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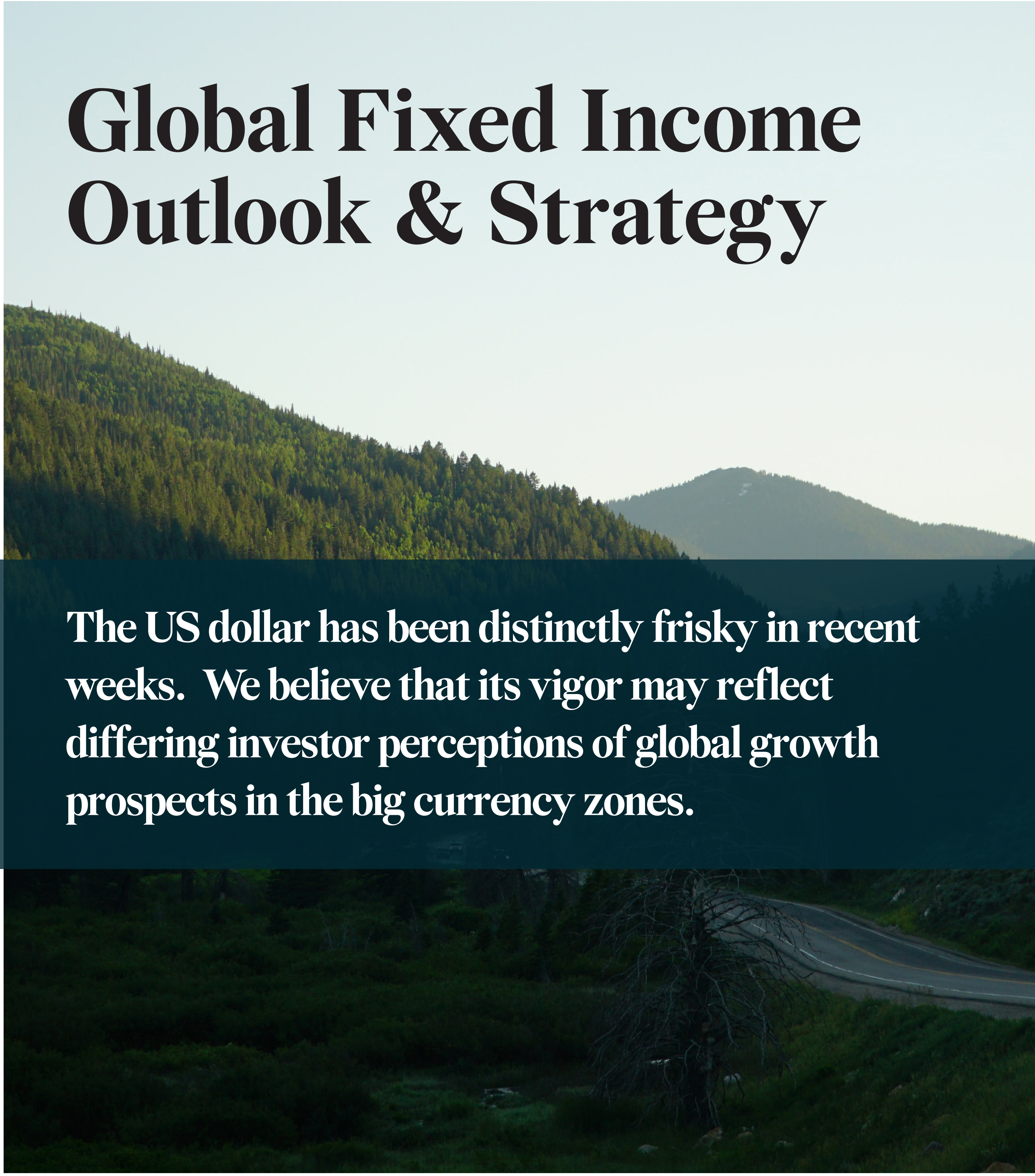
Global Fixed Income Outlook & Strategy



The US dollar has been distinctly frisky in recent weeks. We believe that its vigor may reflect differing investor perceptions of global growth prospects in the big currency zones.

Market Recap & Outlook

Earlier this summer we were bracing for a simultaneous slowdown in the US, Europe, and China. This still looks right for Europe and China, but for the US, we are not so sure. US retail sales roared back to life in July, up 1.0% monthly for the control group and ex-autos. Industrial production also jumped 1.0%. The Institute of Supply Management (ISM) Services Purchasing Managers' Index (PMI) has also been perky recently, though interestingly, the S&P Global US services index does not agree. US payroll growth has slowed but remains firm, while wage growth is holding nicely above inflation, so real incomes should be growing. Beyond this, consumers seem to be spending above their incomes, as the household savings rate has dropped.

Maybe this is just a summer wonder: Big name concerts and high-grossing movies enticed sensation-deprived Americans to go out for one last burst of fun before the darkening days of autumn retrenchment. Or maybe the US economy is simply not in bad shape.

Global bond yields have been volatile but largely sideways for the past month. The 10-yr UST seems to be trying to find a yield plateau at about 4.25%, while the 10-yr German Bund seems increasingly willing to trade above 2.60%.
US yields are now about one percent over the year over year (yoy) CPI, though still below the yoy nominal GDP, an ancient valuation metric popular in the 1990s, which is beginning to be rediscovered.

We believe a novel development in US bond markets has been the return of positive real yields. Even the long-suffering Tips market has enjoyed a yield renaissance. This has not been fun for existing Tips investors in our view, who have seen real 10-yr Tips yields rise from a negative 1% in early 2022 to a positive 2% currently. We see the prior negative real yield as the price investors were willing to pay for inflation protection. As inflation fears and the corresponding demand for protection have subsided, we no longer think US Tips are expensive, and like the mix of real yield and inflation protection currently available.

We believe eurozone investors can only dream of positive real yields for now, as the 2.6% Bund 10-yr yield is about one-half of trailing E-zone CPI. Europe probably still has a rate hike or two ahead of them before policy-makers are sure that inflation will keep subsiding there, though the recession/stagnation we expect should help drive inflation lower soon.

Our Strategy

Absent financial suppression by policy-makers and regulators (Interest on excess reserves at banks used to be zero; reserve requirements were non-zero) we expect positive real yields to persist in the US. After all, real yields are supposed to be a function of the monetary/fiscal policy mix. Loose fiscal, tight money pushed real yields up in the 1980s. We have a similar mix today. Like Volcker then, the Fed is fighting inflation while the fiscal authorities are presiding over a 6% of GDP federal budget deficit at full employment. Connoisseurs of fiscal policy might object that the delta, or fiscal thrust of policy is unchanged, but we believe that just means that we have had more than one year of giant full employment deficits and neglected to make it even worse this year. Fiscal policy is structurally loose, and its intractability was a key theme at Jackson Hole for the [XX date] meeting. Ultimately, inflation has often been a fiscal phenomenon in our view; structural budget deficits have a tradition of being monetized. Inflation is the "tax" you end up paying if you won't pay your other ones.

A final note of closure: the 1980s USD bull market was often attributed to higher US real yields on offer compared to other places. Maybe it is once again a reason for USD strength.

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