Fixed income post-Cholera

Broad macro observations

April, 2023

The fixed income world

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	Component	Description
	Instrument rate of return (YTM)	Change represents change in the price of the instrument (relative to duration); YTM is the return if held to maturity
=		
	Idiosyncratic adjustment	Depends on current (short-term) attitude of the market toward the issuer; here the macro analysis ends and “ideas” take over
+		
	Risk-free to risk spread	Depends on assessment of default risks and supply-demand of bonds in the market; this is a function of duration, credit rating, geography and industry
+		
	Risk-free rate	Usually viewed as YTM of government securities, e.g. USTs
=		
	Adjustment for risk-free rate and local currency	Set by the market and based on anticipated change in refinance rate and (for local currency-denominated bonds) anticipated local rates and FX changes
+		
	USD refinancing rate	Set by Fed, subject to assessment of macro situation and market expectations

The refinance rate

Instrument rate of return (YTM)

=

Idiosyncratic adjustment

+

Risk-free to risk spread

+

Risk-free rate

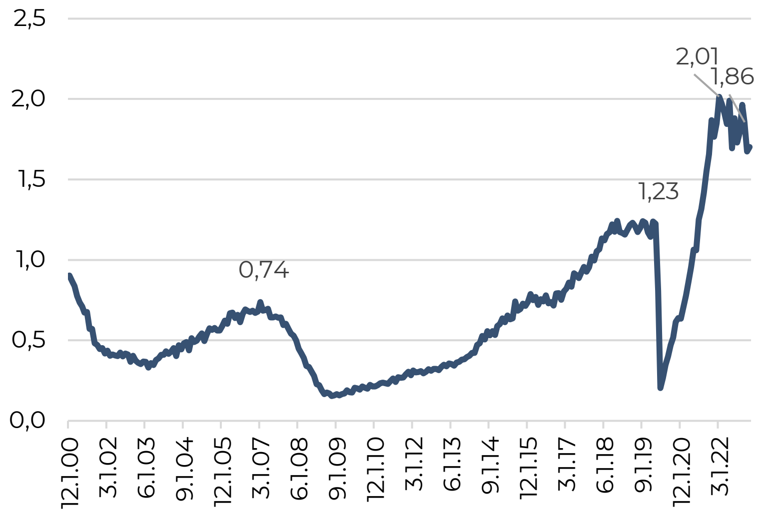
=

Adjustment for risk-free rate and local currency

+

USD refinancing rate

Vacancies/job claims ratio in US



US core CPI inflation, y-o-y

In its fight with inflation, the Fed is essentially dealing with two factors now: (1) wage growth and (2) the rising cost of housing, partially induced by higher interest rates on mortgages. The former is a result of a lower participation rate, higher consumer demand and fragmentation of the world economy; only the latter factor will react to refinance rate changes – there is a direct correlation – which makes the fight even more difficult.

Still, the Fed is optimistic: it thinks that the economy will manage through the high-rate period and sees inflation as the ultimate enemy. Note that demand is already softening.

The refinance rate

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Instrument rate of return (YTM)

=

Idiosyncratic adjustment

+

Risk-free to risk spread

+

Risk-free rate

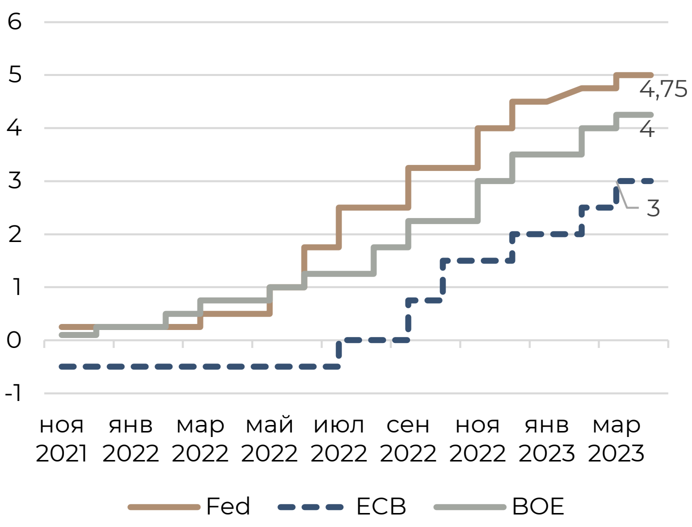
=

Adjustment for risk-free rate and local currency

+

USD refinancing rate

Key rates of major central banks, %



Date of meeting	0	+	-
3/05/23	33%	67%	0
14/06/23	30%	70%	0
26/07/23	48%	36%	16%
20/09/23	37%	13%	49%
01/11/23	22%	6%	73%
13/12/23	9%	1%	90%
31/01/24	3%	0%	97%
20/03/24	0%	0%	99%

The markets, however, expect the refinance rate to rise just 0.25-0.50 pp before coming down in autumn 2023. These expectations correspond neither to Fed signals (indicating an extended period of high rates) nor to the labor market and services and housing data.

