



Year-End Fixed Income Survey 2019

November 6, 2019 | by [Adam Smears](#)

Throughout the year we asked leading bond and currency managers to consider valuations, expectations and outlooks for the coming months.

In this latest survey, we asked 52 managers for their feedback. Interest rate managers absorbed three interest rate cuts since our last survey (including the [recently announced cut on Oct. 30](#)) and now expect another cut to come, broadly in line with what the market is currently pricing. Meanwhile, credit managers are tilting toward being more cautious and shifting from fears of a global slowdown to a potential U.S. recession.

On one hand, we have a U.S. Federal Reserve (the Fed) looking to make precautionary adjustments, and on the other we have credit managers now fearing that perhaps those adjustments aren't enough. There is also an expectation of a modest widening in credit spreads. That is why, in this survey, we explore the question: ***are markets on the same page as the Fed regarding its mid-cycle adjustment approach?***

Mid-cycle adjustment?

Over the course of the year, we experienced the ramifications of a complex trade war between the U.S. and China, Brexit uncertainties and moderating global economic data—notably with weakening manufacturing purchasing managers' indexes (PMIs). However, inflation has remained relatively steady. This backdrop became the battle field with which developed central banks had to contend with.

The Fed is trying to address this backdrop by employing a mid-cycle adjustment approach, which uses precautionary interest rate cuts to ensure the safety and soundness of the nation's markets. Recall that the historical threshold of the mid-cycle adjustment during the last cycles (1995 and 1998) was 75 basis points. With the latest cut of 25 basis points on Oct. 30, this limit has now been reached.

How concerned are markets?

Views from interest rate managers

- As expected by most of the managers, the Fed cut its key interest rate by 25 basis points during the Federal Open Market Committee's October meeting. In terms of rate adjustments, the expectation of managers going forward is for another cut in the next 12 months. Notably, not one manager expects a hike in the next 12 months, and only a small fraction of managers expect there to be a hike in the 12 months beyond that.
- Meanwhile, 70% of managers also believe that we have seen a peak in the federal funds rate this cycle.
- By and large, managers also indicated modest to no real concerns over inflation for the next 12 months.
- 68% of managers further increased their conviction in the steepening of the U.S. Treasury yield curve. It was only a year ago that 59% of managers expected a flatter yield curve. A steeper curve makes sense given their range-bound expectations for the U.S. 10-year Treasury yield, and expectations for another cut in the next 12 months (the most recent cut on Oct. 30 further steepened the curve, as predicted by a majority of managers).

Views from credit managers

- Within the global leveraged credit space, managers shifted their outlook for spreads in the next 12 months from range-bound in Q2 to a moderate widening of 10 to 30 basis points in Q3. Most also believed business fundamentals were modestly deteriorating—the most since this survey started (68% in Q3, vs. 12% in Q2). They also added that a U.S. recession, rather than a slowdown in global growth, was their biggest fear.
- In the global investment-grade credit segment, managers also expect widening credit spreads, but on a more moderate scale. It's worth noting that 58% of managers also thought that credit spreads do not compensate for risks—the highest yet for this survey. However, 40% of managers additionally thought that leverage of Better Business Bureau (BBB)-rated companies in the index will decrease—which is also the most since the survey started. With BBBs becoming such a substantial percentage of investment grade indices, the trajectory of fundamentals is topical at the moment.
- There was a modestly bullish tone when it came to securitized assets, with managers adding a bit more risk than in the last quarter. Credit risk transfer remains the most favoured sector, but BBB-collateralized loan obligations (CLOs) have jumped up materially. Managers also preferred to be long commercial mortgage-backed securities (CMBS).

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Europe and UK

- Since the last survey, managers continued to be less optimistic on Europe (including the UK). In the credit space, Europe had previously been more popular, but the U.S. has maintained its lead in both corporate high-yield and investment-grade credit.
- Foreign exchange (FX) managers have also retained a weakened view on the euro—expressing concerns about the recovery of the European economy.
- For the British pound, the view from FX managers is that Brexit uncertainty remains the driver for the currency, but with a lower probability of a hard Brexit, optimism returned with the sterling trading close to £1.295.

Emerging markets and Japan

- More than half of hard currency emerging-market debt (EMD) managers expect spread tightening, while a large majority of those expect it to be modest. Ukraine is now the most favored country, with the Philippines remaining the least favorite. The biggest shift, however, was in Argentina, where the overweight preference plummeted to a mere 6% in Q3—down from nearly 40% in Q1.
- Local currency EMD rates continue to be viewed as cheap, despite all-time lows in the J.P.Morgan Government Bond Index-Emerging Markets (GBI-EM) Local Currency Index yield. This is largely driven by expectations for lower inflation. The managers' weighted total return expectations dropped down to 5.3% —the lowest since the survey started—likely accounting for the lowest yield recorded in the index.
- FX managers remain neutral on the Japanese yen compared to the previous survey—holding the currency as either a value or risk-averse position.

Conclusion

This survey demonstrates that credit managers are showing some signs of caution, and may not be fully convinced by the trajectory of the Fed's accommodative stance. We believe these managers understand that with tight spreads, future performance is predicated on the Fed being accommodative. **Could this be challenged if the survey's lack of concern around inflation proves to be incorrect?**

While inflation expectations are muted, factors such as momentum in wage inflation could push inflation higher—which may place the Fed in a more challenging situation with structural pressures to keep the dovish tone. With very little room for error, we find it interesting that although interest rate managers are sold on an accommodative Fed, credit managers are exhibiting some vigilance.

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*The **J.P. Morgan Government Bond Index-Emerging Markets Global Diversified Index** is one of a series of comprehensive emerging market debt benchmarks that track local currency bonds issued by emerging market governments.*

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