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MACQUARIE ASSET MANAGEMENT

To hold or to fold?

Fixed Income Strategic Forum 2024 | Issue 01

Key takeaways

Hold	Do we "hold" our view of a recession in 2024? Many historical patterns, leading indicators, and economic data still caution that this will occur.
Fold	Do we "fold" and accept "it's different this time," appreciating that greater use of fiscal policy and significant central bank liquidity will continue to support markets and economies?
Walk away	Do we "walk away," acknowledging that financial markets remain disconnected from the economic cycle? Central bank liquidity is just as significant as the economic outlook.
Run	Do we "run," given even looser fiscal policy could (re) ignite concerns regarding inflation and very stretched government debt levels?

Take an in-depth look

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Investment themes

The scenarios fixed income investors are grappling with in 2024

Hold

Should investors "hold" the view of **a recession to occur in 2024?**

- A large number of **historical patterns, leading indicators, and economic data** still caution that a recession is a strong possibility.
- We fundamentally believe that monetary policy does work, albeit with long and variable lags, and it is now **restrictive** and potentially in **overtightening** territory. This has naturally led to credit tightening, and the economy is yet to feel the full impacts of it.
- If there is a recession, **central banks will be required to cut interest rates, and they will likely cut as aggressively** as in the most recent hiking cycle.

Fold

Should investors "fold" on the view of a recession as **"it's different this time?"**

- Recognise (1) the post-pandemic economy is different with tighter labour markets; (2) the magnitude and **ongoing use of fiscal policy** continues to play a significant offsetting role to much tighter monetary policy; (3) equity market performance, led by the **artificial intelligence revolution** and the "Magnificent Seven" mega tech firms is affording a powerful "halo-like" boost to sentiment; and (4) the ongoing episodic use of (at times, stealthy) **central bank liquidity** will continue to support markets and economies.
- Even so, our analysis suggests **further fiscal expansion and lower interest rates will be required** to avoid recession. Without it, current resilience will likely turn into fragility as the longer and variable lags are increasingly felt.

Walk away

Should investors "walk away," acknowledging that **financial markets** can, and in 2023 arguably did, remain **disconnected from the economic cycle?**

- They adopt the view that the economic outlook isn't as important to financial markets as it once was.
- Instead, focus on the impact of **central bank liquidity** and the application and reduction adjustments of their enormous balance sheets post quantitative easing (QE) are just as, if not more, significant, and **the balance is likely to result in more supported market outcomes.**
- In other words, "walk away" and ignore the view of the economy impacting financial markets, and **instead embrace trading ranges** based on the considerable impacts of ebbs and flows in liquidity.

Run

Should investors "run," given **even looser fiscal policy** could (re)ignite concerns regarding a return to higher inflation, as well as the financing and trajectory of stretched government debt levels?

- The resultant outcome would be the risk of **significant long-end bond volatility with higher yields.**
- The potential for Japan to begin a hiking cycle would exacerbate this scenario, as Japanese savings favour domestic bonds over foreign bonds (such as US Treasuries).
- A world of greater fiscal policy usage also has a significant byproduct – **a higher cost of capital**. This would be a world that is the **complete opposite to what financial markets have enjoyed** over the past few decades… hence "run."

Investment implications

Our investment outlook

- **Economic downside risk remains elevated,** and as such we remain in a **prudent** and **cautious** investment position.
- Our focus remains on maintaining elevated levels of liquidity and a **defensive mindset** favouring duration, which provides attractive yields and a risk offset, along with **high-quality investment grade credit,** which we expect to be less impacted should we see volatility arise.
- We stand ready to lean into markets more heavily should we see valuations become more attractive and will **actively seek out individual pockets of opportunity** and value that remains across markets.

Source: Macquarie. Views as of January 2024, subject to change without notice.