It seems that the Fed will either agree on a higher inflation target (4%?) for the near future or maintain higher rates for longer. The first option may, however, provoke higher inflation (a second wave); the second option would upset the markets.

The fixed income world

Instrument rate of return (YTM)

=

Idiosyncratic adjustment

+

Risk-free to risk spread

+

Risk-free rate

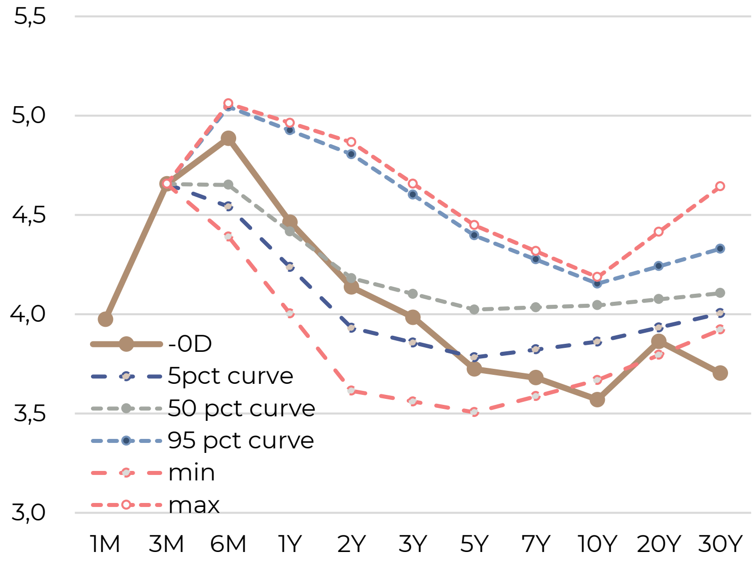
=

Adjustment for risk-free rate and local currency

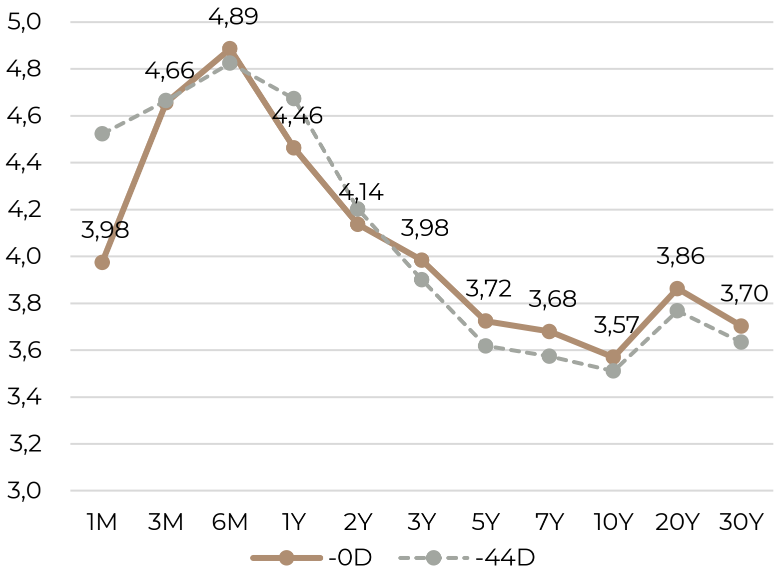
+

USD refinancing rate

Current curve shape and historical maximum inversions



UST curve shape and shape after the Feb 1 meeting



A highly inverted yield curve has persisted for over 1.5 years. It is usually seen as an omen that recession is near; however, there was no inversion in 2008-09, and now the curve is inverted not because the far end is too low, but rather because the near end is too high.

What this really means is that the markets believe that the Fed will succeed in fighting inflation and that rates will go down in two years' time. The markets are sluggishly reacting to data changes and Fed rhetoric – for now. The key question is: are they overly optimistic?

