Navigating the descent

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With the global economic outlook still clouded and equity markets priced for a soft landing, bonds offer attractive yields and resilience across multiple possible outcomes.

The steepest interest-rate-hiking cycle in decades has set global economic activity on a course that remains difficult to map, making it especially important to respect risks and to look to build portfolios capable of performing well in a variety of conditions.

After major economies showed surprising resilience in 2023, we anticipate a downshift toward stagnation or mild contraction in 2024. The standout strength of the U.S. is likely to fade over our six- to 12-month cyclical horizon. Countries with more rate-sensitive markets will likely slow more markedly.

With inflation easing, developed market (DM) central banks have likely reached the end of their hiking cycles. That has shifted attention to the timing and pace of eventual rate cuts.

One of our main arguments for elevated recession risks is that the tighter-for-longer strategy that central banks have been communicating has historically not often coincided with economic soft landings. In instances when hiking cycles did not precede recessions – in the mid-1960s, mid-1980s, and 1990s – the central bank usually moved relatively quickly to cut rates, as a coinciding positive supply shock (global trade expansions, productivity booms, and OPEC production accelerations) contributed to falling inflation.

Post-pandemic supply chain normalisation has already eased inflation measures off their peak in 2022. We expect this disinflation to continue in 2024, with headline and core measures dipping into the 2%-3% range year-over-year across DM. This, plus the potential for a faster cutting cycle, should raise the prospects for a soft landing.

However, with less room for further supply-side gains from a post-pandemic normalisation, at the same time that demand is waning, we would hesitate to declare victory over either inflation or recession risks. With both supply and demand growth expected to be stagnant across DM in 2024, we think recession risks remain more pronounced than usual.

Inflation risks still look most pronounced in the US, where growth could remain somewhat more resilient relative to other DM economies. That's due to the relatively slow pass-through of higher market rates into outstanding debt service payments; higher real excess savings due to larger pandemic-related fiscal stimulus; and growing support from previously enacted legislation aimed at supporting infrastructure, renewable energy, and supply chain investments, which could boost demand in the near term before supply-side benefits offset inflationary pressures.

Investment implications

We view fixed income investments as broadly appealing over our cyclical horizon, given attractive yields and valuations as well as the potential for resilience across multiple economic scenarios. Such resilience is especially important in the wake of the increase in geopolitical risk and market volatility over the past two years. Because attractive yields can be found in high quality bonds, investors do not need to step down in credit quality.

In credit markets, we continue to favor US agency mortgage-backed securities and other high quality assets backed by

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collateral, which offer both attractive yields and downside resiliency. The trend of banks stepping away from certain types of lending will likely persist and afford opportunities in asset-based and specialty finance in private markets.

After central banks globally raised rates in relative synchrony, their paths ahead are likely to be more differentiated. We continue to see the potential for outperformance of global duration versus the US. Our view is based on the relatively higher chance of US economic resilience and the greater downside risks in more rate-sensitive markets, notably, Australia, the UK, and the eurozone.

We believe opportunities in global bond markets are more attractive than they have been over the past decade. Investors with broad, global platforms can access a diversified set of bond exposures and a variety of sources of potential return.

We expect to focus on more liquid DM overall, given attractive yield levels. We also expect to find good opportunities in emerging markets (EM), both in terms of local and external debt. We expect to be overweight EM foreign exchange, with diversified funding currencies to reduce the correlation between higher-carry EM currencies and global risk assets.

Cash yields remain high but can only be locked in overnight, and they could decline quickly, especially if central banks start cutting policy rates. Investors risk missing out by holding cash too long while trying to time a re-entry into markets.

The bond market rally in late 2023 highlighted how investors can achieve more attractive total return in high quality, medium-term bonds – through the combination of yield and price appreciation – without taking on greater interest rate risk in long-dated bonds.

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