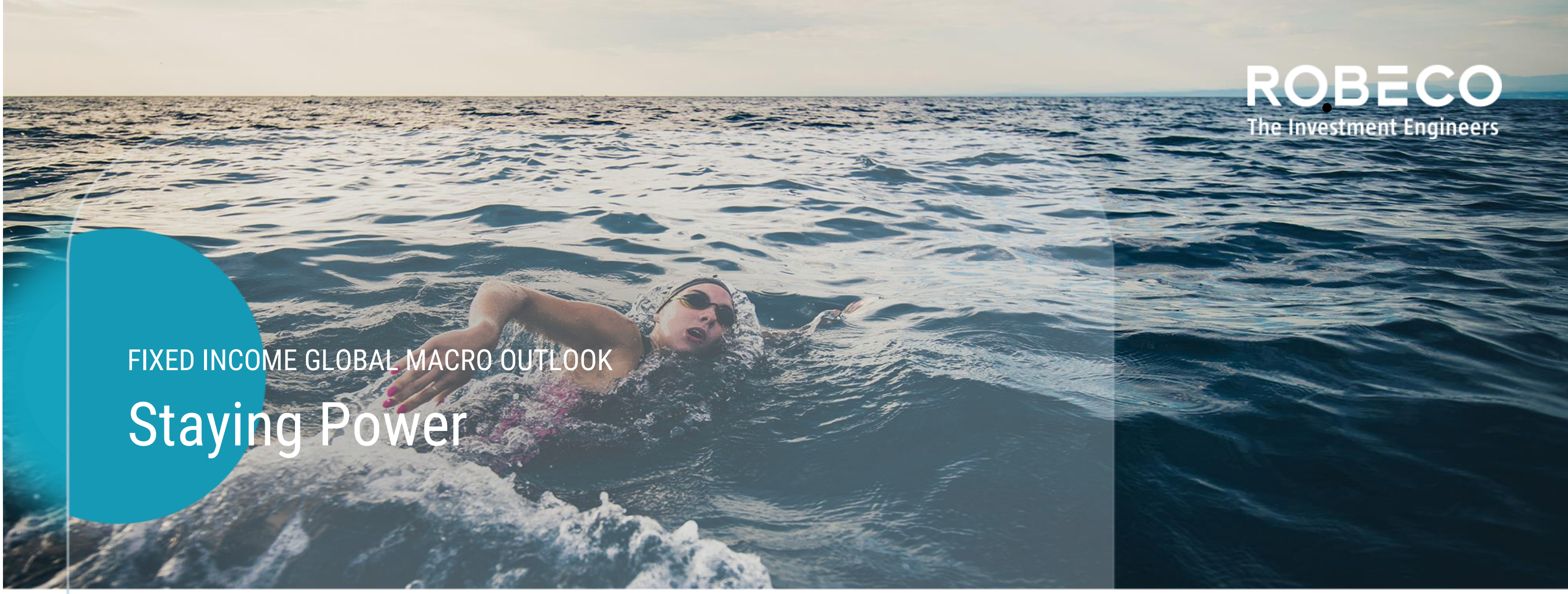

FIXED INCOME GLOBAL MACRO OUTLOOK

Staying Power

- The market is adopting an ‘appeal of bonds’ view
- The long-term policy rate is still priced too high
- Our strategies remain positioned for steeper curves

Some retracement after a strong rally, but longer-term perspective remains supportive for bonds.

Summary

In our Q4 outlook we concluded that ‘it’s hard not to be bullish’. We argued that central banks took a risk by overtightening to win their war against inflation and concluded that this risk management approach to policy was increasing the valuation appeal of bonds. With valuations reaching a 15-year high, we believed that bonds could rally, not only in a recession scenario, which at the time seemed to be regarded by the market as a prerequisite for yields to decline, but also in a soft-landing alternative.

After all, as monetary policy starts to impact growth, inflation declines. Keeping rates on hold would cause real yields to rise and financial conditions to tighten. In this scenario central banks would have to cut rates again to avoid tightening financial conditions too much and then run the risk that the targeted soft landing could evolve into a hard landing.

