# Mid-year outlook: key insights and challenges in fixed income – Transcript

00:00:00:00 - 00:00:10:12
Ritika Gupta
So.

00:00:10:15 - 00:00:20:02
Ritika Gupta
Welcome to Asset TV. I'm Ritika Gupta, and joining me now is Afsaneh Mastouri head of fixed income solutions research at MSCI. Welcome Afsaneh.

00:00:20:04 - 00:00:21:29
Afsaneh Mastouri
Thank you so much for having me.

00:00:22:01 - 00:00:42:12
Ritika Gupta
Well, first of all, we're halfway through 2024. So I want to discuss where we currently are when looking at the markets, but also how key economic and political events could shape, market and asset values in the second half of the year. So in terms of where we are, the first six months of the year, what are your key takeaways?

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Afsaneh Mastouri
Sure, we can actually speak for hours about what was expectation going into 2024 and how far we have come away, and distance yourself from those expectations in both economic sense, in monetary policy sense, and the expectation for the direction of the monetary policy, not just in developed markets, but also in emerging market as well as the the political changes that happen.

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Afsaneh Mastouri
We entered the year with the expectation for quite a high volatility as a result of more than half of the population of the world going into election in emerging markets, in developed markets. But some of the, political changes that happened or the outcomes of the election was completely unexpected. And they introduce some degree of uncertainty.

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Afsaneh Mastouri
The most kind of important, perhaps, implication of the market is that uncertainty about the fiscal policy that has, has would impact not just the economy, but the asset market and, and, and different part of the employment and other factors.

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Ritika Gupta
And another key driver of then monetary policy. We've seen the ECB and the Fed diverging in terms of at least the speed of interest rate cuts, the Fed very much data dependent, waiting for inflation to come down meaningfully. I mean, what is the impact that monetary policy is having on markets?

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Afsaneh Mastouri
Sure. As much as we like to put them together as developed market, the the economic scene in Europe is very different than the economics in the US. They move in tandem. Ultimately there is a bit of the man and chain story happening because of their the trade partnership between two blocks of economy for the lack of better word to express that.

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Afsaneh Mastouri
But, at the moment, we are at that point that the two they are on the path of divergence, at least on, on their main economic factors that we are looking at. US exceptionalism has proven to be driver of the assets market and the performance of the economy. Yet again. We entered the year with the view that US had a great run.

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Afsaneh Mastouri
So, this might come to an end. So, investors have started to look into Europe to look into European stock, given the fact that there was a little bit of an outflow from the European market post-Russia invasion of Ukraine, given the valuation, given the diversification in the market, given the level of currency. So everything was kind of like a rosy picture to have some diversification away from the US into Europe.

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Afsaneh Mastouri
So if you focus on what's happened in Europe in the last six months, what we have seen is that actually, maybe closer to the end of the six months, in the last 1 or 2 months, we have seen that there are issues with the structural issues in the euro were just coming back to the main scene again. There were just that a little bit forgotten by investors, given the, the level of the unification that we saw in support that we saw across the euro post Covid, almost the those, fiscal issues and the structural issues where that that was impediment of, there were stopping or, hindering

00:03:57:26 - 00:04:21:05
Afsaneh Mastouri
the process of integration are coming back to surface. French snap election was one of the biggest surprises. That was not in the price, not in the mind of investors, and is coming to have consequences for the market. Leaving Europe on one side, and obviously ECB, we can come back to that, but I would like to kind of a little bit talk about what the contrasted with the US economy in the US side.

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Afsaneh Mastouri
What we have seen is that we started the year with the expectation that the high level of interest rates and the level of the general level of cost of financing would be prohibitive for financial activity, for, for economic activities. What have we what we have seen is that growth is following the path of trailing 2, 2.5%. You can say that even a little bit above the potential growth.

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Afsaneh Mastouri
So it's pretty strong unemployment stays at the very solid level. There is a conversation that what percentage of that is the contribution of immigration and the immigration policies. But the picture is, it depicts a very, very solid, footing for economy. Leading indicators are started to soften a slightly. But when you look at the hard data, it is still pretty strong, especially industrial production and other levels.

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Afsaneh Mastouri
And the, inflation is coming down. So last year, this month, last year in May we had 5% inflation. The last print of inflation is three, three and half. So so the picture is couldn't be any more expressive of a divergent in the background of economy.

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Ritika Gupta
Absolutely. And I want to pick up on that point that we were talking about the U.S. and the majority of market participants predicting that, you know, one, maybe two interest rate cuts by year end. Can the markets rally in the absence of a rate cut? Can they continue to go higher?

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Afsaneh Mastouri
I think the expectation for the, for the rate cut is, is not, 1 or 2, kind of which is equivalent of a little bit of a preemptive rate card. It's not, far off mind. It's, it's very reasonable. and the effect of the I mean, and it's basically just, what it does is that in general, given the level of core inflation, it just brings there, then the level of the rate closer to what is thought a natural level of interest rate.

