

# Fixed Income Strategy

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## Reassessing key US rate views

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### Fed Funds (current 1.50%-1.75%, next meeting: March 18)

- Amid a strong labor market, housing market and an economy growing above 2.0%, the Fed should not feel overly compelled to cut policy rates any further. However, the risk that an acceleration in the COVID-19 (coronavirus) outbreak can significantly affect global growth has increased meaningfully ([See Strategy Bulletin: A pandemic looks more likely](#)).
- Though still unlikely, US recession risks have risen. The 3-month T-Bill/10-year US Treasury (UST) yield curve has inverted back to -20bp, and futures markets have now priced in more than two full rate cuts by the end of 2020, with the first 25bp cut fully priced in by June (**See Fig. 1 and 2**). While the Fed could feel emboldened to wait for an actual impact to the economy before acting, we believe the committee may take the path of least resistance and follow market expectations.
- Currently, this implies we could see a 25bp rate cut over the summer months. To be fair, expectations change quickly. If coronavirus concerns fade, Treasury yields would rise and rate cut expectations would fall. However, this works both ways. If the recent outbreak news flow in Korea and Italy extends to additional countries, including the US, pricing for a March or April rate cut could grow as well. To be sure, the US Center for Disease Control and Prevention have alerted Americans to prepare for an outbreak at home.
- **Investment strategy:** Whether the Fed cuts now, later or never, short-term US rates are likely to remain low (or move lower). In our view, this is a great environment for borrowers and favors modest amounts of leverage to boost portfolio returns. With the US yield curve inverted, hedging floating-rate liabilities beyond the short-term also becomes very attractive.

### 10-year US Treasury yield expectations

- When asked in 2016 whether 10-year UST yields would go below 1.0%, our response then was “No, not yet”. Today we have returned to the 2016 historic lows, so it is probable we will start hearing the same question yet again (**See Fig. 3**). In our view, much of the near-term direction on US yields is heavily contingent on the news flow surrounding the COVID-19 (coronavirus) and its potential impact on global growth.
- If the virus cannot be contained, the recovery from last year’s trade shock will be derailed. This could lead to a weakening macro outlook, downward earnings revisions and higher equity volatility. In turn, intensifying the demand for safe haven assets. We remind that this would be occurring alongside persistent central bank bond purchases by the Bank of Japan, ECB and Fed. In other words, net supply is already being constrained, while investors deal with \$14 trillion of negative yielding bonds (**See Fig. 4**). If the flu pandemic intensifies to the US (as alluded to above), we would not rule out the possibility for 10-year UST yields to fall to 1.25%, or lower.
- To be fair, there is a binary effect on core rates if virus fears prove exaggerated, the pace of the outbreak slows, or a vaccine is identified. In these scenarios, safe haven flows would reverse and long-term US yields would bounce higher. Unfortunately, the situation may get worse before it gets better. Meaning, any bounce-back may occur from lower levels. If we are able to get back on track over the second half of the year, 10-year yields may only return towards 1.5%.
- **Investment strategy:** For the last 12 months, we have expressed a high conviction on adding high quality duration to balance portfolio risks. Primarily through UST and investment grade (IG) corporate bonds, this was largely to protect against unforeseen circumstances (i.e., global virus pandemic). Fast forward to today, long duration IG corporates have gained 6% YTD and 26% over the last 12 months. Despite tighter spreads and lower yields, high quality bond are still poised to outperform if the flu pandemic accelerates.

