ROBECO
The Investment Engineers

Global Fixed Income Macro Outlook

Twin peaks

- Front-loading of rate hikes to higher peaks means recession is coming
- If history is a guide, we will see a peak in government yields soon…
- …followed only later by a peak in credit spreads

Summary

Intensifying tightening
For all of 2022, we have focused on tighter monetary policy, discussing the dilemma faced by central banks (in 'Czech Mate') and their subsequent decision to prioritize the war on inflation (in 'The Inflation Game'). As we peer into 2023, the themes have not only not changed – they've intensified. Consensus market hopes that the Fed would end their tightening campaign this autumn were squashed by Fed Chairman Powell at Jackson Hole. Hopes that the ECB would continue their "gradual shift" were overturned abruptly by Christine Lagarde's hawkish turn in September. Hopes that inflation might moderate were confounded by an elevated August US CPI release. Hopes of a gradual cooling in labor markets presaging a soft landing that many market participants want to see look wildly optimistic: every single one of the last 16 monthly non-farm payrolls prints has been above 290,000, with the last 3-month average at nearly 400,000. The higher the readings on inflation, wages or jobs, the more central banks will need to jack up rates to recession-inducing levels. Weaker data would suggest a trend towards recession; stronger data, a need for more rate hikes. In a kind of heads-I-win-tails-you-lose central bank environment, until the war on inflation is won, the chance of a soft landing looks slim. Tighter monetary

Outlook
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policy of course has more than just economic consequences. For markets, moving rates into restrictive territory – at 75 bps clips, even in the Eurozone – means a tightening of financial conditions. Meanwhile quantitative tightening is set to accelerate, raising market volatility further. So how to position?

Rates strategy

In yield curves, the macroeconomic and policy backdrop means front-end yields remain under upward pressure in the near term. The EUR yield curve has now started to flatten aggressively, a move we have been expecting all year. The EUR 2s10s swaps curve is now inverted, following the GBP SONIA curve, Korea and US Treasuries in a broadening wave of global curve flattening first presaged in Czechia right back in Q1 (see 'Czech mate').

Yet in time, these moves towards flat and inverted territory are likely to reach an inflection point. Even in the four recessions of the 1968-82 era, bond yields fell materially. By March 2023, on current pricing, year-on-year oil price changes are set to be negative. Broader commodity market moves are also softening: copper, lumber and various cyclical raw materials have already fallen heavily year to date as the growth outlook has darkened. Headline inflation is already moderating in the US. But the rise in various core measures (including rents and wages) means central bank tightening is inked in for the near term. As we head towards what looks like a market turn in rates, and the prospects for much better bond returns during recession, we consider three tests for duration (see the section on Rates Strategy). For portfolio construction, we continue to draw a distinction between the merits of yield curve versus duration strategies.

Yield curves versus duration strategies

As we have mentioned before, to be profitable with large-duration trades, you have to call two things right: the cyclical outlook for growth, and the secular outlook for inflation. Yet for yield curves, the cyclical outlook does most of the job (because inflation premia exist across much of the yield curve and the secular level of rates and inflation is in any case somewhat embedded in official rates). We think there is much more visibility in the data on the cyclical growth outlook, than in the secular inflation outlook.

On the latter, questions remain unanswered: will wage rises lead to second-round effects (see the recent Dutch railway worker settlement for a 9.25% pay rise) or will demand destruction see sharp falls in prices (see the 30% fall in oil prices since March)? Which will dominate? Taking large bets on this unsettled debate looks an inappropriate way to manage client funds in our view, because the risk is still somewhat symmetrical. 2022 is already the worst year for fixed income total returns since 1788 by some counts (See: Bonds in line for worst year in decades | Reuters). Yet betting on a continuation of duration trends – trying to chase momentum for higher yields – looks risky. First, the twelve weeks since our last quarterly outlook have seen huge about-turns in rates: Schatz yields for example have moved from 1.20% down to 0.20% to back over 1.50%. But second, the extensive analysis we have undertaken for our latest Global Macro Quarterly meetings shows we should expect a turn – just not quite yet.

On the other hand, using historical frameworks to identify when yield curves have over-inverted to the point where the curve outlook is asymmetrical, remains a much better risk-reward approach in our view.

