

## Fixed Income Markets in Focus: Bonds in 2024 – A New Paradigm?

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Gillian Kemmerer

Welcome to Asset TV. I'm Gillian Kemmerer. As we move into 2024 with moderate economic growth and easing inflation expected, investors still face uncertainty when it comes to interest rates. How have bonds performed recently, in contrast with equities and what lies ahead? Joining us today to discuss the latest developments in fixed income is Andy Sparks, managing director and head of portfolio management research at MSCI.

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Gillian Kemmerer

Andy, it's always great to have you here in studio and it's a perfect time to be having this conversation. It's one that's being sparked in Davos and beyond. So we've been discussing higher rates for longer for quite some time, both here in the studio, but also just more broadly in the market. Recently, however, there's been an expectation of rate cuts.

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Gillian Kemmerer

So are we out of the woods yet when it comes to inflation?

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Andy Sparks

Well, it is true that yield curves are showing a market expectation that short rates are going to decline very significantly in 2024. And it's also true that government bond yield curves show a generally optimistic view around inflation in 2024, with inflation falling very close to 2% central bank targets. So that's the market expectation. But markets can be wrong and markets were terribly wrong.

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Andy Sparks

Bond markets were terribly wrong in 2022, we had some of the worst performance of the past 40 years. But, you know, ultimately investors need to think a lot about scenarios. I think market expectations are very good for a starting point when an asset allocators are looking at portfolio positioning, but looking at other scenarios and other possibilities is also very important.

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Gillian Kemmerer

So in light of what you just said, what are the key macroeconomic scenarios that investors should consider?

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Andy Sparks

And MSCI, we recently wrote a blog looking at four distinct macroeconomic scenarios. The first scenario was a soft landing scenario, which is pretty much what the market has been increasingly pricing. In the second scenario we looked at was a hard landing. This is one where it turns out that central bank rate hikes were too severe and although they were successful in pushing inflation down, they pushed it down too far and they also pushed the US economy or I should say, the global economy into a recession.

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Andy Sparks

So that was the second scenario. We looked at the hard landing. The third one wasn't it was a resurgence of inflation and the fourth one is was one where it was growth. Growth was very strong. And this might for most most investors would probably be considered a Goldilocks scenario where growth was strong and inflation pressures on inflation were not particularly elevated either.

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Andy Sparks

So relatively stable inflation, but much stronger growth. So those were the four scenarios we looked at. And ultimately we think those are pretty good representation of the scenarios that many investors should be considering.

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Gillian Kemmerer

Now, one of the major conversations going into last year was around the 6040 portfolio. There were calls that it was dead discussions of whether or not it was still something that investors should be considering or maintaining. So it begs the question how have Bonds been performing as a diversifier against equities?

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Andy Sparks

Well, before I answer that explicitly, let me say that between the year 2020 20, bonds tended to act as a diversifier against equity market volatility. So when equities sold off, bonds tended to rally. And so from a portfolio diversification perspective, bonds really weren't anchor in the portfolio. But since the last several years, it's not been like that at all.

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Andy Sparks

It's it's the best example. I'd say is 2022 when we had a real rout in the bond market at the same time that equities sold off a lot. And so in this case, bonds compounded the problem. And so asset allocators have become accustomed or had become accustomed to viewing bonds as this anchor in portfolios. But over the past several years, that has been missing.

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Andy Sparks

So that's a very important consideration for asset allocators to be thinking about.

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Gillian Kemmerer

What are some of the risks and challenges as we see a shift in the bond equity relationship that you just alluded to.

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Andy Sparks

The diminished diversification over the past few years has directly contributed to elevated market volatility, and MSCI research has shown that we've looked historically at potential factors driving the bond equity relationship, and we think it's partly related to the level of inflation as well as the volatility of inflation. And so investors as investors sort of think about what role might they want for their portfolios of for bonds in their portfolios, they should think really carefully about, Well, do you think

that inflation do you think central banks are going to bring inflation under control under that line of reasoning, you might think that the bond equity correlation could it could maybe not necessarily go all the

00:06:05:13 - 00:06:16:26

Andy Sparks

way back the way it had been between 2020 20. But maybe maybe it will act as more of a diversifier compared to what we've seen over the past several years.

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Gillian Kemmerer

Is there a positive outlook for Bonds in 2024?

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Andy Sparks

Well, I come back to the scenarios that I mentioned, and in two of those scenarios, inflation is is benign and coming down. And it's those scenarios where bonds did well out of those four scenarios, it was those two scenarios and those two scenarios were soft landing and hard landing. And so under the soft landing, there's a modest decline in inflation.

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Andy Sparks

There's a modest rally in the bond market, but it's in the hard landing where bonds do really well. And normally we think of hard as being bad. And but the way we modeled that a hard landing, it is very bad for equities. Economic growth is really hit, but inflation comes down a lot. And so bonds do quite well.

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Andy Sparks

And also the the the positive benefits of having bonds in multi asset portfolios is is revived. And although the multi asset portfolios may not do that well, bonds are doing their job of registering positive returns in bad economic times.

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Gillian Kemmerer

Well Andy, from the range of scenarios that you've laid out to some of the challenges in portfolio construction and the look ahead. Thank you so much for taking the time to show us what you're seeing in fixed income for the new year.

00:07:42:18 - 00:07:45:17

Andy Sparks

Thank you very much, Gillian. Always a pleasure being here.

00:07:45:19 - 00:08:15:04

Gillian Kemmerer

And thank you for tuning in from our studios in New York, I'm Gillian Kummer for Asset TV.

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