**High conviction views:** Despite the growing economic uncertainty, many of our high conviction views remain intact.

- 1) **Favor having exposures to longer duration bonds, primarily through US IG corporates** – Despite the risk of wider spreads as risk assets sell-off, longer duration US IG corporates still likely benefit from the coinciding decline in UST yields. We still favor US IG as a part of core portfolios. Best value in maturities between 7-10 years.
- 2) **Stay up in quality in high yield (HY), prefer loans over bonds** – High yield markets will likely remain under pressure as virus fears persist. However, when risk assets sell-off, the HY *loan* market holds up relatively better than HY *bonds*. Recent market action has proven no different. We prefer to maintain an up-in-quality bias in senior secured bank loan debt, which tends to be better protected to the downside. Plus, loan yields are higher than HY bonds.
- 3) **Diversify with consumer-based bonds** – The strong US consumer has been a bright light in a cloudy world. Asset-backed securities, which contain consumer-based loans (i.e., auto loans, credit card receivables, residential mortgages), are an attractive way to diversify portfolios, diversify correlations and enhance yield. Non-agency residential mortgage-backed bonds remain our preferred market.
- 4) **Stay overweight external emerging market debt** – US dollar EM bonds (sovereigns & corporates) are not cheap. However, these assets offer better relative value when compared to developed market bonds. Broadly speaking, EM fundamentals are stronger than many DM economies, while central banks have the capacity to maintain (or improve) favorable policy support. Net supply of external debt is also shrinking, as issuers tilt towards local markets.
- 5) **Value in longer-duration municipals** – For US investors, tax-exempt bonds are in high demand. Indeed, bond fund inflows have averaged over \$1 billion every week for the last 12 months. Foreign investors have also looked at US munis as a way to diversify portfolios. While the short-end is historical expensive (many clients are better off in taxable bonds), maturities beyond 10-years offers good value.

In our upcoming March monthly, we will look to expand on these views and others. For now, here is a list of the most recent publications from the Office of the Chief Investment Strategist.

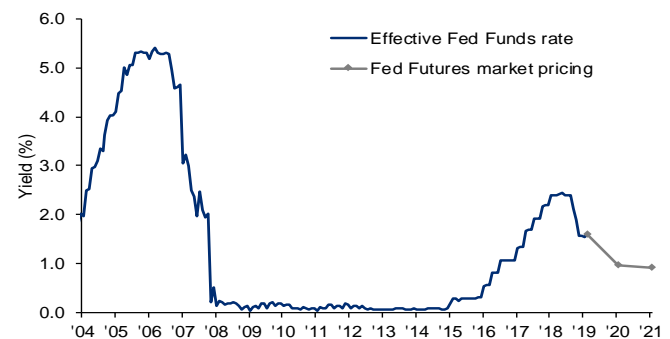
- [GIC Asset Allocation Update – Feb 24, 2020](#)
- [European Strategy | European Banks – Feb 24, 2020](#)
- [Expensive Defensives – Feb 21, 2020](#)
- [Asia Strategy | 5G is Coming to Town – Feb 21, 2020](#)
- [Quadrant | Germs of Steel – Feb 14, 2020](#)

**Figure 1. Yield curve has inverted yet again**



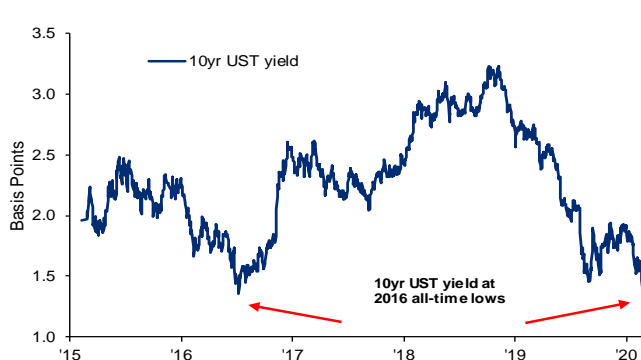
Source: FactSet as of February 25, 2020

**Figure 2. Markets pricing in two full rate cuts this year**



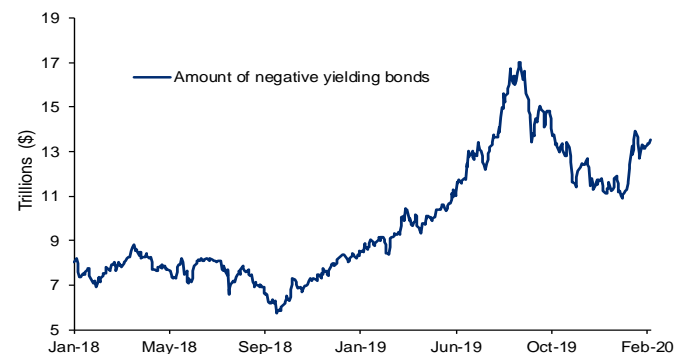
Source: FactSet as of February 25, 2020. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

**Figure 3. 10-year Treasury yield at 2016 all-time lows**



Source: FactSet as of February 25, 2020

**Figure 4. \$14T of negative yielding bonds in the world**



Source: Bloomberg as of February 25, 2020

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