Constructive: Rates/duration

Bonds offer an increasingly **attractive investment proposition.** We will look to **add duration** should yields pick up but will be more nuanced regarding timing as market pricing of cuts and supply dynamics will likely have an impact on short-term volatility.

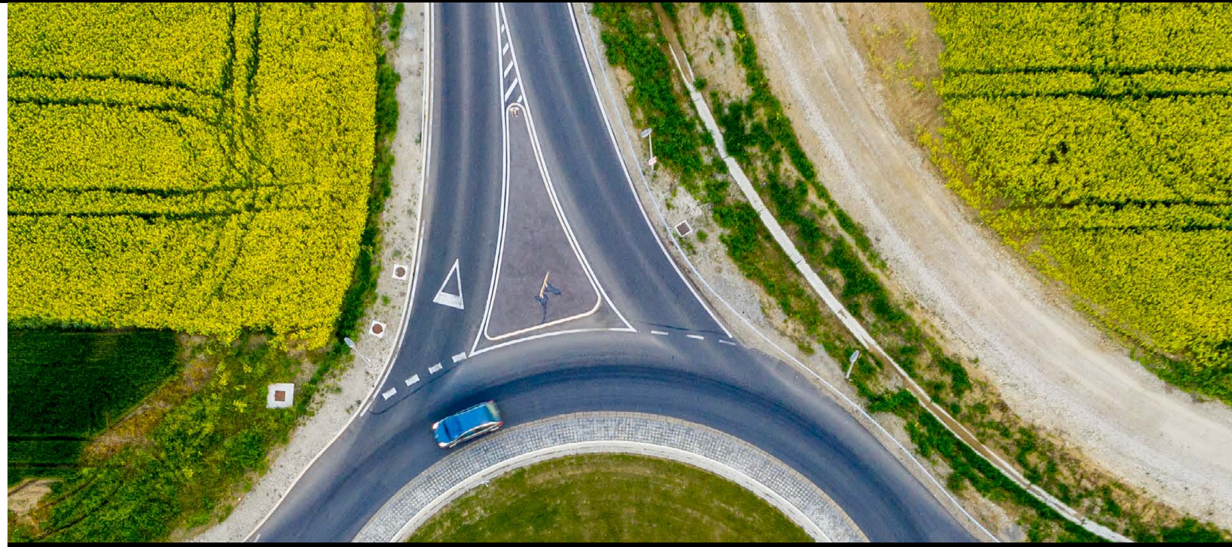
Cautious: Risk markets

Remain cautious on the broad sector. All-in yields in credit markets are providing a compelling return proposition; however, spreads do not reflect the heightened volatility backdrop for markets and the uncertain economic outlook.

We see **selective security investments** with a preference for short-dated investment grade exposures.

Constructive: Cash

There is a heightened importance to **maintain elevated levels of liquidity** to invest in opportunities as they arise when volatility subsides.



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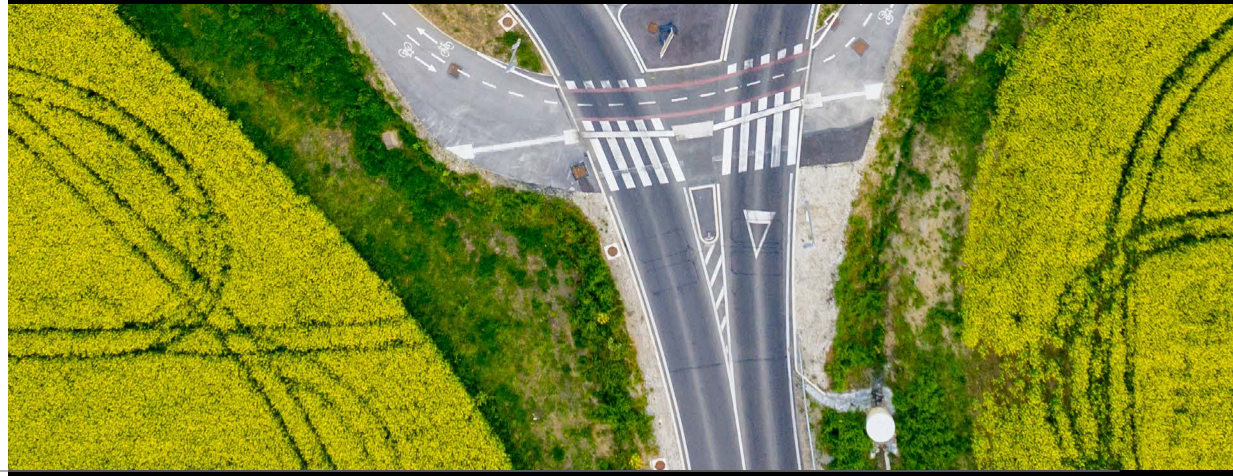