After bond yields reached a peak in October, the market narrative has turned 180 degrees from extremely bearish to extremely bullish; markets seemingly were catching up on the ‘appeal of bonds’ view. Policy rate peaks now seem to have arrived. Downward momentum in core inflation gained traction in many developed and emerging markets, this combined with data that points to weaker growth, but not a recession, has driven both bond yields and credit spreads sharply lower.

Has this rally already gone too far? It’s tempting to conclude that ‘the easy part’ of the rally could be over, if not for the fact that bond markets weren’t really easy this year.

Nonetheless, we believe in the need for staying power to navigate volatility, as we continue to hold the view that yields have room to decline further. Figure 1 (Yield Bloomberg Global Aggregate Index) indicates that even after the recent sharp decline, the index yield is only back to where it was trading this summer. Again, much will depend on the development of fundamentals.

> *“Has this rally already gone too far?*

With regard to growth, we retain our below-consensus view as the drag of past rate hikes continues to feed through. We think it seems premature to conclude that a soft landing should now be the base case for the US economy. Furthermore, the Eurozone economy could stagnate for longer than the consensus thinks. We see broad-based evidence in the corporate sector that higher policy rates are impacting the broader economy via corporate defaults and restructurings in both the private and unlisted debt markets. It is not a question of ‘if’ but rather one of ‘when’ the impact of higher interest rates on the broader economy will become apparent.

FIXED INCOME OUTLOOK DECEMBER 2023
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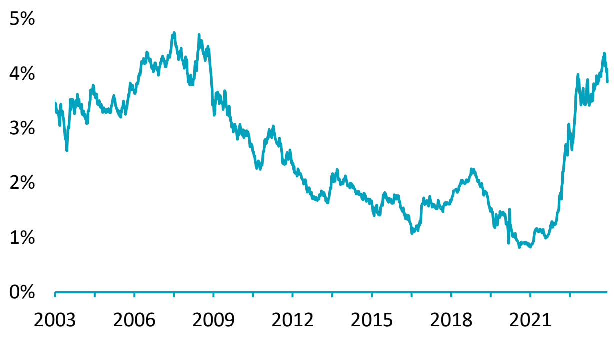
Robeco Global Macro Team

As we believe that the longer-term policy rate discounted by markets still seems too high, we remain constructive on government bonds. Any setback in yields, is likely to be used by investors to add to bond exposures. The exception to this is Japan, a country that is facing higher levels of inflation while economic growth remains relatively strong. The BoJ seems to have realized that their policy mix needs to change away from being very easy.

Figure 1 –Index yield remains elevated



Source: Bloomberg, Robeco, December 2023

Throughout 2023 we have been incrementally buying bonds as yields rose and increasing the duration position of our strategies. These duration longs are predominantly located in 2-to-5-year maturities. We added in the US and in Europe as well as in other regions including the UK and emerging markets such as Czech Republic, Brazil, Thailand and Mexico. In addition, strategies are positioned for a steeper curve and thus underweight long-dated paper. Inverted curves tend to steepen as markets start to price in central bank rate cuts.

In Japan we are running an underweight duration position, with JGB yields expected to rise as the BoJ exits its ultra-loose policy. With regard to credit, we remain cautious. Credit spreads are sharply lower as markets embraced the risk-on narrative. Risks are increasing that markets have become too complacent about a more pronounced slowdown. Hence, we continue to take a neutral approach on credit and favor the higher up in quality approach. We like Covered Bonds, SSA, swap spreads and selected hard currency bonds (Poland and Hungary in EUR) paper over investment grade corporates, and for now prefer to watch the high yield market from the sidelines.

Macroeconomic and policy outlook

- US set to follow Europe into cyclical stagnation or worse, even if China temporary creeps out of its doldrums
- Disinflation and labor market weakness will allow DM central banks to start reversing course in H1 2024
- (Geo)political events could reinforce investor concerns about public debt sustainability

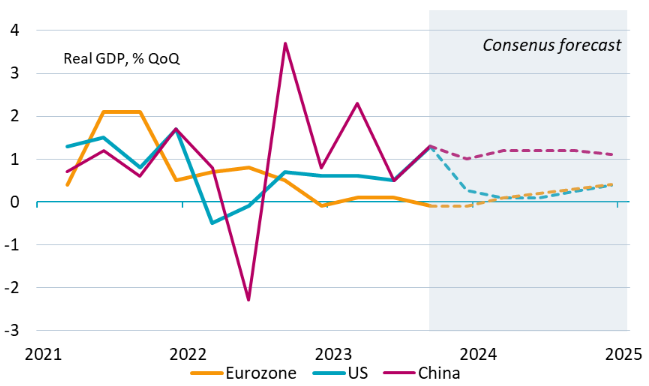
Improved inflation outlook should open the door for rate cuts in 2024, with labor markets determining the speed.

