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2024: Fixed Income in the Age of the 3D Reset

After the bear market in bonds, investors could be forgiven for giving up on the asset class. That could be a mistake.

No investors have felt the economic regime shift of the past three years more keenly than those in fixed-income markets.

Returns have been sobering: US Treasuries have posted their worst loss since the US ratified its constitution in 1787. However, such performance has also created opportunity. Despite inflation being more elevated than during the previous decade, yields—both real and nominal[1]—on higher-quality bonds now stand at their highest levels in 15 years. This not only makes them look cheap in absolute terms but also in relative terms compared to other asset classes, particularly equities.

Additionally, with growth and inflation slowing, and most developed central banks at or near the end of their hiking cycles, this has historically been the moment when investing in bonds has been the most rewarding.

The unprecedented bond-market declines seen over the last three years can be attributed to three key factors. First, the low starting point in yields provided minimal income to offset capital losses. Secondly, major central banks began their most aggressive hiking cycle on record. Finally, the fallout from the pandemic resulted in the highest inflation in 40 years.

Challenges undoubtedly remain amid what we've labelled the "3D Reset," with global trends related to the Ds of *demographics, deglobalization,* and *decarbonization* reshaping the investment landscape. Fiscal dynamics in the US and other developed markets remain problematic while high inflation may be set to linger, and geopolitical tensions could add another layer of uncertainty. But the disappointing returns of the last three years are now in the history books. As we start a new chapter, we must shift our focus toward the potential opportunities that lie ahead.

In terms of valuations, both in an absolute sense and relative to other asset classes, bonds screen[2] as cheaply as they have in the last decade and in the top quartile in terms of their attractiveness over the last 20 years.

That doesn't mean a rally is necessarily imminent. But the higher yields may offer a significant cushion in terms of income to offset any further price declines.

Insight from sub-adviser Schroders Investment Management

Julien Houdain,
Head of Global Unconstrained Fixed Income

Lisa Hornby,
Head of US Multi-Sector Fixed Income

Abdallah Guezour,
Head of Emerging-Market Debt and Commodities

Key Points

- Three major global trends—demographics, deglobalization, and decarbonization—are likely to lead to increasing deficits, debt, and defaults, with major consequences for bond investing.
- We currently assign a high probability to an economic soft landing, but it's difficult to ignore the warning signs around a potential hard landing as tighter financial conditions bite.
- We're starting to see signs of stress from the previously bulletproof consumer. With pandemic savings close to exhausted, consumers are increasingly relying on debt.
- Emerging-market inflation has come under control. The already attractive expected returns in EM fixed income may be boosted further should the US dollar complete its overextended bull cycle.

Global: 3D Reset Will Lead to Deficits, Debt, and Defaults

***Julien Houdain,** Head of Global Unconstrained Fixed Income*

The market has fully embraced the higher-for-longer narrative as inflation challenges persist. But with interest rates now peaking, what's going to drive markets in 2024?

We think the 3Ds of demographics, deglobalization and decarbonization are likely to lead to three more Ds with major consequences for fixed-income investing: deficits, debt, and defaults.

Although this doesn't sound particularly positive for the bond markets, we see some compelling investment opportunities ahead.

Deficits: Elephant in the Room?

"I'm not worried about the deficit. It's big enough to take care of itself." — Ronald Reagan

As bond investors, we—unlike Ronald Reagan—do worry about the size of government budget deficits, which are large for this stage of the economic cycle. And the market is beginning to take notice. Nowhere does this have greater significance than in the US, where the deficit has grown in size beyond anything seen in the pre-pandemic era.

Worryingly, there are apparently few signs of deficit reduction any time soon. While pandemic-support measures have now all but ended, longer-term "green" subsidies, including those offered by the Inflation Reduction Act, (which is helping to fund the decarbonization effort) have now taken up the fiscal baton.