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Fixed income securities are also subject to interest rate risk, which is the risk that the prices of fixed income securities will increase as interest rates fall and decrease as interest rates rise. Interest rate changes are influenced by a number of factors, such as government policy, monetary policy, inflation expectations, and the supply and demand of securities. Fixed income securities with longer maturities or duration generally are more sensitive to interest rate changes.

Fixed income securities may also be subject to prepayment risk, which is the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

International investments entail risks including fluctuation in currency values, differences in accounting principles, or economic or political instability. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility, lower trading volume, and higher risk of market closures. In many emerging markets, there is substantially less publicly available information and the available information may be incomplete or misleading. Legal claims are generally more difficult to pursue.

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Currency risk is the risk that fluctuations in exchange rates between the US dollar and foreign currencies and between various foreign currencies may cause the value of an investment to decline. The market for some (or all) currencies may from time to time have low trading volume and become illiquid, which may prevent an investment from effecting positions or from promptly liquidating unfavourable positions in such markets, thus subjecting the investment to substantial losses.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Liquidity risk is the possibility that securities cannot be readily sold within seven days at approximately the price at which a fund has valued them.

Mortgage-backed (MBS) and asset-backed (ABS) securities, like other fixed income securities, are subject to credit risk and interest rate risk, and may also be subject to prepayment risk and extension risk. Extension risk is the risk that principal on mortgage-backed or asset-backed securities will be repaid more slowly than expected, which may reduce the proceeds available for reinvestment in higher yielding securities. MBS and ABS may decline in value, become more volatile, face difficulties in valuation, or experience reduced liquidity due to changes in interest rates or general economic conditions. Certain MBS or ABS, such as collateralized mortgage obligations, real estate mortgage investment conduits, and stripped MBS, may be more susceptible to these risks.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

Gross domestic product (GDP) is a measure of all goods and services produced by a nation in a year. It is a measure of economic activity.

Quantitative easing (QE) is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increased the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Quantitative tightening (QT) refers to when central banks raise interest rates. In a tightening monetary policy environment, a reduction in the money supply is a factor that can significantly help to slow or keep the domestic currency from inflation.

Recession is a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters.

A Treasury yield refers to the effective yearly interest rate the US government pays on money it borrows to raise capital through selling Treasury bonds, also referred to as Treasury notes or Treasury bills depending on maturity length.

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year US Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. It is also used to predict changes in economic output and growth.

The shape of the yield curve is closely scrutinized because it helps to give an idea of future interest rate change and economic activity. There are three main types of yield curve shapes: normal, inverted and flat (or humped). A normal yield curve is one in which longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time. An inverted yield curve is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of upcoming recession. A flat (or humped) yield curve is one in which the shorterand longer-term yields are very close to each other, which is also a predictor of an economic transition. The slope of the yield curve is also seen as important: the greater the slope, the greater the gap between short- and long-term rates.

Yield curve inversion is when coupon payments on shorter-term Treasury bonds exceed the interest paid on longer-term bonds.

Economic trend information is sourced from Bloomberg unless otherwise noted.

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