Fixed Income Views

November 2024

Fixed Income Allocation

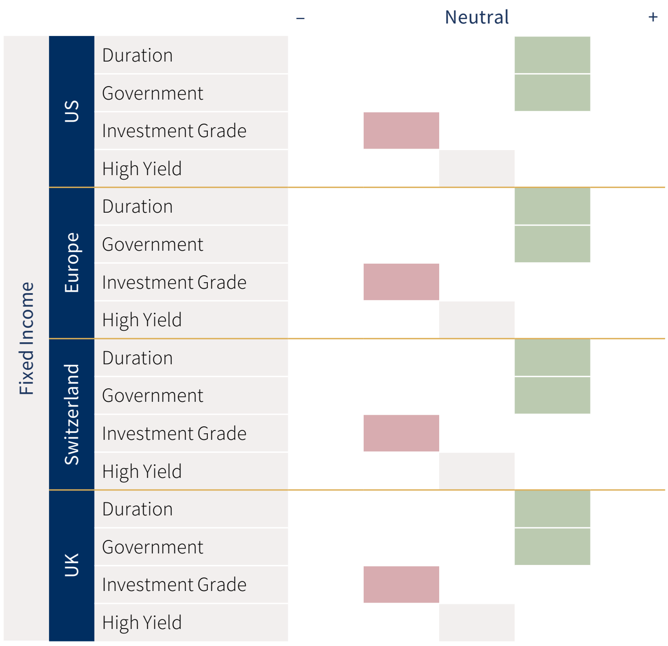
As anticipated, the US Federal Reserve cut interest rates in September, but by 50bp (0.5%) instead of the expected 25bp (0.25%). This did not come as much of a surprise as a larger cut had been discussed in market circles and recent statements from Fed officials had become less hawkish. This context helped investors to interpret the move positively rather than as a sign of impending economic troubles.

The Fed's dual mandate requires it to maintain low inflation and high employment. Recently, it has been somewhat successful on the inflation front, but unemployment has been rising. The rate cut is intended to address this issue. However, the rise in unemployment has been modest, starting from historically low levels, and has been accompanied by spending and output data suggesting that the US economy is still growing, potentially at a faster pace than usual. Consequently, we believe that the Fed's action should be viewed as an insurance policy, rather than a response to a sudden, unannounced economic downturn. Given this perspective, and provided inflation remains under control, further rate cuts are likely before the end of the year.

The Fed's move was preceded by a widely expected second 25bp (0.25%) rate cut from the European Central Bank. It was followed this week by a package of expansionary monetary measures in China, including a small cut in one of the secondary policy rates, and as we write, the Swiss National Bank appears poised to make a third 25bp (0.25%) rate cut.

Given this market-friendly mix, our Asset Allocation committee decided to leave the allocation unaltered in October. We remain neutral on bonds, which only benefit from falling rates – and these gains are only reliable at the short-dated end of the market. Longer-term bond yields can rise if rate cuts are perceived as risky for inflation, and in the US, they have done exactly that since the Fed's move. Inflation currently appears sufficiently subdued to make a significant rise in longer-dated yields unlikely, and on our one-year tactical horizon, we felt there was enough time and room for the longer-dated segment to rally.

As in September, we continue to favor longer-duration exposure across all currency bases, despite the US market's response to the Fed's cut. While the move may have been unnecessary, we doubt it will significantly impact inflation. As short-term rates trend lower, there will be room for longer-duration Treasuries to rally. This does not mean we expect consumer price inflation to remain at or near the 2% target anytime soon, but we believe any overshoot will not be significant enough to trouble markets in our one-year tactical view. Similarly, we continue to favor government bonds over credit, not due to concerns about corporate defaults, but based on valuations: credit spreads have rarely been significantly lower.



Our positioning

EUR: Since June, we have prioritized government bonds over credit. Although credit spreads have tightened modestly recently, from a historical perspective, credits remain relatively expensive and are priced for perfection (low inflation, solid growth, and looser monetary policy). In a rate-cutting environment, we prefer duration over credit risk.

USD: Similarly to Europe, we maintain a neutral stance in our bond asset allocation but have an overweight position in US duration. The main reason for our bullish stance on US duration is the global easing of monetary policy, with inflation returning to central bank targets.

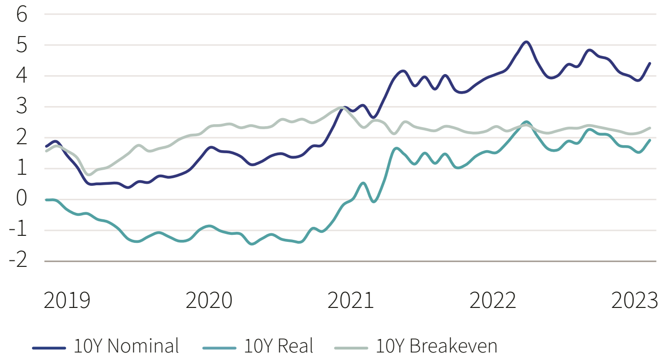
CHF: Our positioning in Switzerland mirrors that in Europe and the US. We remain neutral on speculative credit, underweight investment-grade bonds and overweight government bonds.