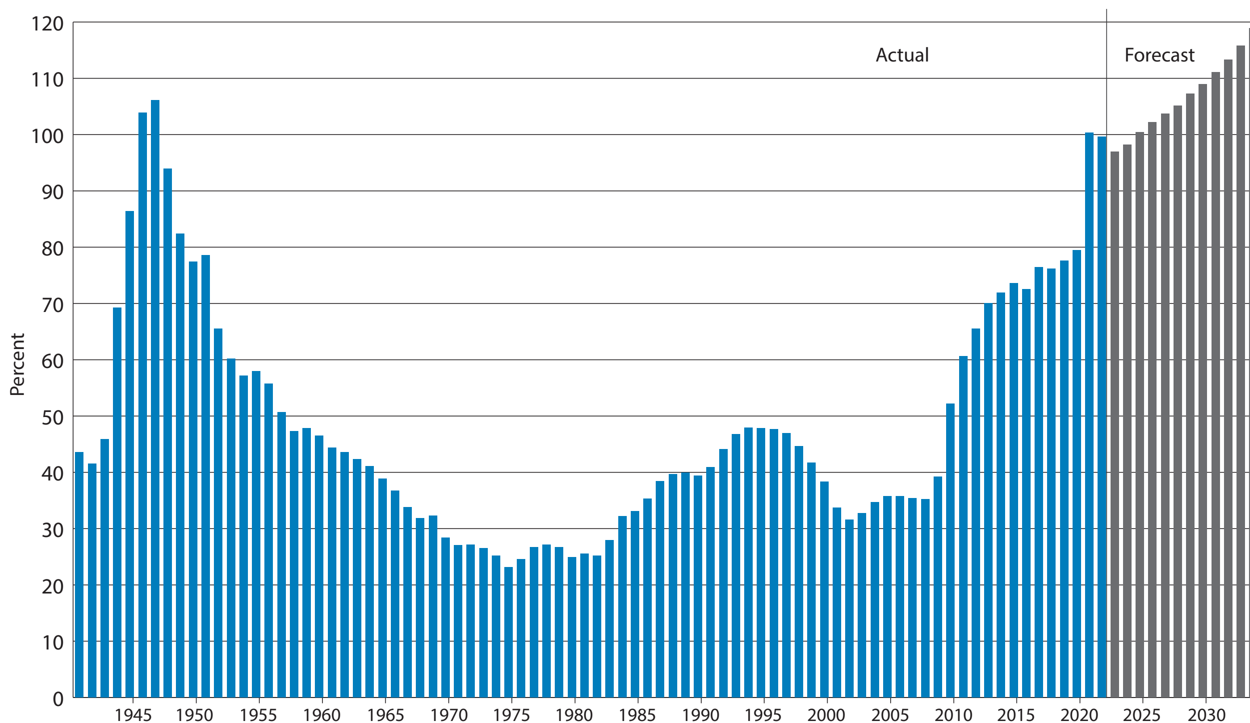
Meanwhile, reshoring in the form of the CHIPS Act—motivated by a desire to protect national interests (part of a broader deglobalization trend) and the requirement to support an aging demographic—are adding fuel to the fiscal fire. The problem: Financing this level of debt is getting significantly more expensive.

In the US, the deficit has grown in size beyond anything seen in the pre-pandemic era. There are apparently few signs of deficit reduction any time soon.

FIGURE 1

US Debt Is Mounting at a Time of Higher Financing Costs

Congressional Budget Office 10-Year Budget Projections: Public Debt* (% of GDP)



As of 11/30/23. *Public debt refers to all federal debt held by individuals, corporations, state or local governments, Federal Reserve Banks, foreign governments, and other entities outside the US government less Federal Financing Bank securities. Data Sources: Macrobond and Schroders.

All these factors point to structurally higher bond yields, but also to a greater level of market divergence as regional fiscal trends differ. This presents interesting cross-market opportunities. Let's take the eurozone, for example. Unlike in the US, the eurozone fiscal narrative is one of consolidation, which warrants a preference for European bond exposure over the US.

Creditors Have Better Memories Than Debtors

Fiscal management is intrinsically linked to our second 'D': debt dynamics. Transitioning to a new era, in which financing costs are higher, is likely to perpetuate a vicious cycle, adding to the stock of debt in the years to come.

After years of price-insensitive buyers (i.e., central banks) dominating demand for debt, they're retreating because of quantitative tightening. This means greater reliance upon price-sensitive buyers of debt, who expect greater compensation for holding a bond over a longer period (i.e., higher "term premia").

This should lead to a steepening of yield curves,[3] meaning a growing difference between long-term and short-term bond yields. Indeed, we see value in strategies that benefit from yield-curve steepening across a number of markets.

