Fixed Income Views

October 2024

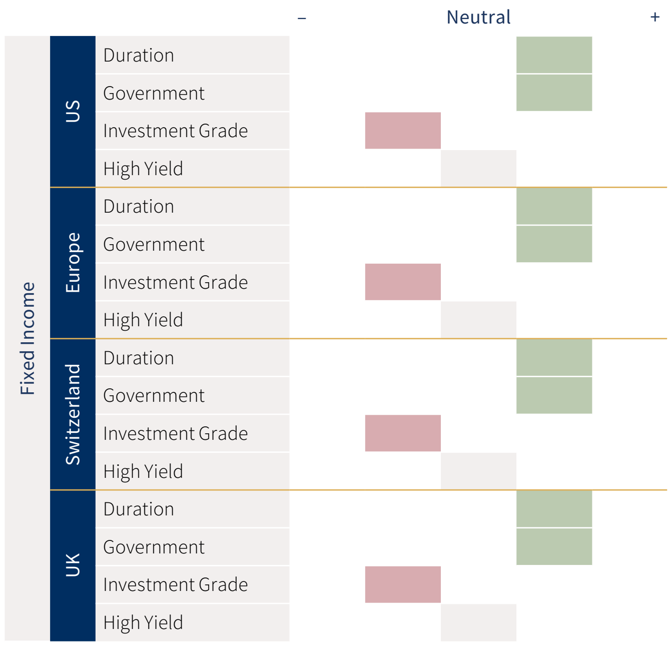
Fixed Income Allocation

September was a significant month for global bonds as the Federal Reserve implemented a widely anticipated rate cut. The US Federal Reserve cut interest rates by half of one percent (50bp) rather than a quarter (25bp). The new dot plot revealed a reduction in the Fed's median forecast for the end of 2024 and 2025 to 4.375% and 3.375%, respectively. However, the longer-term projection saw a slight increase to 2.875% from the previous 2.75%. Additionally, this month witnessed a notable event with the yield curve for US government bonds (difference between 10-year to 2-year yield bonds) disinverting after two years, steepening by over 20 basis points.

The Fed's double mandate requires it to keep inflation down and employment up. It has been delivering recently (more or less) on the inflation front, but unemployment has been drifting higher, and its rate cut is designed to help tackle that. The rise in unemployment has so far however been modest; it started from historically-low levels; and it has been accompanied by spending and output data which suggest that the US economy is still growing, and perhaps at a faster pace than usual. As a result, we agree that the Fed's move is indeed best seen as a sort of insurance policy, rather than as a response to a sudden but as yet unannounced slump in the economy. With this in mind, as long as inflation stays well-behaved, there are likely further rate cuts to come before year-end.

With this market-friendly mix in mind, our asset allocation committee decided to leave its positions unaltered in September. We stay neutral on bonds, which benefit only from falling rates – and those gains are only reliable at the short-dated end of the market. Longer-term bond yields can actually go up if rate cuts are seen as taking a risk with inflation, and in the US they have done exactly that since the Fed's move. This has not helped our positioning within the bond market, where we have been favouring longer duration, and there was some discussion at the committee as to whether this position should be reduced. However, inflation currently seems sufficiently subdued to make a more significant rise in longer-dated yields unlikely, and on our one-year tactical time horizon we felt there was enough time (and room) for the longer-dated segment to rally.

As noted, we continue to favour longer-duration exposure across all currency bases, despite the US market's reaction to the Fed's rate cut. While this move may have been unnecessary, we doubt it will do much inflationary damage. As short-term rates continue to trend lower, there is room for longer-duration Treasuries to rally. We do not expect consumer price inflation to remain near the 2% target anytime soon, but we believe any overshoot will not significantly disrupt markets in our one-year tactical view. Similarly, we continue to favour government bonds over credit – not due to concerns about corporate defaults, but because credit spreads are historically low.



Our positioning

EUR: Since June, we have preferred government bonds over credit. Although credit spreads have tightened slightly, they remain relatively high, priced for ideal conditions (low inflation, strong growth, and loose monetary policy). In a rate-cutting environment, we still prefer duration over credit risk.

USD: In line with our European stance, we maintain a neutral position in our bond allocation but have an overweight in US duration. Our bullish view on US duration stems from looser monetary policy globally and inflation returning to central bank targets.

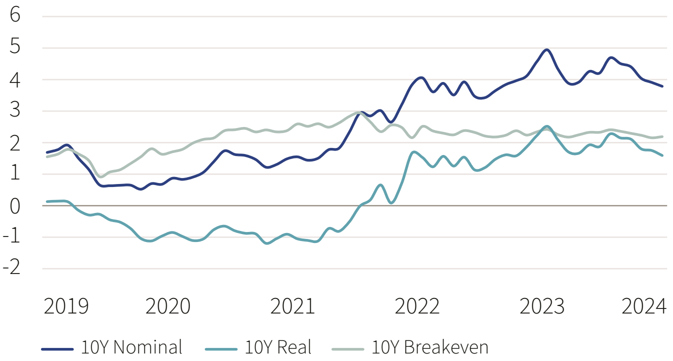
CHF: Our positioning in Switzerland mirrors our approach in Europe and the US. We remain neutral on speculative credit, underweight in investment-grade bonds, and overweight in government bonds.

