Perspectives Podcast

“Who’s Afraid of the Big, Bad Bond Market?”

Transcript, 24 April, 2025

Adam Bass (00:03):
This is MSCI Perspectives, bringing to light insights and analysis that help global investors tackle today's challenges. I'm your host Adam Bass, and today is April 24th, 2025. A little over 30 years ago, James Carville, then a top advisor to US President Bill Clinton, quipped that if reincarnation is real, he'd like to come back as the bond market because, “You can intimidate everybody.” At the time, fast-rising bond yields were curtailing his president's plans and in fact, the reaction of the bond market was one of the key reasons ascribed to the 90-day pause on US currently in place. So it seemed a good time to check in on the bond market and how sharp its teeth remain. For that, we invited back friend of the pod and key member of MSCI's Fixed Income Research Team, Afsaneh Mastouri. Afsaneh, first of all, I just want to welcome you back to the program. Thank you again for joining us.

Afsaneh Mastouri (01:12):
Hi everyone. Adam, great to be here.
Adam Bass (01:14):
The subject of course that we need to start with is the main situation in the markets and in the economies of the world, the US tariffs and the impact that they're having, but if we can, let's start out by taking at least a little step back from that very specific issue and really take a look at what's going on at the macro level if you could.

Afsaneh Mastouri (01:40):
So it's hard to think about it about the macroeconomy without considering this shock, but we certainly can think about the world before 2nd of April. We were in a word that most of the economies recovered fairly well after the COVID shock and subsequent to that, the inflation shock that the global economy faced, that was a global phenomenon, both of this. US did a lot better if you think about the trajectory of growth post pandemic, i.e. take the trajectory of growth at the beginning of 2020 and the actual growth that different economies faced. Almost all of the countries recovered. Most of them had a growth under that trajectory of average of 3%. US recovered and exceeded that trajectory in the last two years. So that created a very positive environment for the risk sentiment coming into this year. The technological advantages and the innovation that we have had in the last two, three years making AI lot more accessible to different corporate user and individuals created some hopes that we might have seen a step-up in productivity, which usually kind of accelerate the growth and changes the trajectory of growth.

(03:08):
So a lot of what we observed over the trend growth in the US was on the back of this technological innovation. Coming back to the kind of monetary side of the picture, inflation came down from the highest level that we have observed in 2022, 2023 and still in almost all of the economies above the level that the central banks target. In some areas softer in some areas still quite distanced. In Europe for

example, the inflation came down, the economy generally became a little bit softer. Labor market is still in a good shape. In US, the inflation I've showed a little bit higher level of stickiness to stay above 2%.

(03:56):
So we saw small step-ups after the trajectory was quite clearly towards a deceleration, but it showed that in almost all economies that the supply and demand shocks that we have observed in 2020 as a result of COVID and then after that the monetary shock to support the economy's grow out of the COVID has created the underlying dynamic that makes it harder for inflation to decelerate back to the 2% level, which is the central bank's target. So this is generally the bigger picture that if we want to think about it, the world was in a good place coming into this year and as it was reflected fairly well into performance of the equity market globally.
Adam Bass (04:46):
Can you help us help investors separate what might be more short-term drivers from the long-term issues that are driving the economy?

Afsaneh Mastouri (04:57):
I remember we had this conversation at the beginning of the year in another podcast series that we had together that knowing the policies that the new administration advertised coming into the election and the performance and their views towards generally trades and US foreign policy. The market had a degree of enthusiasm because clearly the pro-growth policies of the previous in between 2018 to 2021, 22 was giving market some hope that most of the policies are going to be pro-growth. However, there was the economic plan and some of the projections around the tariffs and how the administration is going to go about the long-term plan, which is combination of tariffs, tax reforms and their regulation. There was an underlying unease about the sequencing of these policies and effect of them in the market as well. So we started the year, as I remember we discussed it that if there is one thing which is certain about this year, would be uncertainty.

(06:20):
It proved to be in a higher level than we were expecting it. The impact that they had on the inflationary expectations also makes it harder for monetary policy to react. So I said all of this to say that uncertainty was high, we were expecting it, but it proved to be higher than it was expected and what we expect is that it's going to remain high and it's not just about tariff, it's about the whole package of the fiscal plan. One way of thinking about this is that if what we have seen since 2nd of April repeat itself, i.e. there is a lot of room for negotiation, there is a lot of room for suggesting the policy and pull back from that and watching the market for the reaction, it means that we should expect a degree of political risk premium in the US asset. We are working on kind of modeling this and measuring this, having a more educated measure of this or a better measure.

(07:23):
But you can see already that if you look at the volatility of weeks, volume equity market, volatility of swap options, especially swap rates at the long end of the rate curve. If you look at the level of volatility in a lot of currencies as an example is Canadian dollar. If you look at the different corners of the capital market and looking at the volatility of asset, especially volatility of measures of the volatility and therefore looking element of those, you can see that it seems that the approach toward long-term risk is changing. That's something that any investor when they're thinking about their allocation, especially long-term investors should keep eye on that as a gauge to see if there is a risk premium created in US asset to compensate for this uncertainty.

