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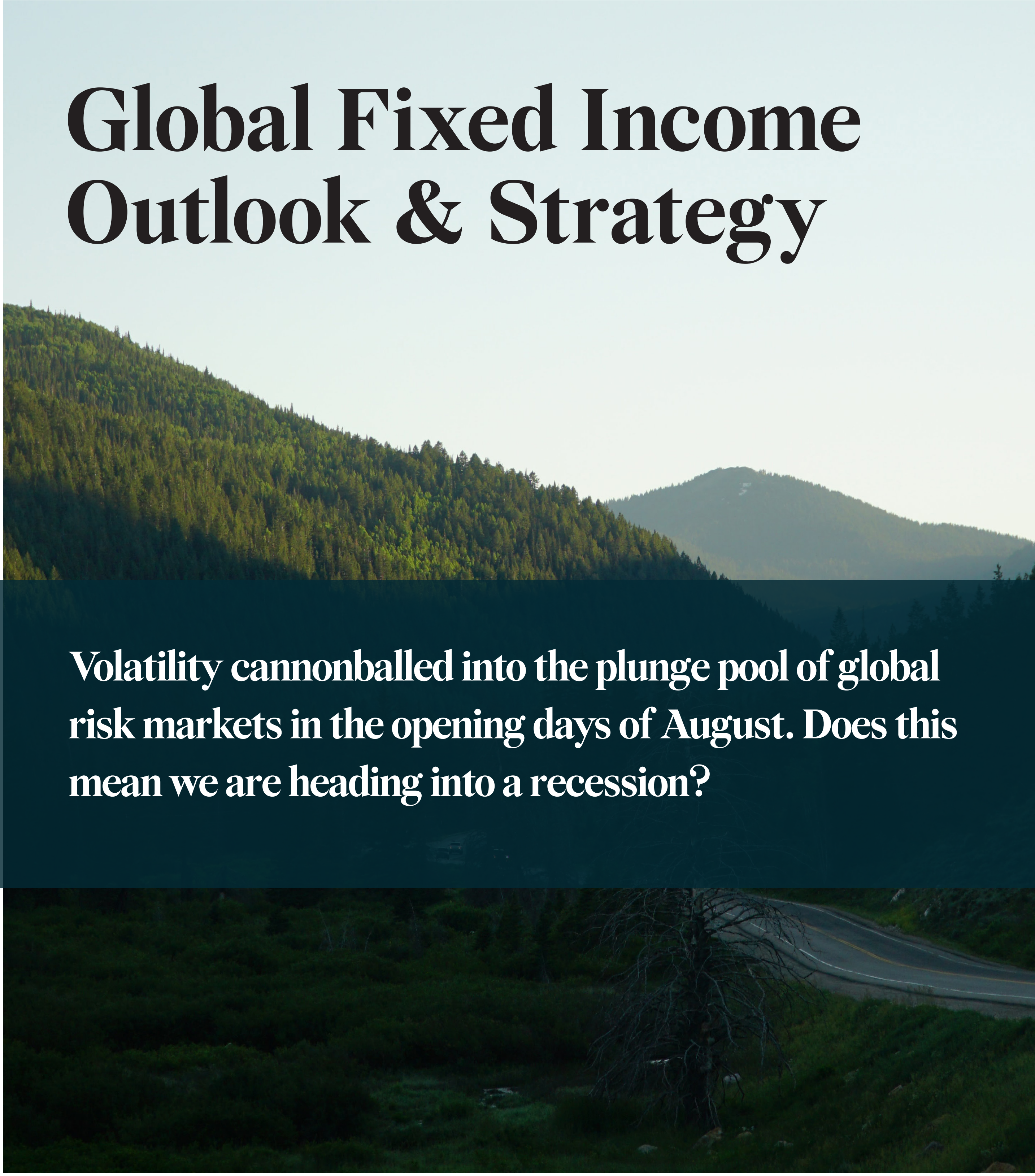

Global Fixed Income Outlook & Strategy

Volatility cannonballed into the plunge pool of global risk markets in the opening days of August. Does this mean we are heading into a recession?

Market Recap & Outlook

As a result of higher volatility, equites are now lower and the yen is stronger. Jan Loeys of J.P. Morgan once defined volatility as "leverage times surprise". This is a handy way to think about volatility, in our view. Leverage Exhibit A is the carry trade, where investors borrow yen (and yuan) to fund long risk asset positions, in Mexican, Brazilian or South African bonds or US tech equities. Exhibit B might be the Japanese retail investor, who seems to have been very levered and long Japanese equities. Exhibit C would be everyone who over-owned US tech stocks, which is most investors.

The "surprise" side of the volatility function also had multiple components in August. Bank of Japan's (BoJ) rate increase of 0.25% barely qualified as a surprise, in our view, since investors (and last month's Outlook) had predicted both the hike and the tapering of quantitative easing. Markets may have been unsettled by the BoJ's hawkish tone and promise/threat of future hikes to come. Friday's US payroll data for July showed unexpected weakness, as total payrolls rose only 114,000 and private payrolls 95,000. Hurricane Beryl may have had an impact. US equities plunged, and this seems to have had a cascade effect on Tokyo, where on Monday August 5th the Nikkei dropped 12% in a day. This was rocket fuel for the yen, as global risk trades were slashed.

Is the US in recession? We doubt it. Economic data continue to give mixed signals. The preliminary Q2 GDP was a stronger than expected 2.8%, and PMIs have been firmer. Weekly initial claims are higher but not nearly at recessionary levels. We believe that the US economy has down-shifted to slow growth, but not to recession. This opens the door for the Federal Reserve to start an easing cycle, but we expect this to be measured, with a first 25bp cut in September of this year, followed by perhaps two more cuts by the end of 2024.

The 10-yr US Treasury yield has fallen from 4.4% at the start of July this year to, briefly, 3.7% at the depth of the equity slump, and is currently 3.95% as we write. Bonds are once more hedging equity weakness. Markets fear recession more than inflation, so after the pandemic-driven inflation/rates meltdown of 2022 when stocks and bonds fell together, normal service has resumed. In our global portfolios we trimmed US duration back to neutral in accounts where we were overweight.

As we enter late summer, the US elections threaten to dominate risk calculations. Here we can add no insight, as the election looks too close to call, and the composition of Congress is equally uncertain. We do see a pronounced Republican edge in the Senate, given the pattern of seats up for re-election. Neither party is especially interested in budget deficits, so the fiscal landscape may limit long bond performance. We expect US term premia to continue grinding higher.

Our Strategy

Credit spreads briefly threatened to widen enough to be interesting, but we are still reluctant to go down in portfolio credit quality given the background of potentially weaker corporate revenues. We expect or maybe just hope that the broad direction of the USD is lower as weak but non-recessionary US growth plus interest rate cuts rekindle interest in other currencies. However, it will be a challenge for the USD to weaken against, say, both the yen and the Mexican peso, as one seems to have been funding the other, in our view.

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Important Disclosures

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