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Afsaneh Mastouri
So that would be supportive of the economy. And if the Fed kind of continues with passing the message or sending the message that they're not in rush pausing on the path of normalization or basically as starting an easing cycle, usually that kind of create is supportive of risk asset. It might not be a best news for for, fixed income for rates specifically, but it means that the credit spreads are likely to stay, quite tight.

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Afsaneh Mastouri
The downside for them can be quite limited, and equities usually that environment, that growth is a strong monetary policy is reactive, but not necessarily up to where it's upside.

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Ritika Gupta
I want to switch gears here. And you did refer to the elections at the start, but you mentioned that they could be unexpected consequences for both emerging markets and Europe's currencies and bonds and therefore by extension, equities. Could you elaborate on that?

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Afsaneh Mastouri
Sure. I think the most surprising election in this year for Euro was, was the announcement of the snap election. Then this was not expected. And I think part of the consequence and part of the, widening of the spread that we see ten year bonds, widen is now one of the widest level at these post, post pandemic levels.

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Afsaneh Mastouri
Part of the reaction sell off in, French stock market CAC 40, despite the fact that their exposure to French economy is actually quite limited is about 20% exposure. So the quite a sharp reaction, we think, as a consequence that the market was not expecting that. One good news there is that we don't see this

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Afsaneh Mastouri

so far to have a spread to other ... or to other semi core, i.e. when you look at the spreads in in Italy specifically, that's usually the bottom about, barometer for the, for the level of spread. They are quite contain. We saw some rally in bonds, a little bit of a kind of defensive approach but but so far it has been contained.

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Afsaneh Mastouri
And I think it's partly because the markets expect it. There is a volatility. There is expectation for volatility that resulted in such a kind of strong reaction. But but market in general sees this problem a localized problem and doesn't want to necessarily get over its head itself to, to price it in others. In general, what I think the best way of approaching that is that even though it's a tail risk, widening of a spread in Europe is a tail risk in medium term,

00:08:57:05 - 00:09:23:21
Afsaneh Mastouri
beyond this election, we have the same issue as we had before crisis, before Covid, the fiscal integration and the structural issues of Euro, is there. Now that some of those policies are reverting back, i.e. now that the fiscal, discipline has to be respected again, fiscal rules are resumed, we would we expect to see some friction, some conversation around that.

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Afsaneh Mastouri
And, it means that the tail risk is low, but the spreads are likely to go up.

00:09:29:12 - 00:09:42:24
Ritika Gupta
And in the US, of course, all eyes on the presidential election. So in the run up to that, I mean, looking at what the potential fiscal policies may be, what do you expect to see in treasuries in the US dollar in the run up to the election?

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Afsaneh Mastouri
Sure. I think that, one thing that it seems like the market's kind of considering its already, to a degree, is pricing. It is that whoever comes to the White House, the result is farther, fiscal expansion, that we have the forecasts that the, the public debt to GDP from 96% that now is going to reach around 115, 16% by the end of the decade.

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Afsaneh Mastouri
So I think that the, the, the direction of the travel is expected for a market. The how we get there is very different of Republicans and Democrats. Democrats tend to be on the increase of the fiscal deficit by increasing the, spending. Republicans are on the tax side. The effects on market could be quite different. I think one of the uncertainties for the market is not just on the on the fiscal policies, also on how each of these kind of to group of candidates to two policy makers, families of policy makers, if those two makers might react, might react to or might impose further tariffs in into to in the, to the, to the US trade

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Afsaneh Mastouri
partners specifically in case of China. So those aspects related to the trade is introducing further uncertainty which is not necessarily directly related to the fiscal policy.

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Ritika Gupta
So Afsaneh, before I let you go, I wanted to get some final thoughts from you and what your key thoughts are for the second half of the year.

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Afsaneh Mastouri
In the U.S, I think we are we agree with the market. When you look in the market, it seems that the soft landing is the main thing. We agree with the markets on that, in the sense that it's hard to see any specific catalyst that would threaten the growth significantly to push us into a deep recession. Given this backdrop, given what is happening with the uncertainty around the election, it, what we hear from investor and what we think that the investor may want to consider is that, changes in the timing structure. And if the Fed basically can't see there is a preemptive rate cut that would support

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Afsaneh Mastouri
the front end of the curve, and the perspective of any fiscal expansion can can introduce some volatility and widening into the, the, widening of the spread into the structure and some, some, basically premium into the timing structure. And this can result into a, steepening of the curve, something that has, been in mind of many investors for, for the last six, seven months.

00:12:14:01 - 00:12:17:15
Ritika Gupta
Thank you so much for sharing your insights with us today.

00:12:15:18 - 00:12:19:21
Afsaneh Mastouri
Thank you so much.

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