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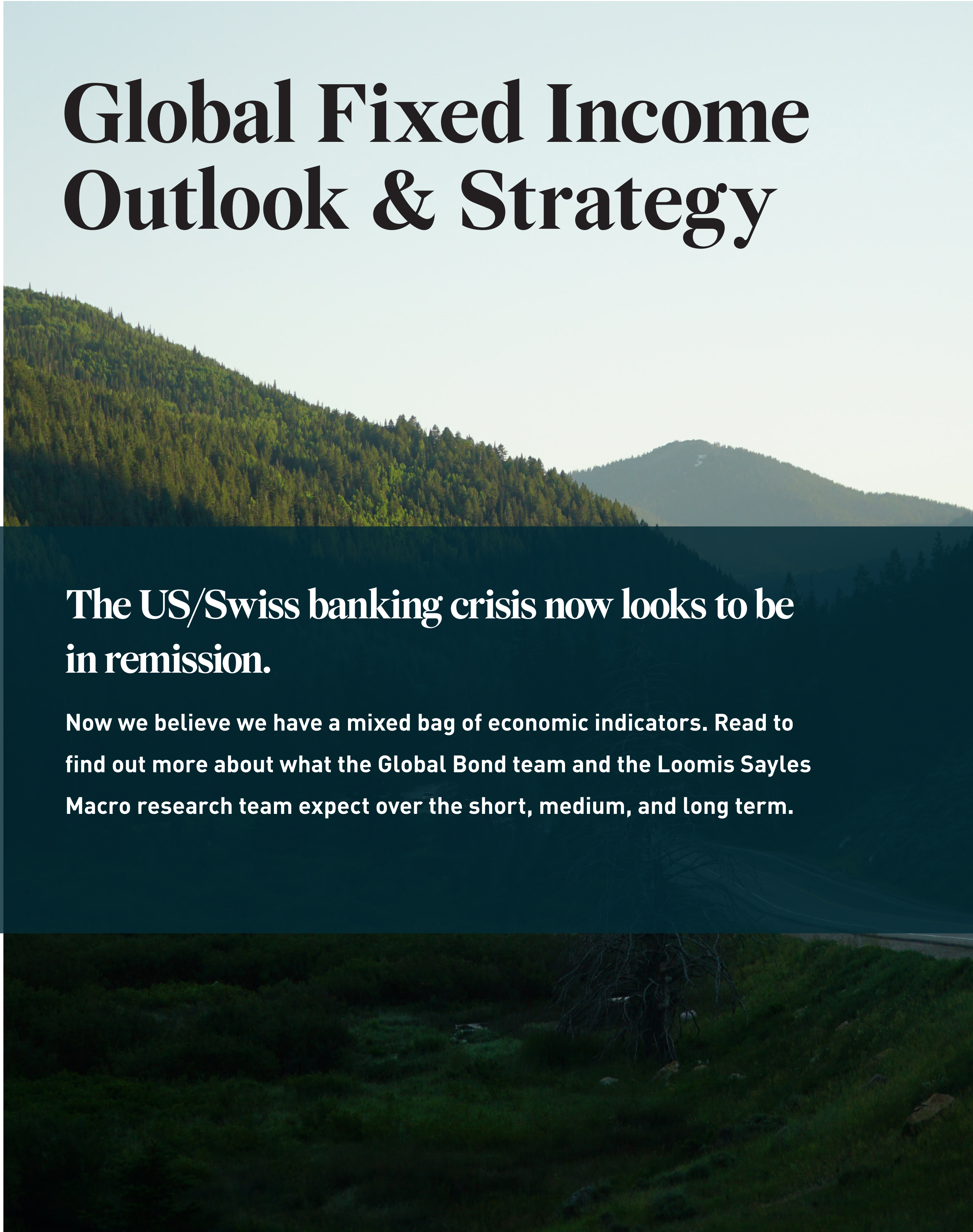

Global Fixed Income Outlook & Strategy

The US/Swiss banking crisis now looks to be in remission.

Now we believe we have a mixed bag of economic indicators. Read to find out more about what the Global Bond team and the Loomis Sayles Macro research team expect over the short, medium, and long term.

Outlook

Between the Federal Reserve and the Federal Home Loan banks some $500bn in more or less instant market liquidity was provided to stem the effects of an incipient run on deposits at regional US banks. These were perceived to have risky levels of bond duration that had not been marked to market. This has now begun to reverse as emergency claims on these last and "next-to-last" resort lenders have recently declined. The coincident Credit Suisse takeover by UBS was unrelated, and reflected a capitulation of depositor and wealth client confidence in the bank's prospects after a long chain of unfortunate events.

How much pressure this episode has placed on lending and the cost of capital to borrowers is unclear, in our view. Money markets have reduced their expectations for future Federal Reserve hikes to 25bp in May, and even the May hike probably depends on the data released in the next month. May hike probabilities rose following the March employment releases, which showed 236,000 new establishment jobs, while the unemployment rate remains pinned at 3.5%, a near-record low.

Loomis Sayles Macro Research expects that we are very likely to see a US earnings recession, and probably an economic recession as well, beginning in Q2 or Q3. Where we disagree with market futures is the prospect of Fed rate cuts shortly after the final hike. If recessionary economic data is mild or mixed, we expect the policymakers to hold interest rates steady as they wait for inflation to fall further.

Inflation is dropping, but it has a long road to get to 2.0%. Headline CPI has dropped to approximately 5.0%, but core inflation is higher. Inflation and bond optimists believe that the supply-chain problems of the past two years are largely solved, and it is just a matter for a bit of demand weakness to overcome pricing inertia. We are not so sure. As we think about longer term horizons, we see reasons for inflation pessimism.

One way to think about the supply side of the economy is to recall the concept of the production function from economic theory. This is a conceptual function in which the output is GDP, and the inputs are the "factors of production", including capital, labor, energy, raw materials, and technology. We are only optimistic about the technology input.

Labor supply is falling in the US, Europe, and even China. We believe the "savings glut" associated with low yields may also be undermined by demographics, as aging will increase dependency ratios just as the labor force shrinks. We believe energy costs will likely rise, both because the Russian resource will likely remain embargoed by war, while the transition away from fossil fuels requires the internalization of an externality, which must by definition increase reported costs. Raw materials also look vulnerable to supply shocks: recall the wheat futures market spike of early 2022 when the potential loss of the central Asian wheat crop generated panic in Egypt. We can also add de-globalization and friend-shoring. Against these we have 3-D printing and Chat GPT. In sum, we are optimistic in the short term about the supply chain, but we are pessimistic in the longer term about the supply side.

What We Expect

We believe the implication is that fair value for neutral Federal policy may prove to be higher in the next ten years than in the decade preceding the pandemic. This also argues for a higher trading range for bond yields than was the case from 2010-2020.

These are medium term concerns, in our view. The immediate risk is that Fed tightening will generate both an earnings recession and even a real recession, which will cap Treasury yields but probably increase credit spreads. We believe these seems the most likely prospects for portfolio factors in the next six months. A potential silver lining for global bond investors is that this mix of lower Treasury yields and higher credit spreads is likely to be USD bearish, so unhedged global portfolios may see the positive currency returns associated with USD bear markets.

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