Growth outlook: second-guessing a soft landing

A looser-than-expected fiscal stance and exceptional labor market resilience are key factors in the current economic scenario. Additionally, a slower-than-usual feed-through of tighter monetary policy and a lower savings rate helped explain why US consumer spending and the broader economy managed to defy the recession warnings heralded by the inverted yield curve in 2023. And in Europe a 'genuine' recession was prevented thanks to fiscal energy support and further services sector recovery – although overall growth has stagnated over the past four quarters.

Looking ahead the consensus expects US growth to hit a soft patch in H1 2024 and to recover to trend in H2 2024 – a view that is also projected for Europe. We are more cautious. Admittedly, the upturn in leading trade data out of Asia suggests that the global manufacturing sector could climb out of its abyss next year, led by China, and in the wake of a smaller drag from property and past stimulus. Moreover, consumer spending in many countries could receive meaningful support from the improvement in real wage dynamics, as inflation dips below wage growth.

Figure 2 - Consensus growth expectations



Source: Bloomberg, Robeco, December 2023

But our concern is this may not be enough to offset the drag from the further feed-through of past rate hikes, the turn to a restrictive fiscal stance, and a sharp slowdown in jobs growth. As such, we believe it is premature to conclude – as equity markets seem to be doing – that a soft landing should now be the base case for the US. We suspect that the Eurozone economy will stay in 'surplus' longer than the consensus thinks and might (still) tumble into recession. Meanwhile, (geo)political events, including the US presidential elections and more far-right election wins across Europe could adversely influence animal spirits and reinforce investor concerns about public debt sustainability.

Inflation outlook: cyclical downtrend intact, pace could slow

Downward momentum in core inflation gained traction in many developed markets (DM) and emerging markets (EM) in recent months, led by goods disinflation. As such, year-on-year core inflation rates caught up with the earlier energy- and food price-led retreat in headline rates. While further progress should be expected in 2024, the pace of disinflation looks set to slow near term. This is certainly the case for the Eurozone, where base effects from last year and the unwind of administered energy price cuts could temporarily push up headline rates, despite the recent relapse in oil prices to the year-to-date lows seen in Q2.

In the end, lower levels of core inflation and a further cooling of wage growth – which is still running above levels (3.5% and 3% respectively) consistent with a sustained return to at-target inflation in the US and Eurozone – will be required before central banks sound the all-clear on inflation. Encouragingly, wage growth in job postings, which has tended to presage the broader trend in wages, has continued to trend lower. This should continue if we are correct on the assumption that growth weakness will start to translate into higher unemployment in the coming quarters.

> *"We suspect that the Eurozone economy will stay in 'surplus' longer than the consensus thinks*

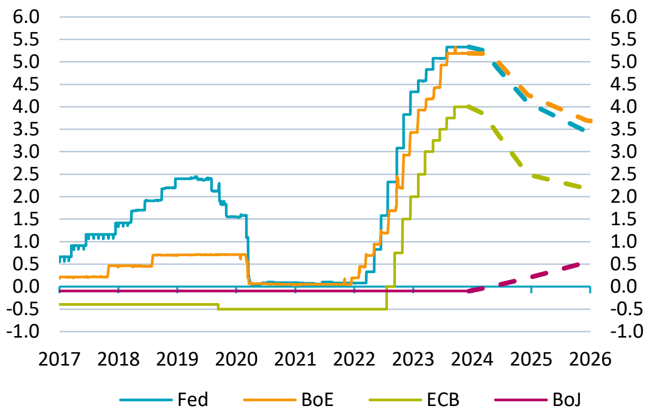
As for regional variations, it is worth reiterating that we believe inflation has structurally returned in Japan and that it could still prove stickier in the UK and Australia.