More broadly, the higher coupons generated can potentially provide not only a cushion against capital losses, but also a genuine alternative to other income-generating asset classes (including equities) for the first time in many years.

We see value in strategies that benefit from yield-curve steepening across a number of markets.

The Big 'D': Default

Default is the ultimate risk to bond investors. For cyclical assets, the macro environment is likely to have the most relevance. We currently assign a high probability to an economic soft landing, but it's difficult to ignore the warning signs around a potential hard landing as tighter financial conditions bite.

With central banks all but finished raising interest rates, the start of a rate-cutting cycle in 2024 would be a real support for bonds. Corporate default rates may rise, although, with balance sheets relatively robust, we're not expecting them to spike significantly.

Nevertheless, the transition to higher funding costs may be much faster in some economies compared to others. The pass-through from higher interest rates is felt much more quickly in Europe, where bank lending is far more prevalent than capital-market funding, which is favored in the US.

As a result, we expect greater market dispersion, not just on a regional basis, but at an issuer level, too, as investors will want to be compensated for allocating to more-levered[4] corporates. This creates opportunities to generate outperformance from careful bond selection.

Although the higher income offered by certain cyclical assets can provide a cushion against losses, we prefer to play it relatively safe given the risks of a potentially sharper slowdown. Our high-quality, lower-beta[4] preference for adding yield to a portfolio: a focus on investment grade (IG) over high yield with an allocation to covered bonds,[5] government-related, and securitized debt.

US: Putting the Income Back in Fixed Income

Lisa Hornby, *Head of US Multi-Sector Fixed Income*

The US economy has shown remarkable resilience over the last 18 months despite a number of headwinds. In the face of the most aggressive rate-hiking cycle witnessed in a generation, markets have grappled with a regional banking crisis, soaring energy costs, a persistently strong dollar, and geopolitical uncertainty.

This economic resilience can be attributed to two primary factors. First, the drawdown of consumer excess savings accumulated during the COVID-19 crisis, which has rapidly diminished from its peak of $2 trillion. And secondly, the implementation in 2022 of federal investment programs, namely the CHIPS and Science Act (approximately $280 billion) and the somewhat ironically named Inflation Reduction Act ($781 billion).

The economic tailwinds provided by these factors over the past 18 months are unlikely to be replicated in the coming quarters. What's more, the full effect of the long and variable lags associated with monetary policy, as acknowledged by the Federal Reserve (Fed), has yet to be fully felt. With more than 500 basis points[6] in rate hikes since the beginning of 2022, bond yields have more than tripled. In a highly indebted economy, it would be rather optimistic to assume there will be no unintended consequences.

We've begun to see some of the consequences of higher interest rates. Financing costs for businesses have continued to move higher in response to the increasing federal funds rate.[7] We're also starting to see signs of stress from the previously bulletproof consumer. With pandemic savings close to exhausted and the savings rate now back below 4% (the bottom decile since 1960), consumers are increasingly relying on debt. Credit-card balances have recently reached an all-time high, above $1 trillion dollars, and delinquencies, while low, are rising. The labor markets remain strong but are showing signs of decelerating. There are indications that investor concerns may shift away from higher rates and toward deteriorating fundamentals and credit risk in 2024.

In terms of allocating across the fixed-income universe, we recommend considering a more selective and opportunistic approach, considering the current yield levels in different sectors.

FIGURE 2

After Record-Low Returns, Bonds May Offer Compelling Value

Index	Yield 10/31/2023	Yield Percentile (Over the last 10 years) 100th (most attractive) 1st (least attractive)	Yield Percentile (Over the last 20 years) 100th (most attractive) 1st (least attractive)
US Aggregate	5.65%	100th	98th
US Treasury	5.03%	100th	99th
US Long Treasury	5.22%	100th	98th
US Securitized	5.96%	100th	98th
US Municipal	4.49%	100th	98th
US Corporate	6.35%	100th	95th
US Short Corporate	6.16%	100th	97th
US Long Corporate	6.54%	100th	90th
US High Yield	9.49%	99th	89th

As of 10/31/23. **Past performance does not guarantee future results.** Indices are not available for direct investment. Indices used: Bloomberg US Aggregate Index, Bloomberg US Long Treasury Index, Bloomberg Securitized Index, Bloomberg Municipal Index, Bloomberg US Corporate Index, ICE BofA US Corporate 1-3 Year Index, Bloomberg US Long Corporate Index, and Bloomberg US High Yield Index. Please see page 6 for index definitions. Data Sources, Bloomberg, ICE BoA.