Yield curves are cyclically mean-reverting over time, be that in high inflation regimes (for example 1965-82), periods of inflation moderation (1982 to mid-1990s), or low inflation (mid-1990s to 2020). That means that excessively inverted yield curves are eventually likely to dis-invert and re-steepen. We therefore recommend using deep inversions in the US Treasury curve to scale into steepening positions – a trade that we think should make 100-150 bps of alpha on its own into H1 2023. Against that, we see some residual room for EUR curves to flatten.

Fixed income asset allocation

As we said last quarter, "We do not yet think recession is priced into high yield spreads". Since then, credit markets attempted a summer rally in July and early August, on the hope of a dovish Fed this autumn. That looked misplaced to us and we have used the rally to lighten up. Since mid-August, spreads have started to widen.

For sure, credit markets have cheapened this year – but only from their most expensive levels post-2008. This leaves the USD BBB OAS, the EUR BBB ASW and spreads for high yield markets sitting at (or even tighter than) their averages for the past quarter of a century. If history is any guide, an average spread is not the right level of compensation for recession. Looking ahead, hopes for a turnaround look over-optimistic to us, given the monetary policy outlook, the reality of what turns credit bear markets around, and the relatively limited scope we see for game-changing fiscal policy. Only EUR swap spreads trade at recessionary or crisis levels.

Then there is sequencing. In the past 50 years, every single recessionary peak in credit spreads has been preceded by a peak in government bond yields. Usually by many months or even years. We do not believe this time will be different. We expect to see twin peaks: first in government bond yields, and then in credit spreads. The trouble is, the gap may be several months – and possibly many basis points – later.

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Macroeconomic and policy outlook

- Taming of inflation likely entails recession, also in US
- Wage growth key to where core inflation lands
- Fiscal and monetary policy generally close friends no more

Growth outlook: hard doubts about a soft landing

In March, we raised the prospect of a US recession being on the horizon, and in June wrote that "Recession is now odds on". From here, we share the opinion of Gerard Minack – one of the external speakers at our *Quarterly Outlook* – that a hard landing for the US economy is very likely. Some have put the probability of US recession over our 6-month investment horizon at 95% and in the Eurozone at 100%. While we would put it a touch lower in a nod to some of the uncertainties (developments such as Russian gas supply and the outcome of the Russia-Ukraine war are hard to forecast with precision), we make no changes to our 'odds on' view.

This base case echoes the view of the likes of Harvard University's Larry Summers, who believe that in order to tame US inflation pressures sustainably, wage growth needs to fall back sharply. And the latter seems hard to envisage without a rise in unemployment of at least 1 ppt – which in the current circumstances most probably requires a noticeable weakening of labor demand. By some estimates, a rise of just 0.5 ppt in the U3 unemployment rate would be consistent with recession – see the Sahm rule for example.

The optimistic case for the US today rests on five factors. First is the still-positive growth in US aggregate real *labor* income – in part driven by jobs growth. Second, the energy shock is less alarming than in Europe (amid large energy self-reliance given differences in climate policies over the past decade). Third is the lingering belief that the Fed could quickly reverse its tightening course. Fourth, the easing of supply bottlenecks should help goods price inflation trends globally. Finally, the lack of serious private sector spending and financial sector imbalances this cycle – the last recession in 2020 was after all only two years ago – argues for a shallow recession.

We would critique these five points as follows. Respectively, the jobs data is usually among the last data series to roll over and confirm recession (long after, for example, a drop in mortgage applications and open economy manufacturing surveys). The second point is reasonable, but only serves to accentuate the even larger risks to European growth in our view. On the third, the better the growth outcome, the more the Fed will need to continue hiking in order to be assured that the inflation threat has been conclusively dealt with (this creates a somewhat 'heads it's recession, tails it's recession-soon-after-anyway' dynamic).

The fourth item looks helpful, but it is stale – the inflation debate has in any case moved on to rents and wages (and European gas and electricity) from 2021's issues of used cars and container ship disruptions. Finally, private sector credit creation has indeed been subdued, but public sector borrowing exploded higher, leaving overall economy-wide debt overhangs at record highs.

Further, markets seem to be underestimating at least five risks, in turn, for a harder landing: First, interest rates are being raised at the fastest rate in over three decades. Second, the labor market is at its tightest since the 1960s. Third, corporate debt is higher today than during any US recession in history, while household debt is higher than in all but one US recession. Meanwhile, the scale of US government debt has doubled from 60% of GDP pre-2008 to 120%. In some countries this is even far higher (see Italy, for example, at >150%).