Fiscal policy: from boost to drag

As stated, fiscal support has helped many economies dodge recessions thus far. But the fiscal stance in many regions is poised to turn less supportive in 2024. In the Eurozone the energy support will start to get unwound, which, together with the further fading of earlier pandemic-related support and cutbacks in Germany due to the recent Karlsruhe verdict, should more than offset the stimulus coming from NGEU recovery funds. In the US, after the decline in tax collection and increased state and local spending in 2023, policy is projected to be slightly contractionary in 2024. In China fiscal policy should be more supportive, though this could be watered down by the debt predicaments of local governments' funding vehicles.

Notwithstanding next year's fiscal outlook, we think that in many economies restoring sound public finances amidst climate and ageing challenges, and nationalist populism tendencies, will prove difficult in coming years. We anticipate that DM central banks will start reversing course by mid-2024. While central banks in Latam and CEE countries have embarked on easing cycles which look set to continue in 2024, most DM counterparts still retain a tightening bias, and this is evident from the ongoing reduction of central bank bond holdings (note that we think the ECB will also start to gradually reduce holdings of bonds snapped up under PEPP by mid-2024).

Figure 3 - Market-implied path for policy rates



Source: Bloomberg, Robeco, December 2023

As for rate policies, we suspect that most DM central banks will be in rate cutting mode by mid-2024, with the exception of Japan, where the BoJ looks set to end negative policy rates while further modifying its yield curve control (YCC) policy. We agree with markets that UK and Australia will be the laggards in the upcoming easing cycle and that, based on the current economic divergence and recent pace of disinflation, the ECB might start cutting a bit sooner than the Fed.

Even though financial markets might be running a bit ahead of themselves in terms of pricing in the timing of the first DM central bank rate cuts, this misses the bigger point that there is still scope to discount a faster return to neutral territory over the next few years. Or to assign a bigger probability to the possibility that if labor market weakness indeed emerges, policy rates temporarily end up somewhat below neutral.

Separately, China's PBoC, like the BoJ, remains on its own course. Although it has been standing pat on conventional rates policy since implementing cuts in June and August, in our view the secular downtrend in policy rates looks set to resume later in 2024. Moreover, it is anticipated that the PBoC's balance sheet will expand meaningfully over the coming years, with loans to banks doing the heavy lifting.

Rates strategy

- Turn in monetary policy cycle expected
- Valuation of long-term yields still above neutral
- Steepening expected from different drivers

Bonds are expected to continue their rally, albeit at a more modest pace after the recent sharp fall in yields.

Strategies for a turn in central bank cycles

In an environment where tightening cycles seem to have concluded, and where we see room for many central banks to cut rates by mid-next year, there is cause for continuing to approach rates markets with a long bias. Some of the upside in bond performances will have been captured by the recent rally, but continued return potential remains, following the massive sell-off over the past two years.

Long-term forwards for US yields are now priced at close to 4.0%, which is at least 50 bps above where we see a long-term neutral. Differences between current market pricing and our long-term neutral estimates are even larger, exceeding 1.0% for UK SONIA yields. For euro rates this is less the case. Here we observe that the rally of the past weeks has brought long-term forwards close to the upper end of where we see neutral. Within our estimated neutral range (1.75-2.25) there is still room for yields to fall further. However, current valuation levels suggest that in global relative value trades we see Bunds as having less potential to outperform versus other rates markets.

> *"Long-term forward yields have come down, but remain above our neutral rate estimate for most markets*

Trades we are currently looking into for global strategies, for instance, include a Treasury-Bunds spread tightener. Additionally, we have taken a position that profits from a tighter US-Canada spread. The 10-year yield differential, at circa 90 bps, is 60 bps away from its average since 2005.

After steepening in the August-October period, curves have flattened again since early November. We believe curve dynamics will change, and rather than the driver being funding stress or inflation uncertainty, we anticipate a more traditional response. This would involve an upcoming turn in monetary policy that first leads to a steepening from lower yields at the belly, followed by a stronger performance of the front end. Therefore, we have most of our steepening positions in 5-30, or 10-30 and have dedicated less risk to 2-10. By selecting these curve segments, the strategies are less exposed to negative carry. This approach presumably reduces their vulnerability to any repricing, particularly in response to rather optimistic market pricing regarding the timing of the first rate cuts.

