LOOMIS | SAYLES

10 JULY 2024

Global Bond Team Perspectives

US economy showing cracks; how long can the tight spread environment last?

Bull Points

1. Corporate fundamentals still remain decent and technicals supportive
2. Inflation is becoming less of a problem
3. The Federal Reserve (Fed) will more than likely cut interest rates this year

Bear Points

1. US economy is now clearly slowing
2. Global growth ex-US marginally better, but still weak
3. Credit valuations rich on any measure
4. Significant geopolitical worries

Outlook

Back in March of this year, we highlighted our bemusement regarding the strength of the US economy in the face of 550 bps of rate hikes, weak growth around the world, and the plethora of current geopolitical risks. Geopolitical risks which, by the way, have only compounded in the past few months with the election of a new Labour government in the UK, political gridlock in France, and the shocking developments regarding President Biden in the US following a disastrous debate performance. Just a few months removed from then, we would argue that cracks are now appearing in the US economy. US GDP growth in 1Q was sluggish at 1.4%, but was dismissed by most since it was due to weak exports and inventories, while we saw domestic consumption remaining solid. But now, 2Q GDP growth is expected to be in the same range and appears to be confirming this slowing trend. Is this evidence of the Fed achieving its soft landing? Or is it the beginning of a more dramatic slowdown? Much of the recent data point to the latter. Credit card and subprime auto past dues are at post-GFC highs and survey data such as University of Michigan Consumer Sentiment, US PMIs, and the LEI index are declining. Other hard data has been weaker over the past couple of months as well such as housing permits, starts, and sales; construction spending, durable goods orders, and retail sales. While these data points, along with a slowing labor market, have assisted the Fed in its inflation fight, the challenge we see will be getting the rate cut timing right before the lagged effect of past monetary policy tightening becomes too much to bear. Markets are currently expecting two rate cuts this year.

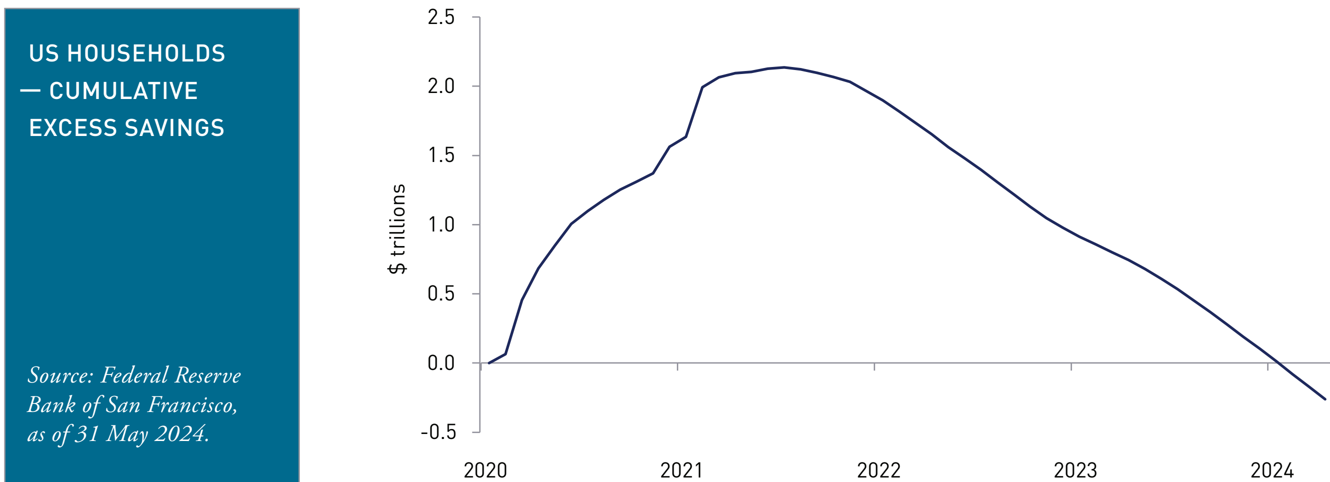
We remain concerned that absent additional fiscal stimulus, which perhaps could come in the form of tax cuts under a Republican administration, and the near depletion of consumer excess savings in the lower to middle income cohorts, could lead to further economic slowdown. Many have argued that the positive wealth effect from booming equity and credit markets can sustain the risk on mentality, but as we have discussed in the past, the breadth of the equity market rally is lackluster and could turn rather quickly, in our view.

Further, the growth situation in Europe is more uninspiring. Although 1Q GDP growth in Europe and the UK was modestly better than expected, it still remains feeble, and both France and the UK must now figure a path

forward under new administrations. The European Central Bank (ECB) just recently cut interest rates, but it was considered a cautious cut as inflation still remains above trend. The market is currently expecting two more interest rate cuts this year, but perhaps that will not be enough to stem the sluggish growth trend, as earnings across the continent still remain rather depressed, in our view.

Our proprietary investment grade and high yield risk premium models continue to signal that the premium available to be harvested is quite thin in an historical context, mainly due to tight spread levels and less a function of forward looking loss estimates, which are not too onerous. That said, our latest model output displayed a slight weakening in our Corporate Health Index (CHIN) owing to some of the aforementioned weaker macro variables and a pullback in interest coverage and leverage.

As could be expected given our views, we continue to run lower than average risk positions in our global corporate portfolios. The overwhelming demand for credit (from pension de-risking, annuity sales, wealth management clients, etc.) given the relatively attractive yields on offer, has continued to provide a strong tailwind. We feel that this technical grab for yield has pushed corporate bond spreads tighter than fundamentals warrant. Weaker earnings, a drawdown in tech stocks, and further cracks in the labor market will be key items that we will monitor.



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