Fourth, 2020 was arguably not a full recession: per the NBER it only lasted 12 weeks, and the annual default rate only rose to 5%, half its recessionary norm of 10%. This means there is arguably unfinished business from the cycle before – which was itself the longest expansion in US history. Fifth, the energy and food price shocks are on a par with the deep recessions of 1973-75 and 1979-80.

Finally, the secular pendulum of market fear and greed reached extraordinary proportions in H2 2020-21, with the creation of SPACs and cryptocurrencies reminiscent of the synthetic product creation of the late 1920s and pre-2008 eras, and stock valuations showing parallels to the excesses of the dotcom era. When some commentators tell us there are no imbalances, they don't appear to be looking very hard.

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Then there is the fragile outlook for China. Since 2009, policy stimulus from Beijing has repeatedly helped the global economy recover. It played a role in the US experiencing soft landings rather than recessions after 2011-12 and 2015-16. Chinese fiscal stimulus returned in 2022, aimed at boosting infrastructure investment. But the scale and backdrop appear much more subdued than before. Lingering weakness in housing demand, ongoing fallout from the 40-year credit boom, macroprudential concerns over debt levels and economic damage from waves of Covid-19 outbreaks amid a continuing zero-Covid approach, all make it hard to count on China to save the day this time round.

'Since 2009, policy stimulus from Beijing has repeatedly helped the global economy recover. [Many factors] make it hard to count on China to save the day this time round'

Tighter US policy, weaker European demand and questions over the extent of Chinese stimulus all have ramifications for many EM economies. There, food and energy prices account for a large share of household expenditures and monetary tightening has been severe in many cases. In this respect it is encouraging that many agricultural commodity prices have retraced from their 1H highs, but the vulnerabilities shown in frontier markets (for example Sri Lanka and Pakistan) and monetary strains in the likes of the CEE illustrate the challenges ahead.

In Europe, policy steps are being taken in the face of potential energy-induced industrial shutdowns this coming winter, with sizeable fiscal measures to curb household energy bills. Nonetheless, the shock to household real incomes still matches that seen in the early 1970s. This, coupled with the sharp tightening in financial conditions ensuing from ECB monetary tightening, implies a considerable risk of a hard consumer-led recession – as in 1973-75. Indeed we think the probability of recession in much of Europe is even higher than in the US. Ironically, GDP figures in the US in 1H were much weaker than in the Eurozone. But that reflects post-pandemic re-opening in Eurozone services which is now petering out, and quirks in the US data.

The high inflation backdrop probably raises the bar for the ECB as well as other central banks to reverse course quickly. While central banks are likely to ease eventually in 2023, they will need to wait first to see that the inflation battle really has been won, resulting in a policy mix that looks set to deepen the downturn, and batter risk assets.

Inflation: expectations, wages and commodities

While headline inflation in the US seems to have peaked at close to 9% in June, a peak in Europe remains elusive for now. In both the Eurozone and the UK, the energy price shock is much more dramatic, keeping European central bankers anxious. Whether US core CPI inflation (currently at 6.3%) has peaked seems less certain, due to lingering upward pressure from rental inflation – which historically has correlated strongly with (still-elevated) wage growth. In any case, both in the UK (6.3%) and the Eurozone (4.3%), core inflation does not seem to have peaked yet, in part due to indirect effects of earlier rises in food and energy price inflation.

In our view, the pace of wage growth, adjusted for productivity, will prove crucial for determining where core inflation lands. For now, there seems little sign of a convincing easing of wage pressures in the US (and UK), supporting the case for ongoing monetary tightening. Wage pressures in the Eurozone are clearly building, especially in Northwestern European countries. Ultimately however, we think Eurozone wages are likely to remain relatively more contained than in the US and the UK – assuming the ECB continues to normalize policy.

In China and parts of Asia, inflation pressures have remained more subdued, due to a smaller price impact from logistics disruptions, more forceful government price intervention and cyclical reasons. Nevertheless, food price-led rises in inflation have forced more Asian central banks into tightening action. Meanwhile in Japan, where underlying inflation pressure has remained subdued, yen weakness is boosting imported inflation, suggesting that over time Japan may not fully escape the global inflation wave.

