Fixed-Income Markets in Focus: On the Road to Recovery?

Jenna Dagenhart: Certain recession indicators are flashing red. Today, we'll cover how investors are evaluating bonds versus equities in light of these warning signs as well as the effect of inflation and central bank monetary policies. Joining us now with more on the latest developments and market trends is Andy Sparks, managing director and head of portfolio management research at MSCI. Well, Andy, great to have you back with us.

Andy Sparks: Thank you very much, Jenna. Pleasure to be here.

Jenna Dagenhart: So what have we seen Andy across equity and fixed income markets over the past year? Then what about more recently over the past few months?

Andy Sparks: Well, for the bond market, there's been good news and bad news. So the good news is that returns in 2023 are positive, which is really good compared to 2022 when they were very significantly negative.

Jenna Dagenhart: Oh, yeah, very different story this year.

Andy Sparks: That is right. The less good news is A, equity returns characterize them as spectacular so far this year with the MSCI USA equity index being up over 20% year to date. And that's far, far better than different bond market sectors have performed. Also, take into account of course, that there has been inflation this year. So if you look at large components of the investment grade bond market, specifically US treasuries, their returns are positive, but they're lower than inflation. So on an inflation adjusted basis, treasuries have had negative returns this year.

And then in other words, in terms of the real consumption basket that investment could buy, it buys less now after having invested in treasuries than a consumer could have had taking that invested in mind the basket at the beginning of the year. So ultimately, investors are looking for after inflation adjusted returns. And like I said, in the treasury market, which is the largest part of the investment grade market, they're actually negative this year taking into account inflation.

Jenna Dagenhart: Yeah. I want to talk a little bit more about inflation, Andy. What are your expectations and what about your expectations for central bank monetary policy?

Andy Sparks: So number one, last week we had the CPI release, which was really good news on the inflation front, very significant declines in inflation, broad based. I'm sure that number was very welcomed by the Fed, but I think in probably premature to take a victory lap at this point. The market, as well as the Fed has consistently understated inflation over the past couple of years. There have been quite a few unpleasant surprises. And so, although this month's number looked really good, one month does not make a trend. And in fact, if you go back to the prior month's CPI release, it was unexpectedly high, and a lot of market participants were talking about stubbornly high inflation.

So just because we have one-month, investors, I think, need to be a little cautious and a little skeptical. I wouldn't be surprised if members of the Fed FOMC continue to be pretty cautious. But probably, internally, they're probably call it cautiously optimistic that maybe we have turned a corner here. We'll ultimately have to wait and see. If you look at the US Treasury market, if you looked at the

relationship between prices of treasury link securities and nominal treasuries, that gives us an idea of the market expectation of inflation.

Next year, it's approximately 2%, which is pretty much in line with what the Fed's long-term inflation target is. So we'll ultimately have to wait and see, but I think we're trending towards more optimism on the inflation front. But there will be some skeptics and we'll just have to wait and see. If you look at interest rate futures markets specific to what the market is thinking about Federal Reserve policy, they think there will be one more rate hike and then it'll stay there for the rest of the year with declines starting next year, which again is consistent with the Federal Reserve's projections from the June FOMC meeting.

As of a couple of months ago, there had been some discrepancy between what the interest rate futures market thought was going to happen versus Fed policymakers with the market thinking there'd be cuts in 2023. But what we've seen over the past year and a half is that each time there's been some discrepancy between what the futures markets thought versus the Fed. Generally speaking, the futures market has thrown in the talent and have gone with the Fed and the same thing seems to be occurring this time around as well.

Jenna Dagenhart: And of course, one reason to be optimistic too about the economy is the labor market. The labor market has been tremendously strong and resilient. So, I'm sure the Fed is taking that into account as well.

Andy Sparks: Absolutely. And Chair Powell has talked quite a bit about, and he's been asked a lot about "Can the Fed engineer a soft landing?" That's what the Fed has wanted as opposed to a hard landing or a stagflationary environment. And so MSCI, we had a recent blog where we were looking at four different macroeconomic scenarios and we looked at projected returns across sectors in each one of those scenarios, but we did not give a probability to those scenarios. But the Fed has been hoping that the soft landing could be engineered, and I think there were a lot of skeptics a few months ago that it would be possible.

And effectively, the Fed has been trying to thread a needle and it sure seems like that possibility of a soft landing is growing and you might think the eye of the needle is growing, a little easier to get that thread in there. And ultimately, we'll have to wait and see. So that would be generally a very good scenario for capital market participants, but we'll have to wait and see whether that happens or not.

Jenna Dagenhart: Those are very tough to achieve when you look back historically as well.

Andy Sparks: That's right. But you're right, the news on the labor market has been very good. We'll be getting more economic data, as well as earnings from various companies coming in. So it all is accumulative. But so far, I think the economic performance has surprised participants to the upside so far this year.

