Fixed income outlook: harnessing a higher-for-longer conviction

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Fixed Income

A shifting outlook for inflation, interest rates and economic growth is creating a complex market environment. But we think investors may now be starting to come around to our belief that interest rates are likely to have to stay higher for longer to tame sticky inflation. With the prospect of further near-term market instability, investors may want to consider remaining flexible and deploying their risk budgets tactically and incrementally.

Investors searching for clues about the likely direction of interest rates could be forgiven for scratching their heads. Falling inflation and signs that the economic outlook may not be as bad as feared had fuelled hopes major central banks – foremost the US Federal Reserve (Fed) – may soon begin to pivot away from a path of higher interest rates they have pursued since 2022. In response, markets rallied across the opening weeks of 2023. But the release of the latest US jobs data showed employers hired more workers than expected in January.[1] Bonds sold off as investors shifted gears – believing the latest data suggested the US economy may be running too hot and that the Fed would have to stay the course with policy tightening.

In our view, investors may now be coming around to our belief that central banks will likely have to keep interest rates elevated to tackle sticky core inflation. In short, interest rates may have to stay higher for longer. We think this belief is reinforced by the latest messaging from the Fed and the European Central Bank. Fed chair Jay Powell and

Key takeaways

- Investors are facing a complex environment, with uncertainties surrounding inflation, interest rates and economic growth.
- Strong recent US jobs data and a commitment by the Federal Reserve to taming inflation indicate interest rates may stay higher for longer – and investors may now be starting to believe that outlook.
- The role of central banks will remain in focus; policymakers will be hard-pressed to shake off the perception of "bond market-makers" or "fiscal-policy underwriters".
- Investments geared at minimising volatility may help guard against the risk of fresh market fluctuations caused by changes in inflation and economic growth outlook.

[1] Source: US Bureau of Labor Statistics: Employment Situation Summary - 2023 M01 Results (bls.gov)

ECB president Christine Lagarde have both reaffirmed their central bank's willingness to keep rates high to ensure a sustainable decline in inflation towards its price stability objective.

Going forward, we expect central banks will be hard-pressed to shake off any market perception of their role as "bond market-makers" or "fiscal-policy underwriters" of last resort. As expectations around liquidity and fiscal dominance come to an end, expect bouts of market volatility.

Shifting economic growth outlooks may compound uncertainties in a complex market environment. Our proprietary leading indicators forecast that global growth continues to run below its trend rate over the coming months. We expect recessions in the US and Europe, given headwinds from tightening financial conditions and the squeeze in household real incomes, although the slowdowns may be milder than previously anticipated.

Focus on quality and beware of volatility

Measures of implied and realised bond volatility have eased from their recent highs last year. But the shifting macro outlook means there might be further instability. In this environment, it may be wise to avoid taking too much outright, one-directional risk in portfolios in the near term. Ideas to think about in the near future:

- Considering the inherent macro uncertainty at this point of the rates and credit cycle, it may be the wrong time to aggressively increase outright duration or credit risk.
- Many government bond yield curves are flattish to inverted, so short-maturity bonds could lock in yield income as high as – or even higher than – that offered by long-maturity debt. But investors should remember: short-maturity bonds may not help much to dampen portfolio volatility as the front-end of yield curves remains vulnerable to further shocks from the repricing of terminal short-term rates.
- Combining short-maturity cash bonds with derivatives-based overlay strategies that can help minimise rate, spread and currency volatility may help in this environment. It's important to note that there can be cash outlay and performance costs associated with these hedging strategies.

Fundamentals are a lot better than heading into previous periods of economic slowdown, but there's still uncertainty over terminal policy rates and the fallout for growth. Our outlook continues to favour defensive positioning in fixed income with plenty of room ahead to add risk gradually through higher-quality debt sold by higher-quality issuers.