Morgan Stanley
INVESTMENT MANAGEMENT

What's Next For Fixed Income Markets

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The post-pandemic surge in yields represents a paradigm shift that is reshaping opportunities and risks across the fixed income landscape.

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Key points

- Rosy forecasts for a return to pre-pandemic yields and inflation rates are too optimistic and ignore longer-term historical trends.
- We believe that slowing globalization, tight labor markets and, notably, expansive fiscal policy should sustain yields at levels more in keeping with long-term averages.
- We see compelling value in the short end of the curve and credit plus sectors.

INVESTMENT IMPLICATIONS

1 Reduce Risk On The Short End

Short duration strategies can reduce duration and term risk and offer returns in excess of historical averages.

2 Stay Active In Credit

Compensation for high yield bonds and loans remains compelling, but active management will remain key in an environment of heightened risk.

3 Emerging Markets Assets

Emerging markets assets have historically outperformed during bouts of U.S. dollar weakness, which we may see if high inflation and deficits persist.

Market Myopia?

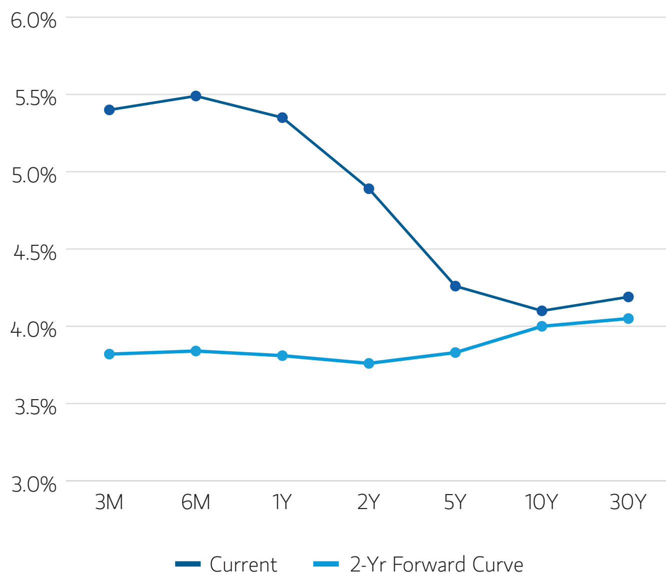
Market pricing for 2-year forward contracts posits a return to the ultra-low yields that predominated in the years between the global financial crisis and 2022 (left-hand chart, *Display 1*). However, we think the outlook fails to appreciate how unusual yield levels were during the inter-crisis period (i.e., post-GFC to the pandemic) and how last year's paradigm shift for rates will have a lasting impact.

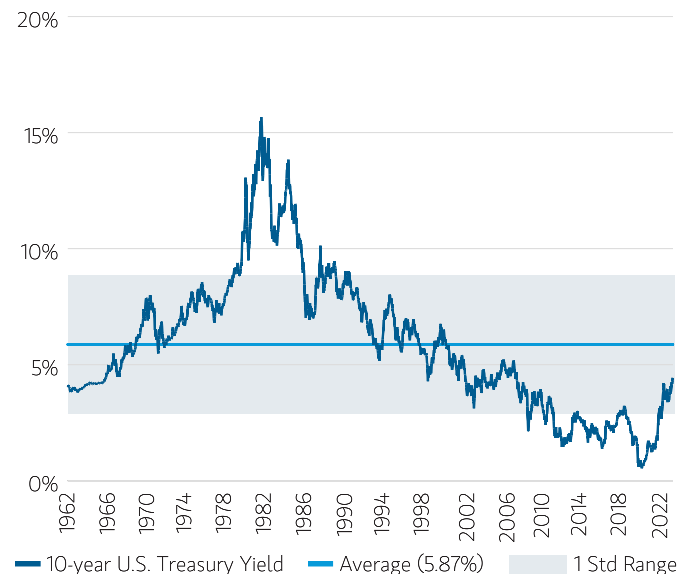
The financial repression of yesteryear, which ushered in ultra-low rates, is likely the hallmark of a bygone era. Instead, we expect U.S. Treasury yields at the long end to rise toward levels more in keeping with historical averages (right-hand chart, *Display 1*).