A further sharp retreat in global commodity prices could help steer headline inflation in many DM and EM countries to much less elevated levels in 2023. But for this to have positive implications for growth, these ideally would need to be driven by favorable supply developments rather than a plunge in commodities demand in the wake of global recession. The commodity experts we consulted during our *Quarterly Outlook*, however, underscored that further supply relief might not be imminent.

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Fiscal & monetary policy: no longer close friends

Despite the recent Inflation Reduction Act and Student Loan relief, the US fiscal impulse – which measures the change in incremental support – remains in clear negative territory. With inflation at current levels and Democrats likely to lose their majority in the House after the 8 November mid-terms, we see little room for material fiscal stimulus in coming quarters. In China, by contrast, the stance of fiscal policy has turned more expansionary, even though the new stimulus continues to be more beneficial for (infrastructure) production than consumer spending.

In the UK and the Eurozone, fresh fiscal support has been announced in the wake of the energy crisis with the aim to support households and energy companies. Together with ongoing support from the NextGenerationEU recovery fund, this should keep the fiscal impulse in the latter region in positive territory – although a fair amount of the recent support is expected to be funded by withdrawing money from the corporate sector (rather than by fresh borrowing).

'We do not think that fiscal policy can provide the game-changer for the growth outlook into 2023 that it did in 2020'

In any case, we do not think that fiscal policy can provide the game-changer for the growth outlook into 2023 that it did in 2020. There are four reasons for our view. First, deficits from the Covid crisis are still largely unrepaired – after all, it has only been two years since the last recession. On the latest data, deficits stand at -3% in the US, over -5% in the UK, -6% in France and -7% in Italy. Second, as discussed, central banks cannot execute QE with inflation near 10%, which means the covert financing of large fiscal deficits as in 2020 is not possible. Third, pro-growth fiscal policy is arguably inflationary – after all, many believe the outsized US fiscal support in 2020 was key to the origins of the goods price inflation that has morphed into 2022's central bank travails.

Finally, while many governments are taking measures to *support* domestic demand – an inclination that could grow further if recession transpires – central banks are stepping up efforts to avoid above-target inflation from getting entrenched, and now believe that this entails *dampening* demand. Indeed, both Fed Chair Powell and ECB Executive Board member Schnabel recently warned in Jackson Hole that monetary tightening will likely cause "some pain" for economies. Any inflation-inducing fiscal help might merely raise the quotient of monetary policy tightening required.

Tightening across developed markets is predominantly taking the form of policy rate hikes in large increments, such as typically seen in emerging market economies. The aim is to pull policy rates quickly into restrictive territory, i.e. above neutral. We agree with markets that this probably entails policy rates with handles of 4, 3 and 2 in, respectively, the US, UK and the Eurozone in early 2023. That said, we think it will prove challenging for the ECB in particular to sustain policy rates at levels well above 2% in coming years – as market forwards imply – in part because policy would end up being most restrictive in regions where fundamentals suggest they shouldn't be. In Japan, much like in China, a rate hike does not seem to be on the horizon, although we expect the BoJ to widen the band at which it allows the 10-year yield to move around its 0% target under its yield-curve control (YCC) policy in the October or December meeting (see our latest *Central Bank Watcher*).

Meanwhile, in the background, many G10 central banks, including the BoC, BoE and the Fed, continue to tighten their monetary stance via a steady reduction of their government bond holdings. This is done primarily via only *partially* reinvesting proceeds from maturing bonds. The RBNZ has commenced with active bond sales, though, and the BoE has signaled it is about to do so – although this could prove an empty threat after the recent changes to the bond supply outlook given the recently announced fiscal spending measures by the UK government. Highlighting its outlier western status, the ECB continues to fully reinvest maturing bonds held under the APP and PEPP – with some flexibility in the latter to support EGB spreads. However, discussions within the ECB on quantitative tightening will likely start in October, paving the way for a gradual reduction in APP holdings in the course of 2023.

Looking ahead, given the battle against inflation, any new wave of QE is highly unlikely to be launched anytime soon (the ECB's new Transmission Protection Instrument tool is not QE). Given the darkening growth outlook, we clearly can't rule out further initiatives such as the UK Energy Markets Financing Scheme, whereby the central bank is called upon to help tackle the energy crisis. But the big picture is clear: no deflation threat, no QE.