Our focus remains on building liquidity in high-quality sectors such as Treasuries and agency mortgage-backed securities (MBS) as well as short and intermediate-dated corporates.

We believe there may be better occasions to add risk in the coming quarters as higher rates affect the economy and slower growth begins to weigh more heavily on corporate earnings. Once markets dislocate, there may be a significant opportunity to rotate out of liquid sectors and into higher-risk assets.

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Emerging-Market (EM) Debt: End of the Exodus?

Abdallah Guezour, *Head of Emerging-Market Debt and Commodities*

The exodus of investors from EM debt in 2022 continued in 2023. Record outflows and depressed net new issuance have made the asset class severely under-represented in global investors' portfolios.

Despite this challenging flow backdrop, EM bonds and currencies have started to perform reasonably well. Tightening global financial liquidity, US-induced

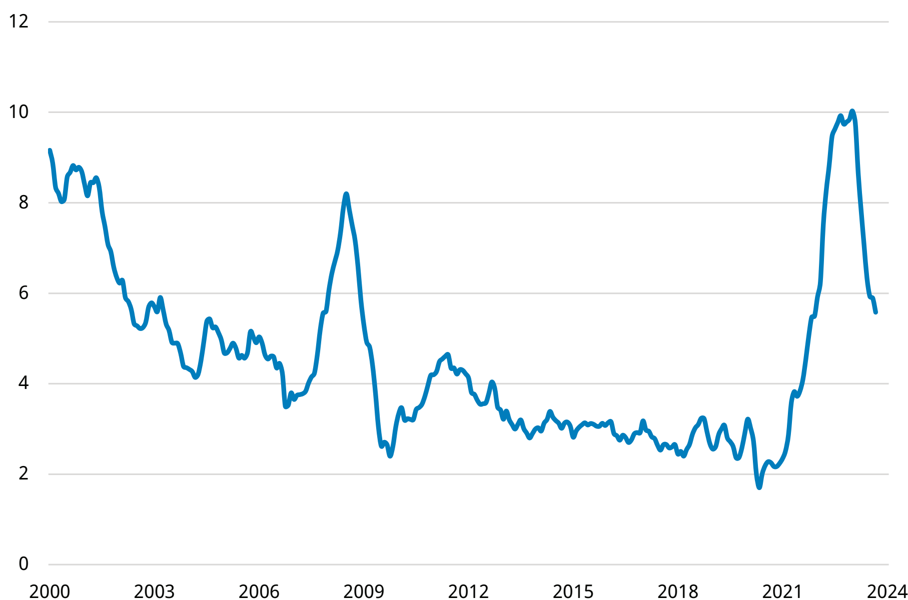
fixed-income volatility, broad US dollar strength, China's disappointing growth trajectory, and recent geopolitical dislocations have all been absorbed well by various EM fixed-income sectors recently.

Spreads[8] in dollar-denominated IG debt barely moved, while both EM dollar high-yield and local-currency debt generated positive total returns in 2023. We expect this recovery in performance may gain traction in 2024. This is because several dollar and local currency-denominated debt markets remain supported by not only their attractive levels of yields, but also disciplined monetary-policy frameworks that have brought inflation under control, improved balance of payments, and led to lower reliance on short-term foreign capital. These macroeconomic adjustments may lead to EM economies outperforming their developed counterparts in terms of growth.

Several EM debt markets remain supported by attractive yield levels and disciplined monetary-policy frameworks that have brought inflation under control.

Following a proactive hiking cycle that has taken the average real policy rate as high as 7%, several EM central banks are now regaining the right to ease (**FIGURE 3**). We expect these rate cuts to be moderate in most EM countries given the risks associated with diverging too much from the US Federal Reserve, which still appears committed to a relatively tighter monetary stance.

FIGURE 3
EM Inflation* Has Come Under Control



As of 10/31/23. *17 major equal-weighted emerging markets. Data Sources: Schroders Economics Group, LSEG Data & Analytics.