The fixed income world

Instrument rate of return (YTM)

=

Idiosyncratic adjustment

+

Risk-free to risk spread

+

Risk-free rate

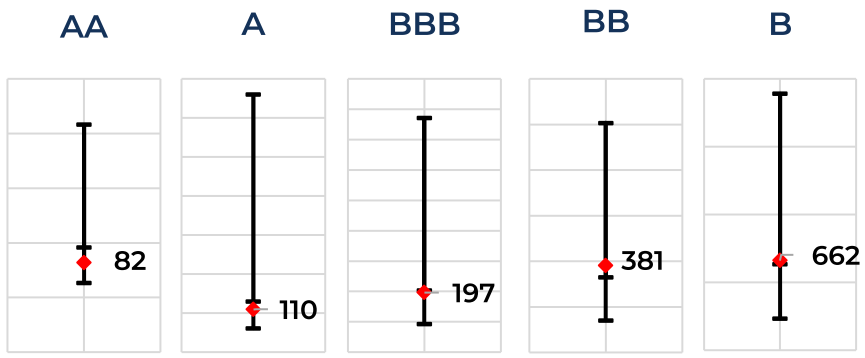
=

Adjustment for risk-free rate and local currency

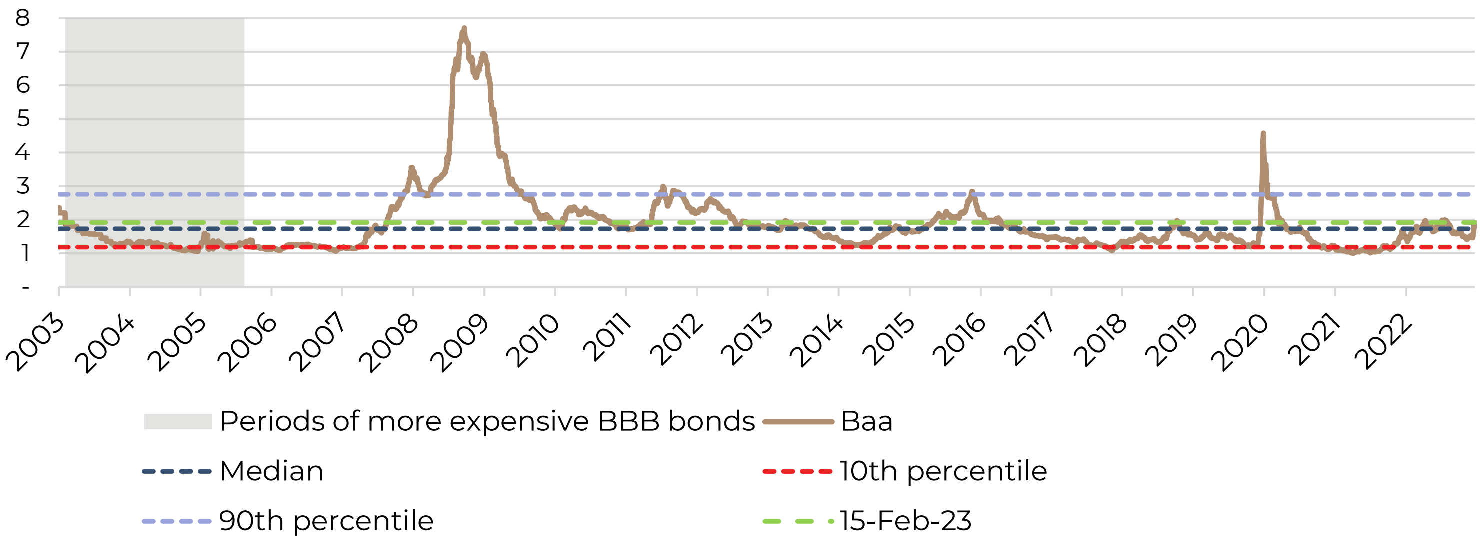
+

USD refinancing rate

Generally, spreads are close to median levels historically, though these median levels are quite low, as the history is mostly periods of low interest rates (and spreads move in line with prime rates, the lower rates are the easier it is to refinance).