Adam Bass (08:22):
And so you're saying is these are some proxies per se, such as the link to US dollar to Canadian dollar for example that investors might want to look to in order to quantify this policy risk premium as you're saying?

Afsaneh Mastouri (08:41):
Exactly. This is a preview of the work that we are doing. We are working on hopefully to be able to measure this to create a set of metrics to be able to measure this risk premium. In the short term we might have some shocks, some volatility. If this volatility dissipates and disappear from the market, it would be just the side effect of the shocks, but we suspect that the investors should consider adjusting the risk premium for different US assets and also global asset for this new risk factor, but the premium that it would have in different asset classes is going to be different and it would be measured differently. The indicators that I offered here such as volatility of VIX or volume in the rate environment in the long end of the rate are some examples of the metrics that we are considering to first measure this risk factor and also to come up with an appropriate framework assigning a risk premium.
Adam Bass (09:50):
If we turn to perhaps the most well-known measure within the fixed income world, the yield curve, what are we seeing there in terms of issuance of treasuries at different spots on the curve?

Afsaneh Mastouri (10:03):
Sure, actually that was one thing that I wanted to complete my answer to the previous question as well. When you think about the magnitude of the response in different markets, specifically let's focus here in rate market, we need to differentiate the long-term trends from short-term trends and we need to differentiate macro and micro drivers of the volatility. If we think about what happened in the rates generally in the last 40 years, there were three or four main and large drivers that kept the secular trend in the interest rate going so that the yield curves flatten in general and also the general level of the rates come down post-1980s. The first driver was globalization. Global economy being able to take advantage of the cheap labor available in emerging markets. So that was the first driver that pulled the inflation lower in general. Supply sites kind of factored, pulled the inflation lower and as a result, generally we saw the lower level of the rates.

(11:24):
The second one was the demographic factor, aging population. This is a trend that it continues. It has started in developed market. It's still too early to say that emerging market is going through the same process as well, but there are signs that we can see that the emerging market, generally the whole world sees the trend of aging. It's important because it means that the balance is going to move towards saving as opposed to consumption and then usually the higher saving means that more depressed level of yields for the safer asset, and one of the most important one was it's a macro but tactical is that the central banks and generate the global central banks increase their allocation to US treasuries as a reserve for a US dollar position as a reserve currency and their allocation to treasuries that created this sustainable and constant demand from all over the world, for US treasuries.

(12:25):
If you think about it except the first factor, none of the other factors is impacted by the turning the policy, and that's something that we have to keep in mind that it's very hard to say what was the contribution from each of these factors, but it's clear that the second which was demography and the third one, which was basically the role of treasury as a reserve management for different economies. These two factors are very slow and they haven't changed. There are other tactical factors that they are

contributing more to volatility of the rates in short term from a position of the leverage traders, supply and demand that we have seen long end of the US treasury curve. Generally the long end of the curves are the areas that they are very segmented. The demand specifically is very particular.

(13:22):
If there is excess supply, we are going to see a reaction of the market. The yields can move quite sharply. There are innovation in the market. There are good news, but nevertheless impact the long end of the curve. There are innovation in the financial market that adds to the supply of the duration to the market. Example of that is long-dated funds, private credit funds that offer a longer duration to market. So these assets and this innovation also impacts the supply of the duration in the market and does not certainly help to reduce the volatility in the long end.
Adam Bass (14:03):
Let's talk more about that last point if we can in terms of the role that the private credit markets are playing here. We've definitely seen a trend where they've stepped in other areas of the market, we've talked on this program before about how private markets are stepping in terms of commercial real estate, but for corporate America trying to get funding, why are the private credit markets an attractive alternative for them?

Afsaneh Mastouri (14:34):
In all of the doom and gloom and all of the uncertainty and a little bit of a scary word that the investors are dealing with, potentially private credits can offer a better perspective. It's not to say to increase allocation to that group or not. It is to emphasize on diversifying role that this fairly newly created asset class can have and the impact of that that can have in the portfolio of investors. Let me step back and look into what private credit is doing and how they are integrating in the macroeconomy, and then how they are impacting investors' portfolio. In terms of macroeconomy and how they are helping on underlying growth, what banks were forced to drop from their balance sheet post-financial crisis, gradually was picked up by private credit. There has been certainly a change in the behavior of retail side in terms of demand for leverage in terms of the real estate investment.