Such cautious monetary easing by key EM central banks is likely to reinforce credibility, sustain the recent stabilization of currencies that are equally supported by improving trade balances, and lead to a return of capital to local-government bond markets.

Ten-year local-government bond yields of Brazil (11.5%), Mexico (9.7%), Colombia (11%), South Africa, (12%) and Indonesia (6.8%) may be particularly well-positioned to generate high returns in 2024.

EM dollar debt also may offer appealing pockets of value, especially in sovereign high yield. Spreads remain at historically high levels, but a cautious and selective approach is warranted toward this sub-sector. Some high-yield sovereign issuers, such as Nigeria, are experiencing strong reform momentum, a benign maturity

profile, and current-account surpluses while offering dollar bond yields in excess of 11%. Although the levels of spreads in EM dollar IG debt indices appear less appealing as they are extremely tight relative to history, it's important to consider that highly rated "AA" and "A" Gulf countries now represent about 20% of the EM IG universe.

The already attractive expected returns in EM fixed income may be boosted further should the US dollar complete its overextended bull cycle. The dollar is extremely overvalued as unsustainable US twin deficits are now starting to act as a major headwind for the greenback.

We think the post-pandemic long-term bull cycle in commodities is still in place and is also a potential tailwind for several EM bonds and currencies. After a period of strong gains, the commodities complex saw a correction from the highs seen in 2022, as investors turned more cautious on the outlook for global demand.

Looking ahead, we're entering the age of the 3D Reset with increasing risks of further waves of inflation and deepening geopolitical conflicts. Resilient commodity demand and constrained supply should also drive prices higher in the long run, especially in commodities leveraged to the energy-transition investment boom. Such a backdrop may support an active allocation to the commodities complex as a strategic hedge for investors' portfolios.

Index Definitions

Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.

The Bloomberg US Long Treasury Index measures the performance of US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with a maturity greater than 10 years.

The Bloomberg U.S. Securitized Index is a subset of the Bloomberg U.S. Aggregate Bond Index and only includes the securities that are classified under BCLASS Level 1 "Securitized" group. This group includes MBS Pass-through, ABS, CMBS and covered assets.

Bloomberg Municipal Bond Index is designed to cover the USD-denominated long-term tax exempt bond market.

Bloomberg US Corporate Index is a market-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more.

The ICE BofA US Corporate 1-3 Year Index includes publicly issued U.S. Treasury debt, U.S. government agency debt, taxable debt issued by U.S. states and territories and their political subdivisions, debt issued by U.S. and non-U.S. corporations, non-U.S. government debt and supranational debt.

The Bloomberg US Long Corporate Index is designed to measure the performance of U.S. corporate bonds that have a maturity of greater than or equal to 10 years.

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

To learn more about opportunities in fixed income, please talk to your financial representative.

[1] Nominal interest rates refer to interest rates that are unadjusted for inflation. Real interest rates factor inflation into the equation to give investors a more accurate measure of their potential buying power.

[2] Typical factors to consider when screening bonds for investment include: the bond's maturity and redemption features; credit quality (rating by Moody's or Standard and Poor's); interest rate; price/yield ratio; tax status.

[3] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturing dates; its slope is used to forecast the state of the economy and interest-rate changes.

[4] Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index.

[5] Covered bonds are debt securities issued by a bank or mortgage institution and collateralized against a pool of assets that, in case of failure of the issuer, can cover claims at any point in time.

[6] A basis point (bps) is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices, and the yield of a fixed-income security.

[7] The federal funds rate is the interest rate that banks charge each other to borrow or lend excess reserves overnight.

[8] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

Important Risks: Investing involves risk, including the possible loss of principal. Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in high yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Investments in the commodities market may increase liquidity risk, volatility, and risk of loss of adverse developments occur. • Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject investors to greater volatility than traditional investments. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets. • Obligations of US Government agencies are supported by varying degrees of credit but are generally not backed by the full faith and credit of the US Government. • Municipal securities may be adversely impacted by state/local, political, economic, or market conditions. Although municipal securities that are exempt from federal income taxes, investors may be subject to the federal Alternative Minimum Tax as well as state and local income taxes. Capital gains, if any, are taxable.

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