Credit spreads of BBB rated US bonds



The fixed income world

Instrument rate of return (YTM)

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Idiosyncratic adjustment

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Risk-free to risk spread

+

Risk-free rate

=

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+

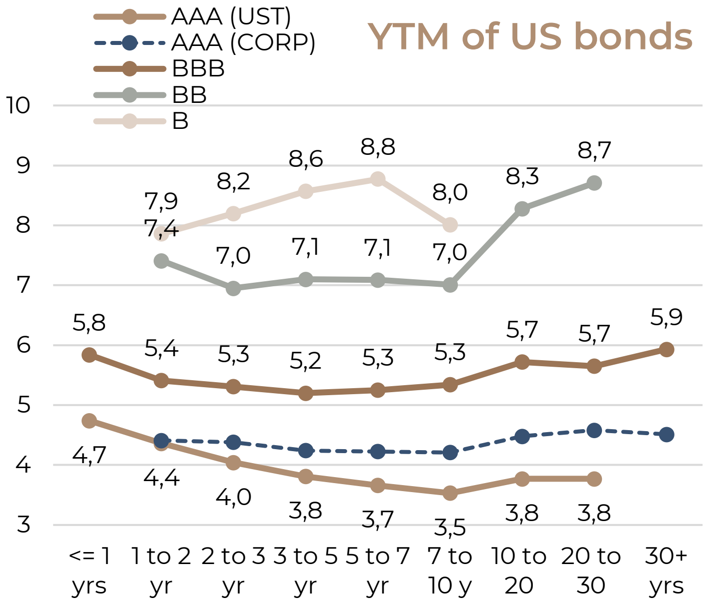
USD refinancing rate

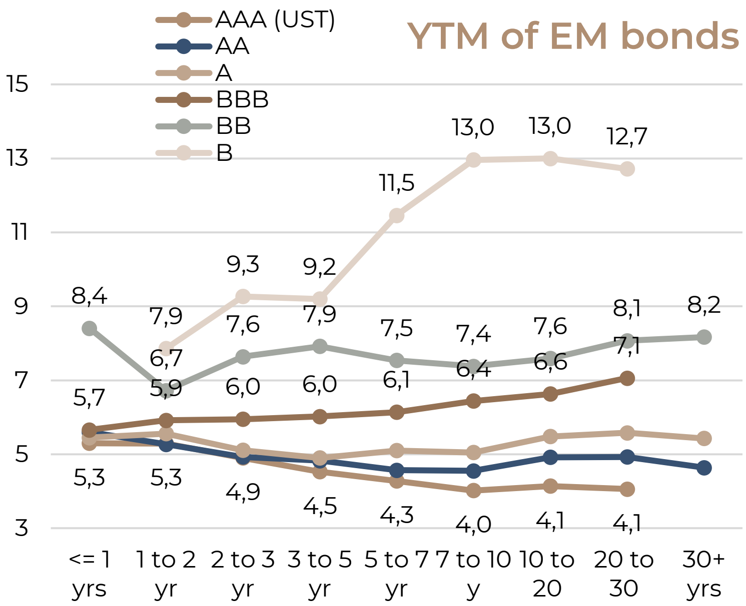
Duration does not mean much in the context of a HTM strategy – the curves are mostly flat.

However, it matters a lot in terms of expected, speculative returns: since we expect the curve to normalize:

- the prices of short-term bonds will most likely rise (at a low multiplier, however);
- and the prices of long-term bonds will depend on the "new normal" for the risk-free rate and new spread levels (at a high multiplier).

Though we do not foresee the risk-free rate being higher in the medium term, spreads might widen so that the combined effect is not clear.





The fixed income world

Instrument rate of return (YTM)

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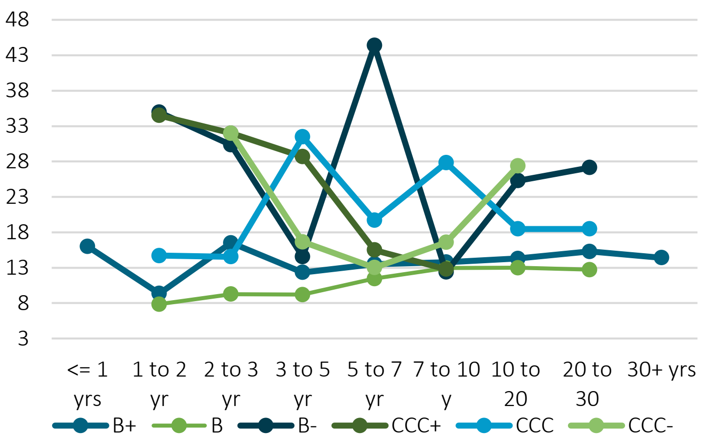
USD refinancing rate