Chart Flash

US and Eurozone

US 10-year yield breakdown (%)

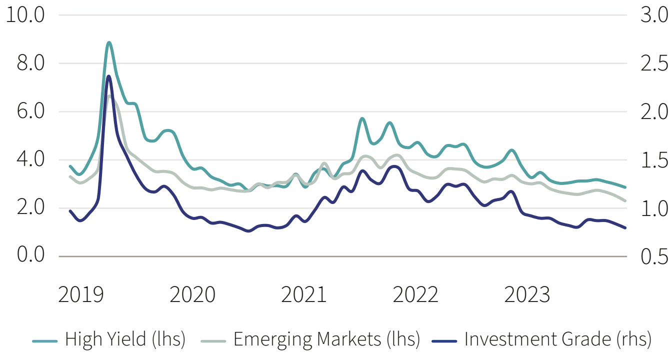
Yields surged in October



All data source: Bloomberg, 31.03.2019 - 31.10.2024. 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 (%)

Almost unchanged in October



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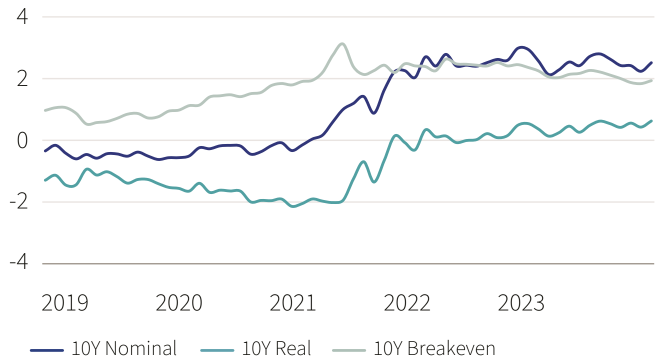
In October, US bonds were characterized by uncertainty over rate cut expectations and the upcoming presidential election. A much stronger than expected labor market report led to a sell-off in the 2-year Treasury yield at the beginning of the month, as expectations for further easing this year diminished. As the month progressed, 10-year yields rose, driven by increasing probabilities of a Republican sweep. This raised the risk of a looser fiscal policy in the coming years, pushing the 10-year term premium up 30bps over the month.

EU 10-year yield breakdown (%)

Yields steadily higher



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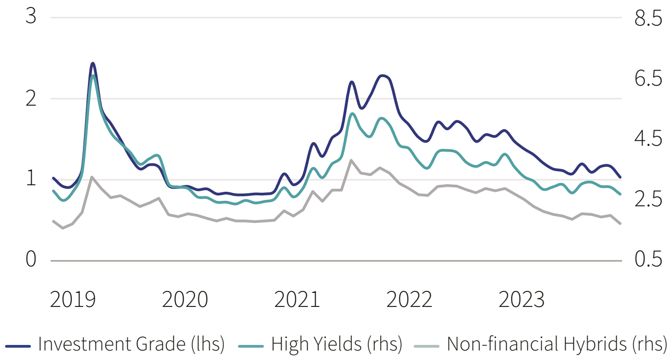
EU credit spreads evolution (%)

Falling credit spreads



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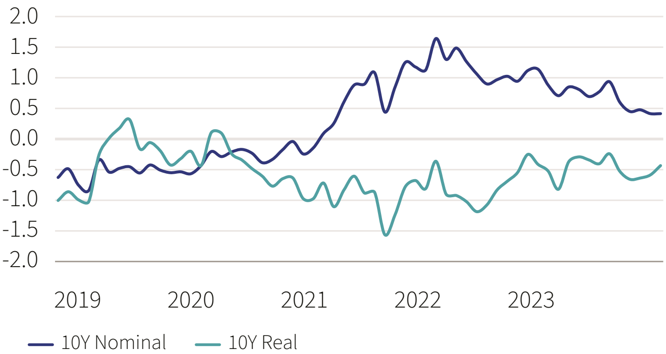
In Europe, fixed income markets spent the first half of the month anticipating a 50bp (0.5%) cut at the ECB's December meeting. However, by the end of October, these expectations were revised down to a single 25bp (0.25%) cut. This adjustment was driven by stronger than expected GDP and inflation data towards the end of the month. German government bonds continued to outperform Treasuries, a trend that began in mid-September. Meanwhile, France's credit rating was reviewed by Moody's and Fitch, both of which revised their outlooks from "stable" to "negative".

Chart Flash

Switzerland

CH 10-year yield breakdown (%)

Swiss government bonds yields unchanged



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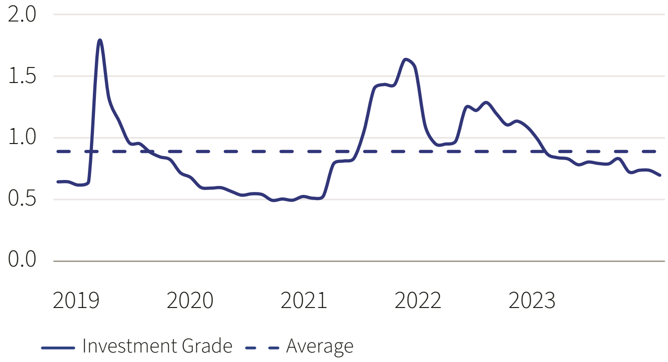
CH credit spreads evolution (%)

Credit spreads lower



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The Swiss National Bank (SNB) cut the deposit rate by 25bps in September. Markets continue to expect a further 25bp cut by the SNB in December 2024. The 10-year Swiss government bonds outperformed their US and German counterparts, with the yield on the 10-year Swiss government bond remaining stable in October.

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