Figure 4 – US 5-30 yield curve spreads

Source: Bloomberg, Robeco, December 2023

Within global rates markets Japan remains an important exception. The BoJ is still in an early phase of its tightening cycle, which suggests there is more upside potential in yields in this market. This explains our underweight in JGBs. Any upward pressure on yields from the short end and belly of the curve will probably lead to curve flattening, as we have seen more recently in many global markets.

Fixed income asset allocation

- Strong technicals in investment grade credit
- High yield still dominated by dispersion
- Risk allocated to assets up in quality

Cautious approach as tight spreads meet weakening fundamentals

Credit markets: investment grade credit beta close to one

Since our last quarterly outlook in September we have seen some spread widening in investment grade and significant spread widening in high yield markets throughout October. This was based on the 'higher for longer' narrative that dominated rates markets. Spreads widened on EUR high yield from 415 bps to just under a spread of 500 bps. This quickly reversed in November as spreads tightened all the way back.

It's remarkable that the market narrative has shifted so much in such a short timeframe. At the time of writing spreads are at similar levels with EUR investment grade tightening 3 bps over the last quarter. We have also seen a more meaningful tightening in USD investment grade spreads of 9 bps to a spread level of 110 bps. We previously advocated for a defensive credit positioning with a credit beta of close to 1 via an up-in-quality portfolio. Broadly speaking, our view has not changed.

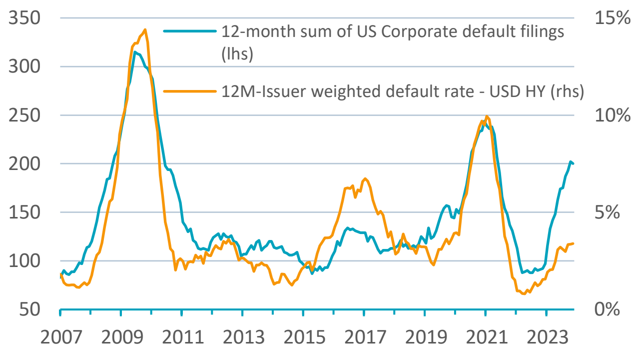
For credit spreads to tighten further we continue to believe a drop in broader interest rate volatility is required. This seems unlikely as the market has tried to price in central bank cuts multiple times, before changing focus and pricing out easing. The volatility in incoming data will make it harder for the market to stick with a single market theme for the next few quarters, keeping rates volatility elevated.

There are some strong technicals at work in the investment grade credit market. Investment grade corporates are reluctant to issue at the current expensive yields and if they do, corporates mainly issue shorter maturities. Meanwhile, with all-in yields at 4% and 5.5% in EUR and USD investment grade credit respectively (a level briefly seen during the Eurozone crisis in 2013 for EUR credit; for USD credit one has to go back to the GFC to have comparable yield levels), many institutional and buy-and-hold investors are willing to lock-in these attractive yield levels. This high demand, coupled with relatively low supply is especially visible in long-maturity credits where spreads vs government bonds tightened to levels not seen in the past 20 years.

In the case of high yield, we see that levels of dispersion are still relatively high, although average spreads are tight. This indicates that adding to any new positions in high yield would mean buying into a tight market or taking on significant idiosyncratic risk in certain distressed issuers. Defaults in high yield have been tracking at a stable pace throughout the year. We still believe that there is a high risk these will rise going forward. This is based on two observations. First, broader-based corporate default filings in the US have continued to rise and the difference between the broad economy and high yield default rates is widening (see Figure 5), a historically notable trend. In our view, the high yield market, eventually, cannot escape the developments in the broader economy. Secondly, defaults in the leveraged loan market have picked up sharply. Higher interest rates are felt more quickly in the leveraged loan market as coupons are based on floating interest rates which reset shortly after changes in central bank policy rates.

According to data collected by Moody's, the leveraged loan 12-month default rate (issuer weighted) increased to 5.4% in October. This is around the 80th percentile for data since 2000. For USD high yield the default rate is 'just' at the 50th percentile. The majority of the impact from higher coupons will only be felt when high yield companies refinance.