(15:48):
But if we leave that aspect aside, the banks were forced to restructure their balance sheet, control the risk, and that inevitably impacted a small and medium-sized businesses as well. The good news or the kind of like a positive influence of private credit is that a private credit is capable of offering funding to that area of the market. So small medium-sized companies, they don't have large balance sheets, they necessarily do not have large leverages, but their size and the complexity and generally the economy of them doesn't allow them to go to the public market for either issuing bonds, or they are not favorably positioned or considered by the banks because of their exposure to cyclicality or other risk factors. Private credit market can complete this menu of funding for these companies. So that's how we see them as a positive factor, lubricating the funding market for corporates, especially the corporates that they might have some home bias, some domestic biases.
(
17:02):
From the other end of the spectrum, what do they offer investors is that aspect is interesting as well. As we were discussing, this asset class is targeting providing funding or targeting companies that they tend to look into alternatives or look for alternatives to banks and the public bond market. There are areas of this that in terms of the industry coverage, it's complementary to the public market in terms of the duration and nature of the financial instruments that they are offering, they are complementary to the public market. So overall for investors, they two role. One is they can be complementary in terms of

exposure to different area of the macro economy and exposure to different type of asset classes, and then the other angle is that for longer term investors like those that they tend to be by nature, buy and hold like insurance sector, they have a demand for long duration, flexible yet long duration and private credit because of the nature of especially close-in funds can offer that long-term duration and customize sector and geographical allocation.

Adam Bass (18:33):
On the other side of that, are there special considerations for investors to evaluate the risk and even some of the potential opportunities, but let's focus on the risks on what has traditionally been a pretty opaque asset class and a reason some folks have stayed away, right?

Afsaneh Mastouri (18:54):
This is a very hot topic and also top of the mind for a lot of investors. Maybe in the last five years, a lot of institutional investors approach to investing in private credit was very much, it's an subset of alternative investment and the satellite investment, i.e. we would have or a major allocation of 40, 60, or any other type of allocation and we would set aside between five to 10% for alternatives to improve the yield without increasing the target risk as much. That story is changing as basically the asset class is growing. Now more and more investors are considering increasing their investment, but for that to happen, they need to understand this opaque asset class better, i.e. in terms of the aggregated exposure. A lot of investors that I speak with them these days, the question that they have is that I want to make sure that the exposure that I have in private credit in terms of both sector allocation and also financial instruments is complementary to my public credit investment.

(20:04):
So the narrative has changed quite significantly from this is a marginal allocation in my satellite investment to this is now a serious allocation as part of my credit portfolio allocation, now we have the conversations are about total credit. Now, this is part of the total credit allocation. That's a part that has less exposure to duration, can be customized, can give me a different type of exposure. So if I want to look at equal footing and look at the risk of this asset class versus public, what are the tools available? I'm pretty sure you've heard of it very recently, we have announced a partnership with Moody's.

(20:51):
So this is one of the tools basically that investors in public market are very much used to it when it comes to investment in credit to look into likelihood of the default of the borrower and also a recovery rates. I.e. if I buy and hold, what would be the downside risk to my portfolio? So with this kind of partnership that we have, we would be able to offer that insight into private market, very similar to the metrics that investors are used to in public market. This would be a great tool to help for a scalability of the investment in this space.

Adam Bass (21:36):
So Afsaneh, understood that in this moment especially, it's very difficult if not impossible to look too far into the future, but if we can think about it in terms of what type of signals or indicators might investors in the fixed income side of the market be watching for, whether it's on the macro or micro level?

Afsaneh Mastouri (22:04):
Sure, it's a very hard question to answer and I really invite everybody to think about this, that if these policies implemented as they suggested, they change a lot of dynamics that would naturally impact capital market and capital market assumptions for everyone. Do we know what might happen the other

side of it? Really, no. Are we able to model it? We can model them. As you know, we do a lot of scenario analysis. The caveat to those type of modeling is that inevitably, this is a new environment. A lot of correlation structures might not hold, a lot of dynamics might not hold, and I personally think when I'm looking at the market, I think now the market has come to the conclusion that there is, as we can see in the risk asset and rates especially long end of the curve, what we see is that the market has come to conclusion that there is a risk, that this is not a short-term volatility to go away, but to measure the magnitude of this.

(23:17):
What I'm doing is that I keep eye on factories like PMIs and the forward-looking element of them to understand better how the real economy is and how the expectations in the real economy is impacted. If you look at the PMI, there are elements like new orders, inventory levels and others that they are really about the positioning of small and medium-term businesses and large businesses, how they are positioning themselves to deal with this economic situation, and that's a long-term effect. If the new orders start to come down or inventories goes up, these are the effects that they're not going to be absorbed very quickly and they would have ripple effect on stock market and in rates market than others.

Adam Bass (24:09):
That's all for this week. Our thanks to Afsaneh and of course to all of you for listening. Next up on the program, an eye-opening examination of those ever-expanding private markets that Afsaneh was just talking about. We'll speak one-on-one with MSCI's head of private assets, Luke Flemmer. Until then, I'm your host Adam Bass and this is MSCI Perspectives.

About MSCI