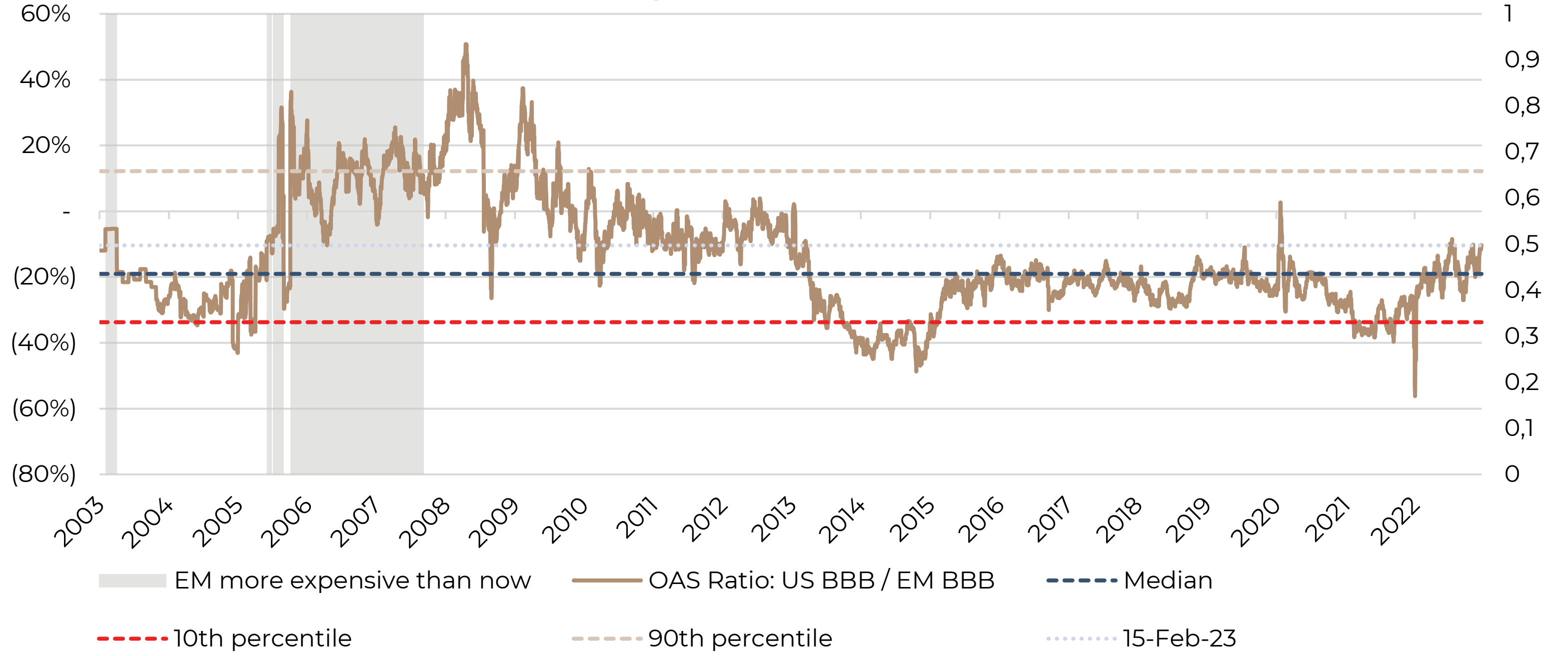
EM to US spreads look low given the refinancing cost. That is one reason why EM debt should be considered only with extra caution.

Other reasons include broad excess leverage, poor reporting and auditing practices, widespread creative accounting, potential liquidity squeezes and shifts in economic conditions for territories due to economic fragmentation.