Figure 5 - Economy wide versus corporate bond defaults



Source: Bloomberg, Robeco, December 2023

We feel that the developments in the high yield and leveraged loan market are important for understanding the impact of higher interest rates on corporate fundamentals. This is expected to lead to a rise in defaults in the upcoming quarters. It is important to stress that the high yield default rate is increasing more slowly versus default rates observed in loan markets and the broader economy default filings. The difference can be explained by the amount of (pre)funding done by high yield companies during the pandemic, when rates were at their all-time-low due to Quantitative Easing and other stimulative measures. So far so good, but the 'savings reservoir' for these companies is nearing its due date!

As we have descried in previous quarterly outlooks, there is a significant amount of refinancing required in the high yield market. This will have a large impact on fundamentals going forward. Average coupons on debt due in the next two years in EUR high yield is around 3.5%, while the current yield on 3-year maturity bonds is around 6.5%-7%. This implies that refinanced bonds will come with roughly double the interest costs, or alternatively companies will be required to significantly deleverage. This is combined with the fact that 30% of outstanding debt is due for refinancing in the next couple of years. We believe that a shorter average maturity and the larger impact of coupon resets spell double trouble. High yield default rates are thus seen to converge to levels in the loan market and broader economy default filings.

Additionally, high inflation has been a tailwind for many fundamental credit indicators as earnings have grown at a high nominal pace. With the trend in inflation coming down, coupled with our below-consensus growth expectation (see the Macroeconomic and policy outlook section), fundamentals are likely to appear weaker going forward. Hence, we feel that the right approach in our portfolios is a cautious approach to corporate bonds. Overall, we are running a neutral credit beta. We are sidelined in high yield for the reasons explained above and prefer to allocate our risk points in covered bonds, swap spreads and SSA over investment grade.

Peripheral bonds: more challenges ahead?

Peripheral bond spreads rallied over the past quarter, as markets' attention towards ECB policy shifted. The focus has moved from the potential of end-of-rate hikes to setting an actual date and the impact of rate cuts next year. Lower yields help the affordability of debt from highly indebted countries like Italy, but a decline in yields also impacts structurally increasing potential growth.

Growth in Italy over the past years benefitted from the 'superbonus' tax credit, which led to a large construction boom. That boom has now passed, while the costs still need to be financed. NGEU money will support Italy up until 2026, but after that, Italy will need to find ways to improve potential growth without supportive measures from Europe. This worry was also expressed by one of our speakers, who mentioned that in the coming years Italy's debt/GDP ratio is likely to start rising again. With 10-year BTPs spreads versus Germany (+/-170 bps) at the lower end of our expected range, the country is vulnerable towards a change in risk sentiment by markets.

If the ECB announces bringing forward the end date for PEPP reinvestments from its current 'end of 2024' estimate, this could negatively impact the spread to some extent in the coming months. We continue to take a bullish stance towards Greek government bonds that we began buying last January and have gradually increased since. Now that both S&P and Fitch have upgraded the country to BBB-, Greek bonds will return to all relevant Bloomberg indices as per 1 February and this is expected to lead to forced buying of Greek government bonds by investors who follow benchmarks.

While most of the contraction is behind us, we still think the spread versus Germany will gradually squeeze tighter due to the limited free float of Greek bonds. More upgrades in 2024 are to be expected, as Greece is likely to show one of the highest growth rates in Europe next year, and debt/GDP will continue to decline rapidly.

> *" Forced buying expected for Greek government bonds*

Emerging market debt: wary of complacency

A marked easing of global financial conditions over the last quarter, thanks in large part to a softer USD tone, has spurred a revival in the fortunes of EM risk assets into year-end. In our eyes, this further heightens the importance of issuer selection within emerging market debt (EMD). This is especially evident in the hard currency space.

By most valuation metrics, EM sovereign credits appear tight against treasuries, especially in Asia. While the growing sense that several troubled frontier issuers will soon complete their restructurings contributes to overall index tightening, we cannot ignore technical factors such as the impact of restrained net issuance by larger markets. A further flight to relative safety vis-à-vis China's property sector is also on the cards.