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Rates strategy

- Peak in rates still closely tied to central bank action
- Main markets still look vulnerable, but prospects improving for some regions
- Opportunities on the curve

Not yet a time for longs, say our duration metrics

With central banks tightening at a fast pace, rates have resumed their upward trajectory. Front-end yields, in particular, have now surpassed their June highs in many markets. While there have been tactical opportunities for overweight duration positions in June-July, we would argue it is still too early to position for a more strategic turn towards lower yields, despite the base case of recession that we foresee in the US and the Eurozone. The opportunity will come, but it could be costly to position too soon. We look briefly at our short list of signals for identifying long-duration opportunities. See the longer list discussed in 'The Inflation Game'.

1. Has the 2s10s curve inverted?
The 2s10s curve has inverted in a growing number of rates markets, including US Treasuries, UK Gilts, EUR swaps and many markets in Latam and CEE. The Eurozone bond market and many Asian markets still have upward-sloping curves. Our research suggests that curve inversion is an indication of potential outperformance versus forwards, with the signal getting more powerful over time. So this signal is indeed pointing to potential opportunities in the US, UK and several Latam and CEE markets.

2. Have 2-year yields dived below the main official rate?
In a small group of emerging rates markets such as Brazil and Poland, 2-year yields are indeed below the main official rate. In most developed markets, however, 2-year yields still exceed official rates by a significant number of basis points. Among the developed markets, Canada is probably closest to reaching this marker.

3. Have we seen the second-to-last rate hike in this cycle?
The size of the steps that are currently being taken suggests many central banks will get to their last hike relatively quickly. Still, for the ECB, Fed and BoE it is unlikely that the second-to-last hike is reached in September. Getting there within the next three months is realistic, though. Within developed markets, Canada is probably closest to reaching this point. Broadening the scope to emerging markets again points to Latam as an interesting region. Central banks such as Banxico and BCB may indeed have already reached their second-to-last hike in this cycle.

From this short list of duration opportunity metrics, only the 2s10s have started to flash green for the larger rates markets. Within developed markets, only Sweden and possibly Canada have started to look attractive on more than one metric. We therefore conclude that it is as yet too early for strategic overweight duration positions in the main rates markets. Still, the rapid pace of official rate hikes suggests that the outlook for duration could become more constructive in the months ahead.

The one government bond market that has consistently beaten the rest of the world is China – in 2022 as in 2021. We have been overweight China government bonds (CGBs) for many quarters now. Our macroeconomic outlook (see previous section) suggests CGBs will continue their path of delivering positive total returns over the longer run. For a selected group of other emerging markets such as Brazil and Mexico, our short list of duration markers now also points to potential opportunities that are worth exploring. In markets where tightening has only started fairly recently (Eurozone) or where a hawkish turn is expected to start at a later stage (Japan), we continue to favor underweight duration positions.

We continue to see opportunities in the curves for active positioning. US and Eurozone 2s10s curves could flatten (or invert) further in the coming months. We are positioned for such a move in Eurozone markets. Still, this trade is time-limited by the growth outlook and we have already locked in gains. The absence of inversions in the Bund curve in the past 12 years and the lower likely level of EUR R* means the degree of flatness or inversion in the EUR bond curve will likely be less than in the US, UK, LATAM and CEE.
For the US we are inclined to use any sizeable moves towards further inversion as an opportunity to continue building a steepener position. After a sharp push towards inversion in the past quarters, the UK curve could also start to offer steepening opportunities soon. In Japan we continue to favor 10-30 flatteners, with the spread of this curve segment near historical highs.

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Fixed income asset allocation

- Investment grade and high yield spreads still not pricing recession
- Recessionary credit bear markets usually only end with a QE announcement
- History shows that credit spread peaks only occur some time after yield peaks

Credit markets – not priced for recession

Last quarter, we suggested that "US investment grade spreads of +150 suggest something closer to a mid-cycle hiccup". Anyone who has read Jay Powell's Jackson Hole speech should be surprised by that pricing. His speech included the phrases: "a sustained period of below-trend growth...there will very likely be some softening of labor market conditions... some pain to households and businesses... [and] unfortunate costs". The Fed have not always called the economic outlook right, but if they have a bias to being wrong, it is usually on the over-optimistic side. Don't just take our word for it: as the Fed see it, you have been warned.

Recessions typically mean a USD IG OAS somewhere wider than +200 bps. For various reasons, we don't expect the +400 levels of 2020 or the +600 levels of 2008, but even in 2002 (a relatively mild recession), spreads reached north of +270.