Jenna Dagenhart: Although, of course, one reason to be cautious could be the inverted yield curve, some might say. What would you say in response to people looking at the inverted yield curve and other data out there predicting a recession?

Andy Sparks: It's very steeply inverted, and there's been a lot of research including academic research looking at whether that is a good predictor of economic downturns. And it generally has a pretty good record, not perfect. And I would say particularly in the current environment, I think investors need to be

concerned about false signals and take into account the Fed has two different criteria that it's focused on. And it's really their goals are A, to have maximum employment and B, to have stable prices. And the narrative, the causal factor for maybe why in the past a steeply inverted yield curve oftentimes led to recession is the view that the economy was slowing and the Fed to prevent it from slowing too much would have to begin easy. But this time around maybe partly a little bit because this feeling that a soft landing is maybe more achievable now. The Fed may be more focused on inflation this time around.

And Chair Powell has definitely talked about this over the past few months. And so the idea is that the Fed has had to be very vigilant. It's had to raise rates significantly and keep them high. That's the projection for this year, as we mentioned a little earlier. But ultimately, Chair Powell has also said if they have really good news on the inflation front, they can begin to talk about being less aggressive in keeping rates high and possibly even leading to cuts. And that could occur even in the absence of a concern about a recession.

And so, if you look in the rearview mirror and just look at empirical data, you might think, "Okay, we're headed for a recession." And a lot of people are focused on the inverted curve as signaling flashing though those red lights that a recession is on the way. But like I said, there's some other scenarios, particularly if you combine the possibility of a soft landing with a reduction in inflation, that does take some pressure off the Fed, and they may begin to talk about easing a little earlier than expected. And maybe this time around, the inverted curve will not result in a recession. We'll see.

Jenna Dagenhart: And finally, Andy, what are investors thinking about in light of all of this when it comes to their allocations to bonds versus equities? I mean, they haven't performed as well as equities this year, as you mentioned, but those yields are pretty high.

Andy Sparks: They are, and that's a crucial thing. And we like looking at real yields in the bond market, and we look at them for short maturities, mid-maturities, and long maturities. And across the board, they're pretty high by the standards of the past 12 to 14 years. And it's particularly true in the short end, but even out at the 10 year it is. And so yields are still relatively high. And if you look at measures of valuation in the equity market, so we like looking at the forward earnings yield and the equity market. And if you look at the relationship between that forward equity earnings yield to real yields from the bond market, it seems that the equity yield seem a little bit on the tight side compared to his relative to bond yields by the standards of the past 20 years. And so if you just use that as a measure of valuation, you might say that bonds look cheap.

But the important question for investors, "They might be cheap, but could they get cheaper?" And so as tempting as it is to say, "Okay. Now, is the time to rotate into bonds, just given the relatively attractive yields," I think it is important that investors look at what could go wrong here. And I won't go down a laundry list, but several things. Number one, as I mentioned before, we did have this blog looking at various macro scenarios. And the worst one for capital market participants is the stagflation scenario where... And like I said before, it's probably premature to declare victory on the inflation front. Unexpected things could happen. So there could be some downside attached to that. So in terms of the bond market skeptics, just focus on that as one reason to be a little cautious on bonds. Another reason could be, let's just call it a debt overhang.

And everyone knows there's been a lot of fiscal stimulus. The Congressional Budget Office has put out its forecast over the next 10 years, and it looks like there's going to be growing treasury issuance, not just in absolute terms, but also relative to GDP. And the question is, "Who are going to be the buyers for that?" And we'll ultimately have to wait and see. I'd say one potential vulnerability for the

fixed income market are foreign buyers. And if you look at foreign holdings of treasuries over the past year or so, year and a half, those holdings have gone down in absolute terms even though the amount of treasuries has gone up. And the question is whether that trend could continue. And so that is, I think, one supply and demand imbalance that investors should be focused on. Another question in terms of, "Are there going to be enough buyers for bonds?" Is to think a little bit about the trend towards alternatives in portfolios and investors, institutional investors adding allocation to alternatives that's generally being funded from the public markets in their portfolios.

Could be equities, could also be fixed income. Private credit is a pretty hot area among a lot of investors these days. And as clients seek alternatives to the public markets, that could put some pressure on bond yields as well. So we'll ultimately have to wait and see, but these demographics are important. And are there going to be enough buyers given the increasing debt? So I think a lot of investors want to say, "Well, yes. From a yield perspective, the sector does look more attractive now, but maybe yields are going to continue going up and we'll ultimately have to wait and see on that."

Jenna Dagenhart: Well, Andy, you better leave it there. Thank you so much for joining us.

Andy Sparks: Thank you very much, Jen. Always a pleasure.

Jenna Dagenhart: Of course. And thank you to everyone watching. Once again, that was Andy Sparks, managing director and head of portfolio management research at MSCI. And I'm Jenna Dagenhart with Asset TV.

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