Deeper analysis of global index constituents, however, suggests markets remain wary despite the aggressive rallies in recent months. Consequently, we see space for aggregate spreads to compress further, especially if sovereigns continue to prioritize local market funding and starve credit markets. Tight 5-year CDS spreads reinforce the sense of stretched credit market valuations. The vast majority of EM sovereigns are trading close to one standard deviation below the post-2010 norm. Only those markets with well-known troubles appear elevated, alluding to potential complacency. With global growth and inflation prospects continuing to soften, dynamics in local currency debt markets remain constructive. Brazil and Mexico continue to stand out in the EM space, with prior aggressive policy action percolating through both markets, sustaining elevated real yields and creating ample room for policy rate cuts and broad-based bond rallies.

In Asia, we remain selective, with Thailand and Indonesia our favored markets to take duration risk. Sluggish core and headline CPI momentum indicates real yields could soon become more attractive. Adding to the case, positioning analysis suggests both are consensus underweights among offshore investors, offering scope for outperformance as the trend in higher real yields materializes. Softening inflation, twinned with souring growth prospects contributes to a compelling argument for Bank of Korea to grow incrementally more dovish, driving 10-year KTB yields lower.

The contrast with Japan's macro and policy context alludes to a sustained compression in the cross market spread. We remain wary of food inflation pressures in India and the Philippines. Burgeoning weakness in the balance of payments may prod both central banks to remain hawkish and possibly even hike rates to tackle inflation.

Among CEEMEA markets, we are positioned for lower rates in Czechia and Hungary. Czechia looks well placed to embark on policy easing, driving a marked re-steepening of the curve. Hungary has been a market darling of late. We expect positive sentiment to continue on the back of an improved inflation outlook. Still, we do expect both inflation and rates in Hungary to settle at higher levels than pre-Covid. Meanwhile, we continue to think the market underappreciates South Africa's political, fiscal and macro challenges that are liable to weigh heavily on the ZAR and local rates markets.

FX yen remains our top of the pops

Signs of souring global growth momentum continues to emerge. This, twinned with softening inflation momentum, suggests it is only a matter of time before rate cutting cycles begin. Markets have already begun to price in such an outcome, expecting the Fed to be reasonably aggressive in its own easing cycle, triggering a substantial weakening of the trade-weighted USD in both nominal and real terms in Q4 2023. Yet, the eagerness to anticipate Fed rate cuts so far overlooks the greater-than-anticipated resilience of US consumer demand, as well as its influence on the Fed's reaction function. Consequently, risk of a resurgence in broad USD strength resulting from a return to contrasting policy cycles remains.

Against this backdrop, we continue to see the Japanese yen as the only clear value case in the FX space. Japanese core inflation pressure has sustained, while momentum indicators show the potential for CPI gauges to persist near levels not seen since the 1980s. Not only has this prompted the Bank of Japan (BoJ) to relax its Yield Curve Control policy, but discussion of policy rate hikes has begun to emerge.

Further wage hikes are anticipated in forthcoming labor negotiation rounds. This has the potential to add greater inflation pressure and cause the BoJ to tighten by more than the 35 bps which is currently priced in by the market over the coming year. Calculations also suggest markets have priced the 10-year JGB to be around 1% by end-2024, offering scope for still greater compression in yield differentials with US Treasuries to drive yen outperformance. The greater relative allure of JGB yields for local investors that discourages JPY-hedged flows into offshore government bonds and corporate credit further adds to the case.

Given the uncertainty surrounding the USD backdrop, we prefer a more neutral stance in EM FX. Singapore's highly open economy and sluggish 2024 growth prospects should discourage further policy tightening, while the Singapore dollar's elevated position in the Nominal Effective Exchange Rate band indicates it is likely to underperform its peers. Yet, with few clear and imminent catalysts, we see limited value in maintaining the position at this juncture.

Table 1 - Asset class preferences

	Constructive	Neutral	Cautious
Bunds	✓		
US Treasuries	✓		
JGBs			✓
Euro periphery			✓
EM local	✓		
IG credit		✓	
HY credit			✓
SSA	✓		
Swap spreads	✓		

Source: Bloomberg, Robeco, December 2023

We wish to thank Lorenzo Codogno (LC Macro Advisors), Jonathan Goulden (JP Morgen), and Bhanu Baweja (UBS) for contributing to our quarterly outlook meetings.

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