Global IG valuations don't seem to have changed much versus three months ago. Now that the summer rally has fizzled out, we are left at similar levels, with the USD IG OAS at +145 and the EUR IG at +190. The latter looks optically cheap for a 5-year spread-duration market, versus the US, which has to compensate for 7 years of spread duration. Yet that would be a superficial conclusion: looking beneath the surface, the EUR IG ASW is still only at +93 versus around +160 in the US. Credit risk is thus underpriced in Europe versus the US, even before considering Europe's winter energy challenges, the shocking policy mistake of being dependent on Russia for gas, or the lack of planning for refining capacity amid the climate energy transition.

The difference in valuations is of course the swap spread, and EUR swap spreads and AAA SSAs on our metrics remain the most attractive part of the global spread product set-up from a relative-value perspective. Recent price action and volatility means swap spreads are not for the faint-hearted, but as with most long-term value opportunities, some tolerance for near-term mark to market is the price to pay for what looks like a strategic mean-reverting trade.

As for credit, as we wrote last time, should IG credit spreads move materially above +200 and high yield head to +900, the abundant portfolio opportunities we believe this will bring would dwarf any other strategy consideration, in our view. If recession transpires, we have good visibility on where the basis points will come from, as returns from those stressed levels are cyclically very attractive – see 1991, 2003, 2009 or the remainder of 2020 after the 23 March wides, for example. Prospective returns will be extremely attractive once recession is priced in. That's just not today's trade yet.

In the meantime, those managers who have already spent the year overweight credit, may well face outflows, VaR and tracking-error challenges, leading to forced selling at back bids amid poor liquidity, taking spreads to their usual recessionary levels. We have seen some of the typical market factors in a credit bear market, such as a sharp drop in high yield supply as access to capital becomes scarce and refinancing risks rise. Yet we haven't seen the big fund outflows yet. That chapter looks set to come.

Similarly in ratings trends, the usual recessionary pattern of a pickup in fallen angel ratings transitions has barely begun (mainly, we think, because the bulk of the growth downturn remains ahead of us). Credit spreads don't tend to turn around until the downgrades have really begun. Finally, looking at the internal structure of credit markets, while dispersion has begun to increase, that process looks only halfway done. US CCCs, for example, are nowhere near to pricing in the kind of dispersion that is typical in a recession.

How do credit bear markets end?

The last four recessionary credit bear markets have ended either when QE is announced (for example in November 2008 or late March 2020), or when it is threatened (for example in former Fed Chair Bernanke's 'helicopter' speech in autumn 2002 or Mario Draghi's 'Bumblebee' speech in July 2012). The problem today is that no western central banker can dream of announcing or threatening QE with inflation near 10%.

That leaves fiscal policy. During the Covid crisis, governments of both left and right-wing persuasions

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discovered that trillions of dollars could be thrown at an unforeseen emergency with the tacit agreement of opposition parties and electorates, with tremendously beneficial short-term effects for growth. Surely in 2022, market bulls argue, governments could simply rescue economies from the energy and cost-of-living crisis with a few trillion of spending here or there? While the UK and German governments have announced quite large headline packages on energy policy, we don't believe there is scope for game-changing fiscal policy. We see four barriers, as outlined in the *Macroeconomic and policy outlook* section.

'The problem today is that no western central banker can dream of announcing or threatening QE with inflation near 10%'

Twin peaks

The biggest inhibitor to a credit rally, however, is in the sequencing between government bond yields and credit spreads. We have researched this topic in depth – and it's a bit complicated, so bear with us. (The reward for your attention is what we believe to be the key to fixed income alpha over the next 12 months…).

Many managers had their formative years between the mid-1990s and the 2011-12 Eurozone Crisis. During this fifteen-year period, credit spreads and bond yields were generally negatively correlated: economic expansions typically brought somewhat higher yields and tighter spreads; recessions brought the reverse.

Now, the period from 2013 ushered in a new era. The lingering nature of QE and the alternating periods of QE, tapering and QT it introduced, meant that real yields became more dominant. Falling real yields meant tighter credit spreads, while higher real yields meant widening. That changed the rates and credit regime because it meant that co-movement of yields and spreads (for example, lower in 2012 and 2019, higher in the summer of 2013, H1 2015 and 2018) upended the prior negative correlation that had prevailed for so long.

