue premiums are likely needed to attract interest, leading to higher spreads. The country with the single largest increase in net issuance is Italy, at around EUR 50 billion, with upside risks in case of prolonged energy subsidies, or a step-up in NGEU investments.

Fundamentally, we are less worried about Spain and Portugal for now, although valuations already (more than) reflect this, certainly versus swaps. Moreover, the recent negative outlook for France by S&P due to "rising risks to the country's public finances and the resulting fiscal space reduction" also underscores that rating agencies are getting more worried about government finances.

EM debt: vulnerable to global growth slowdown

Emerging market assets have recently bounced, yet are still heading for their worst annual performance since the GFC. This remains an uncertain time for EM FX and fixed income, with recession for DM economies coming, while at the same time peaks on inflation and rates are coming into view. Still, we think there is reason to become constructive on parts of EM assets and in particular local bonds in Latam and Eastern Europe. Again we must stress that EM sovereigns are a heterogenous asset class. It matters which countries one chooses to buy and to sell.

'...debt management agents will need to compete with each other for the marginal investor, meaning large new issue premiums are likely needed'

In our view, there are three main arguments to be supportive on the local EM bond market. First, some EM central banks are closer to expected peak rates in the tightening cycle, than their peers. Latam central banks, for instance, have been unprecedented in their proactivity on tightening versus DM peers. Yet, the heterogeneous nature of EM is evident here, with many EM Asian central banks lagging far behind those in Latam and Eastern Europe. Second, nominal yields on selected local EM government bonds have repriced substantially.

Benchmark local yields in Latam and Eastern Europe have increased on average by 500bps and 400bps respectively, while benchmark Asian yields have only risen by 100bps. This is another reason to be cautious in Asia. The final point relates to flows and positioning. Global ownership of EM assets stands at almost its lowest point since the GFC with cumulative year-to-date flows posting record negative numbers. From a portfolio perspective, we find yields in Brazil, Mexico, the Czech Republic and Poland attractive either versus Asian countries on a cross-asset basis, or versus corporate US high yield for example. Timing will matter, given the wild 250bp swings in Polish yields for example since our last quarterly. Still, in recessions, EM local countries that do not have idiosyncratic problems tend to outperform high yield: that makes for a clear asset allocation choice, given their superior ex-ante Sortino ratio.

FX: more divergence between EM currencies

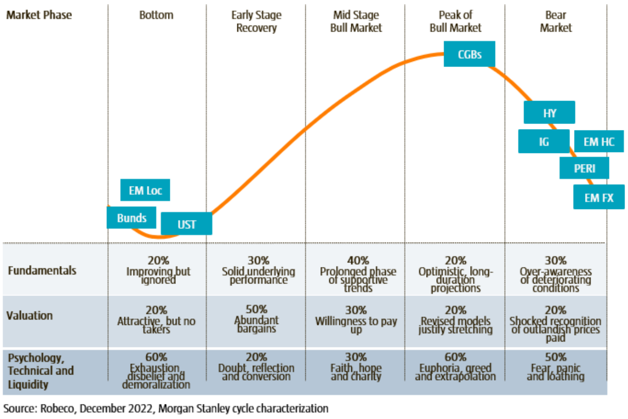
In FX, we think the end of the cyclical bull market in the USD is approaching. Indeed, USD or US Dollar Index (DXY) peaks historically happen close to peak terminal rate pricing or peak Fed funds. Still, with the Fed gradually scaling down the pace and size of hikes it is difficult to see the USD strengthen materially from here. The dollar tends to rise meaningfully in tightening cycles or during risk-off market regimes.

As 2022 has progressed, other DM central banks have been compelled to hike in similar increments, and at a similar pace to the Fed. The rate differential argument is losing steam and we would favor a neutral USD position as a result. Calling for a bear market in the USD is a bit more complicated, given that it most likely requires a material set of rate cuts which we might not get until H2 2023 at the earliest. Furthermore, with recession risk on the rise across most of the G7, we cannot rule out a risk-off regime leading to some upward pressure on the US dollar.

One currency we favor in this climate is the Japanese yen. Quite notably, inflation is on the rise in Japan, and we expect some upward pressure in wages next year. Inflation rates and wages are nowhere near the levels seen elsewhere in DM, yet are sufficiently high to give the BoJ room to tweak parts of its monetary policy setting. The central bank could, for instance, end negative policy rates and adjust its yield curve control (YCC) policy. Both these policies have had adverse effects on financial stability and the yen in the past year and are increasingly scrutinized domestically. Versus the JPY we like to stay selectively underweight a number of cyclical Asia currencies, including the KRW, MYR and SGD, as the global economic slowdown continues into 2023.

Asset class positioning

Figure 1 | The market cycle



Source: Robeco, December 2022

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