EM bond yield curves, YTM %



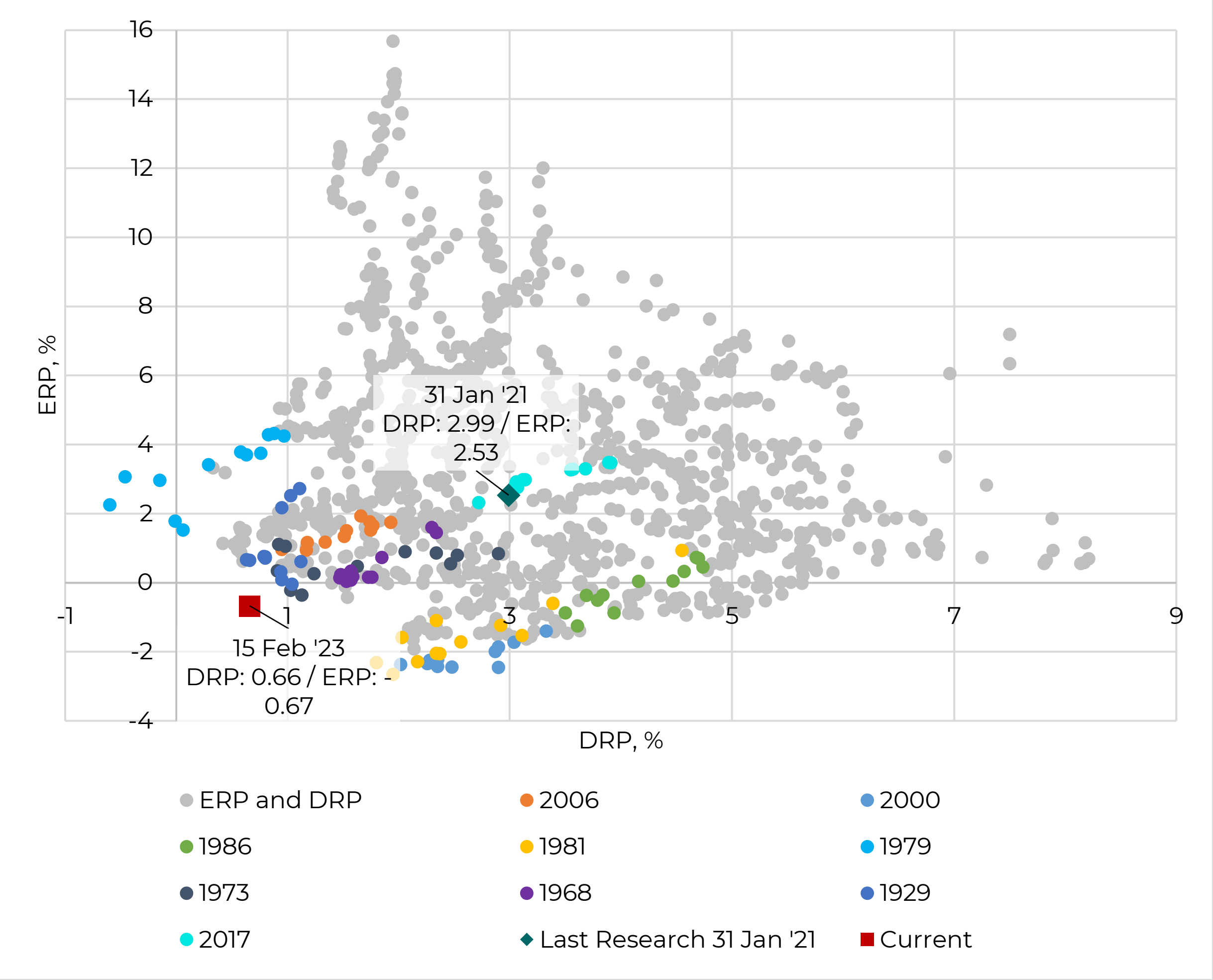
EM to US spreads (average)



In a nutshell

- The consensus forecast suggests S&P 500 earnings will fall 1.0% in 2023 and rise 9.7% in 2024;
- However, the labor market and inflation data indicate another 1-2 hikes in the refinance rate;
- Continuously rising Fed rates indicate a higher probability of a soft landing for the economy, which suggests that earnings growth is overestimated;
- Treasury yields already exceed the price/earnings ratio for US corporates – it has never happened before, even in 2006;
- In 1973 and 2000, when equity risk premiums fell below 0, the market subsequently tumbled;
- Current valuations can be sustained only if the Fed stops raising rates and corporate earnings grow rapidly (this is unlikely).
- Eventually, the debt markets will look more attractive than equity markets;
- However, extra care should be applied to picking securities – we expect a credit crunch due to higher costs from debt and economic shifts.
- On top of that, we are entering a period of geopolitical realignment – conflicts could flare up in many places – which should be accounted for as well.

Risk premiums in the US debt and equity markets since 1921



Our strategy guidelines for fixed income instruments

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The passive part of the portfolio should consist of short-duration instruments – the normalization of the curve will drive yields down at the near end, while the far end is unclear.