2022 has continued this more recent pattern, as a combination of rate hikes and actual or prospective QT has seen higher government bond yields and wider spreads over the year to date. (The intra-year picture has been clouded by intermittent risk-on and risk-off regimes but the big picture move in 2022 has been one of higher yields and spreads – an elongated version, if you will, of the Taper Tantrum in 2013.) The key is what happens next.

Over the last quarter, markets have romanced the idea of a 'pivot', whereby lower yields will bring tighter spreads. This path could theoretically occur in the event of a soft landing amid low inflation (as seen in 2019, for example). But inflation is hardly low. And as discussed, the chance of a soft landing looks slim in our view. Further, the thesis of a co-movement lower in yields and spreads has never been seen in a recession in the last fifty years!

Instead, historical analysis reveals that what happens in recessions is that government bond yields peak before credit spreads peak. This is intuitive. When growth slows and recession transpires, central banks cut rates. The Fed do so because the labor market forms part of their dual mandate; the ECB do so because of their price stability objective. Either way, hundreds of basis points of central bank rate cuts are typical in recessions (the last four US recessions have seen the Fed cut rates by 675 bps, 475 bps, 500 bps and 225 bps). Credit spreads, meanwhile, widen, often to over 200 bps for investment grade (as discussed) and over 900 bps for high yield. Hence, the peak in government bond yields happens some time (often quarters or years) before the peak in credit spreads – because government yields peak before the rate cuts, and spreads typically only peak once the cuts are done.

What about the 1970s? The elevated inflation backdrop of the four recessions from 1969 to 1982 is arguably more relevant to today than the history of the past thirty years. We therefore conducted an extensive analysis of front-end yields, 10-year yields, fed funds, inflation and credit spreads in recessions when inflation is high. What we find is the same conclusion as in the rest of the last half century of macroeconomic and market data. In recessions, government bond yields peak before credit spreads – even when inflation is high. The gap between the two peaks varies: 12-month yields peaked in 1970 and 1981, a year or more before the credit spread peak, whereas the gap in 1979-80 was only two months. But the sequencing has never changed for fed funds and front-end yields. We do not think this time will be different.

'In recessions, government bond yields peak before credit spreads – even when inflation is high'

Peripheral bonds: structurally weaker fundamentals in Italy

In our previous Quarterly we wrote that a sustained tightening of 10-year Italian government bond spreads versus Germany to below 200 bps seemed challenging.

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That projection has been proven correct, as we have seen a gradual widening of spreads over the past months, amid a more hawkish ECB and the collapse of the unity government led by Mario Draghi.

The formation of a rightwing coalition headed by Brothers of Italy leader Georgia Meloni seems likely, after the 25 September elections. The election outcome itself may, in our opinion, not be a trigger for severe widening. In 2018 markets also hardly responded when Lega and M5S joined forces, because the projected election outcome wasn't a surprise anymore.

Next to that, Ms. Meloni has been working hard to convince the outside world that she has moderated her stance on many sensitive policy topics. A discussion about an EU exit is not on the table at all. We have our doubts, though, whether she will continue to sound fiscally prudent in a situation where the country finds itself in a recession. Moreover, the relationship with the EU could turn more sour if agreed structural reforms, which are needed in order to disburse further NGEU money, were to be challenged, reversed or maybe not implemented at all.

Increasing borrowing costs is another factor supporting wider BTP-Bund spreads. Ten-year BTPs now trade at a yield of around 4% and concerns are increasing around the costs of servicing the large Italian debt burden – a burden which ballooned higher during the Covid years. Moreover, ECB research suggests that a given ECB policy rate is already more restrictive for some Southern European economies than for those in Northwestern Europe.

'...as the capital key is still a binding element, this rotation towards periphery can't go on forever'

So far the ECB has been using redemptions from the giant PEPP program to rotate proceeds from maturing bonds of core countries into peripheral bonds to contain their spreads. But as the capital key is still a binding element, this rotation can't go on forever. The second line of defense to avoid fragmentation is the recently announced Transmission Protection Instrument (TPI). Through TPI the ECB can purchase sovereign bonds issued by countries which face disorderly interest spread widening that is not justified given their economic fundamentals and that jeopardize the ECB's monetary transmission. Nonetheless, spreads first need to widen sharply before this tool would likely be activated. In addition, when the cause of spread widening is political upheaval, or a rift with the EU, the ECB should be hesitant to deploy this instrument.