Chart Flash

US and Eurozone

US 10-year yield breakdown (%)

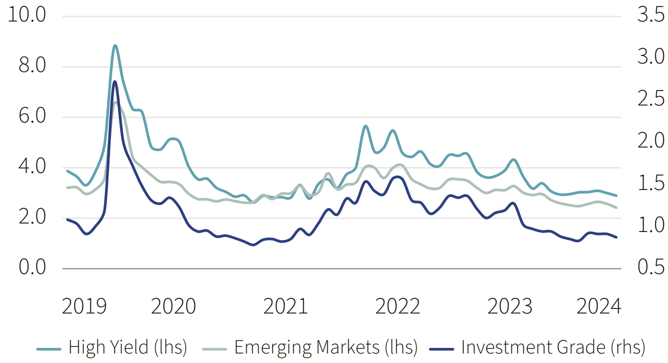
Yields fell ahead of the Fed meeting but returned to their early-month levels



All data source: Bloomberg, 31.03.2019 - 30.09.2024. Past performance is not indicative of future performance and investments and the income from them can fall as well as rise.

US credit spreads evolution (%)

Credit spreads lower



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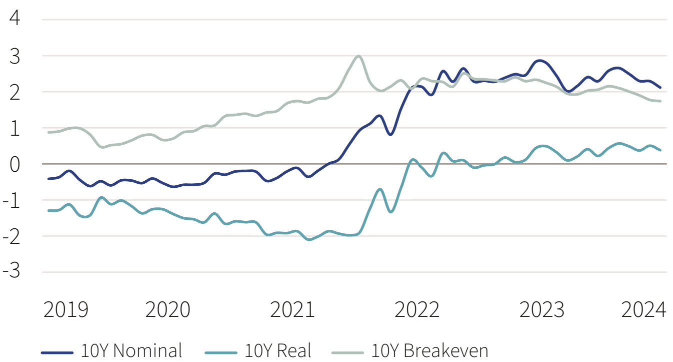
On September 18th, the Federal Reserve implemented a 50 basis point rate cut, the first since March 2020. Markets had anticipated this reduction, leading to a decline in yields by over 20 basis points and a re-steepening of the yield curve. For the first time since summer 2022, the yield curve became positive, meaning that yields on 10-year bonds were higher than those on 2-year bonds. However, in the second half of the month, yields rose back to their initial levels due to improved macroeconomic data. Meanwhile, credit spreads benefited from the looser monetary policy and a solid economic outlook.

EU 10-year yield breakdown (%)

Yields lower



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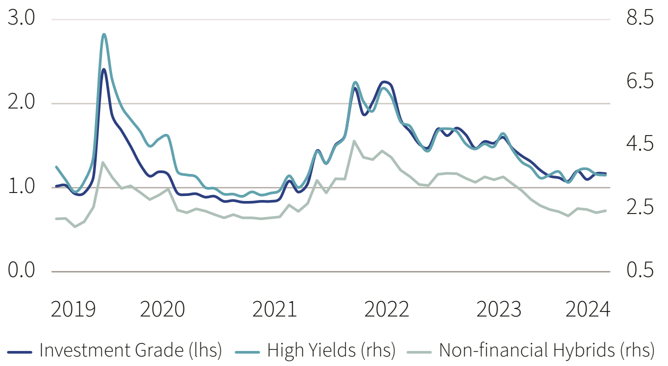
EU credit spreads evolution (%)

Almost unchanged in September



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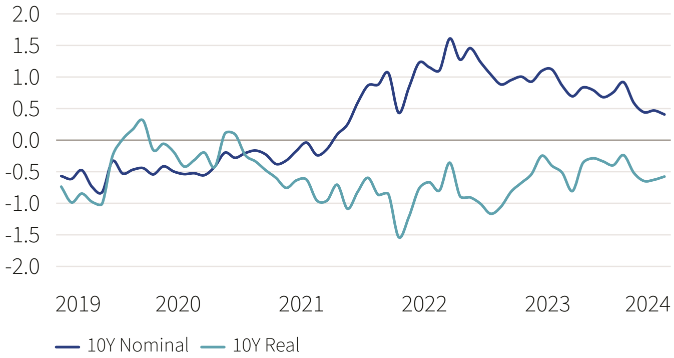
In September, similar to the US, German government bonds re-inverted for the first time since the end of 2022. This rally in bonds was driven by expectations of a rate cut by the ECB in October, two months earlier than previously anticipated. These expectations stemmed from weaker economic data across the Eurozone. Markets are now pricing in a further 25 basis point cut in October, with a likelihood of 90%. Meanwhile, the spread between German and French government bonds widened by 10 basis points, a level last time seen after the announcement of snap elections in France in June. Notably, for the first time, the yield on a Spanish 10-year government bond is now lower than of a 10-year French government bond.

Chart Flash

Switzerland

CH 10-year yield breakdown (%)

Yields lower



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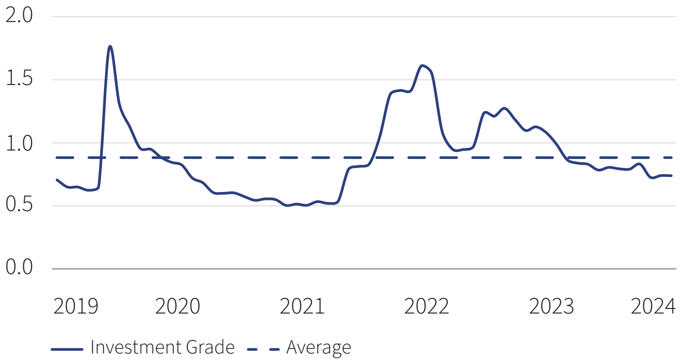
CH credit spreads evolution (%)

Credit spreads stable



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In September, the Swiss National Bank (SNB) cut the deposit rate by 25 basis points. Since the beginning of the year, the deposit rate has fallen from 1.75% to 1.00%, with markets pricing in another cut for December 2024. The yield on the 10-year Swiss government bond decreased by approximately six basis points in September, reflecting the dovish monetary policy outlook.

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