No private credit, RE secured credit, low liquidity – no market valuation portfolios (too risky).

The US is better than the non-US.

DMs are better than EMs.

Investment grades are better than speculative ratings.

Whenever speculative ratings and especially EM are concerned, ETFs are better than picking individual securities.

The active part of the portfolio may include:

- Long-duration securities, based on macro assessments and anticipated market movements (but be sure you can outsmart the market);
- Specific "stories" where you know more than the market.
- Undervalued-against-peers (but be sure there is no fundamental reason for that).

P.S. There is nothing bad in good old market-neutral products!

We target a 7-10% annualized return in three years

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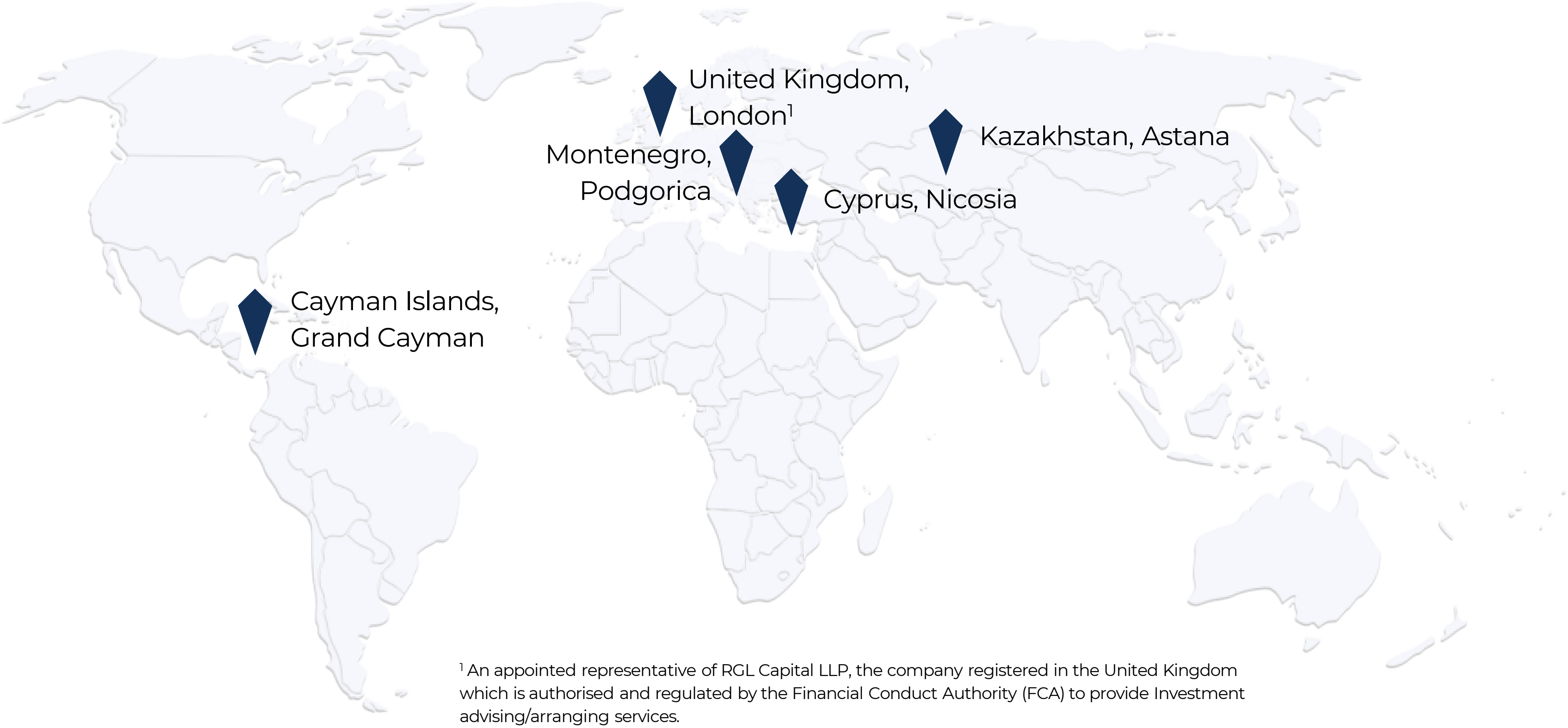

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