Fundamentally we are much less worried about Spain and Portugal for now, but valuations, especially versus the likes of AAA-rated government-related agencies and supranational bonds, are not very appealing in our analysis. Net issuance has already increased as the ECB has ended net purchases, but in an environment where the ECB introduces QT and governments also need to finance growing deficits at higher rates, non-core yields probably need to rise further in order to attract additional investors.

EM debt: vulnerable to global growth slowdown

The global macro backdrop has further deteriorated since our last GMQO publication, with growth expectations revised lower across regions, while inflation rates and policy rates are higher. Europe's economy has expanded robustly throughout Q2 but is now slowing sharply due to the energy crisis and its subsequent effects on household income and industrial production (shutdowns). The US is less exposed to this crisis, given its self-reliance on energy, but is experiencing a policy-induced slowdown thanks to the Fed's actions.

A marked and coincident slowing of G10 economies and China does not bode well for EM economies, in our view. Sliding global trade volumes re-enforce such fears. This reflects in part the post-pandemic rotation from goods to services consumption, but also an overall slowing in global demand, including investment spending. Equally so, commodity prices have fallen significantly, led initially by cyclically sensitive industrial metals but more recently also by oil prices, as the outlook for global demand has worsened. Although the latter should support oil-importing EM economies, a broader demand-driven fall in commodity prices weighs heavily on the majority of the EM universe. Last but not least, USD appreciation and rising treasury yields have sharply tightened EMs' external financing conditions, applying a further drag on growth.

Looking at the different regions, growth is expected to slow more materially in North Asia than Southeast Asia in 2023, as tailwinds from a strong external recovery turn into headwinds from a weaker export backdrop. The growth story is similar for Latin America, with most economies likely to experience a stall in economic activity, due to monetary tightening and falling commodity prices. For Eastern Europe, the backdrop is more impactful, as large downgrades are inevitable given exposure to the Euro Area and energy-rationing concerns going into the winter months. We are concerned for the likes of Hungary given its toxic mix of very sticky inflation, currency instability and a worrying external situation that, more likely than not, may require an IMF program to resolve. Hence, our overall EM stance remains conservative. Opportunities are building in

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Latin American local bonds as many of those central banks near the end of their tightening cycles and domestic growth cools. Brazil and Mexico look especially appealing. Eastern Europe rates remain untouchable as ongoing tightening is needed to tame the inflation and wage-price spiral that keeps on surprising. Finally, we remain underweight Asia local markets as these central banks are only just starting to tighten policy.

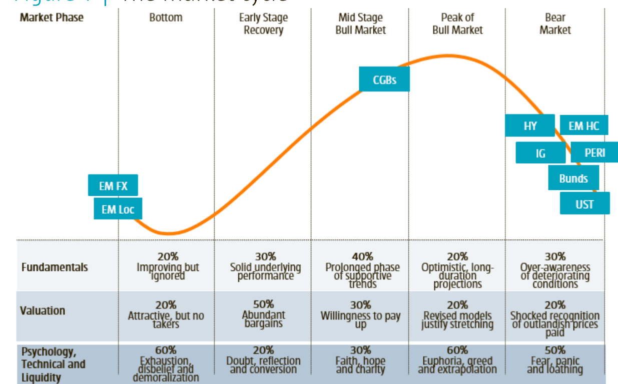
FX: more divergence between EM currencies

Since the start of 2022, the market has repeatedly considered it likely that too much Fed tightening could be in the price and a pivot was in the making, only to be blind-sided by fresh hawkish surprises, be it CPI prints, FOMC member speeches or stronger-than-expected growth. The combination of stickier-than-desired inflation amid a relatively strong labor market suggests the Fed will remain on a hawkish path. This trajectory pushes investors to continue seeking the safety of the USD, supporting it into year-end.

We expect a material economic slowdown into 2023 which, in combination with a more benign inflationary environment, should give the Fed the room to stop tightening and allow for an unwind of USD strength. Consequently, the scale of USD gains from here may prove limited, unless markets reprice Fed expectations markedly higher. In this context, EM and cyclical DM FX are expected to weaken further into year-end and 2023, albeit with meaningful differentiation across EM regions. Latin America could well outperform Asian and Eastern European currencies for reasons mentioned above. Overall, we are overweight the USD, JPY, THB while underweight the MXN, IDR, MYR and KRW.

Asset class positioning

Figure 1 | The market cycle



Source: Robeco, September 2022

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