DISPLAY 1

Market Overly Optimistic on Rates

Past performance is no guarantee of future results.





Source: Bloomberg, Federal Reserve Bank of New York, MSIM. Data as of September 22, 2023. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Beyond the Inflation Aberration

Interest rates and inflation markets continue to price in an orderly return toward the 2% inflation target of the U.S. Federal Reserve (Fed) and the European Central Bank. While this is certainly possible, history suggests that the risks are asymmetrically skewed towards higher inflation once the inflation genie has been let out of the bottle.

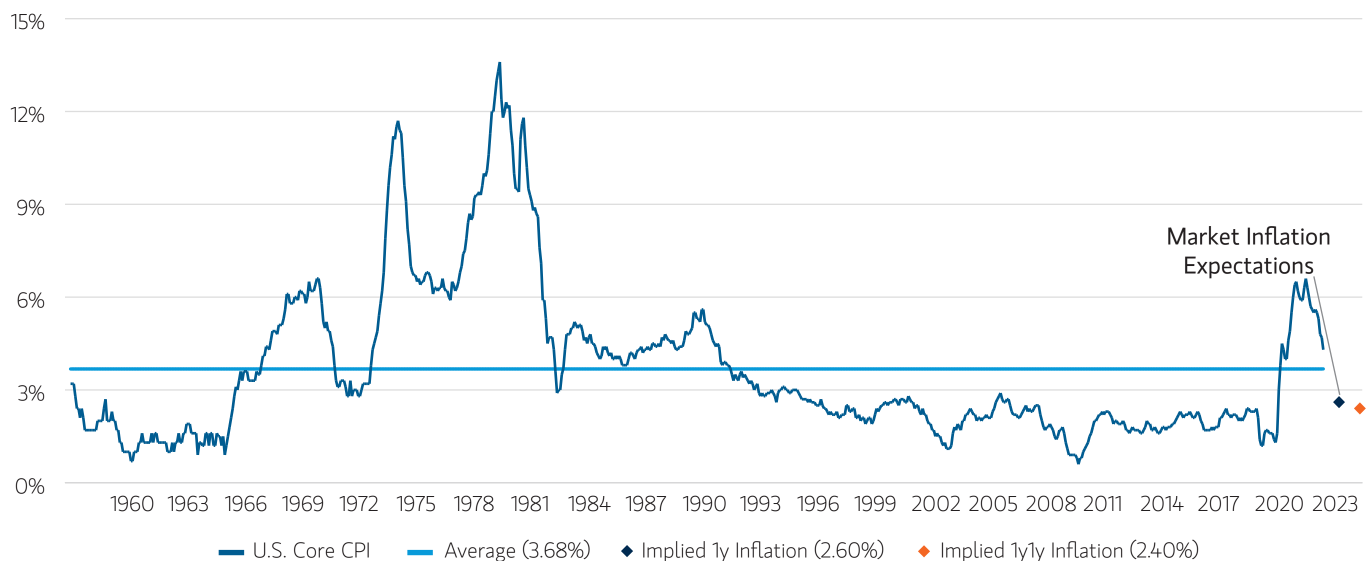
The chart below is a simple one: Core CPI going back to the late 1950s. The arrow points to current inflation expectations and, while the level seems reasonable given inflation behavior over the past 20 years, the longer history suggests inflation rarely stays that low and steady.

The Fed has effectively told the market that they are done raising rates for the foreseeable future, which is understandable given the speed at which they have moved. If inflation proves to be sticky, expect to see the inflation premium in markets rise and yield curves steepen.

DISPLAY 2

Inflation Perception Gap

Realized Core Inflation and Implied Inflation from Swaps



Source: Bloomberg, MSIM. Data as of August 31, 2023. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Ballooning Budget Deficit

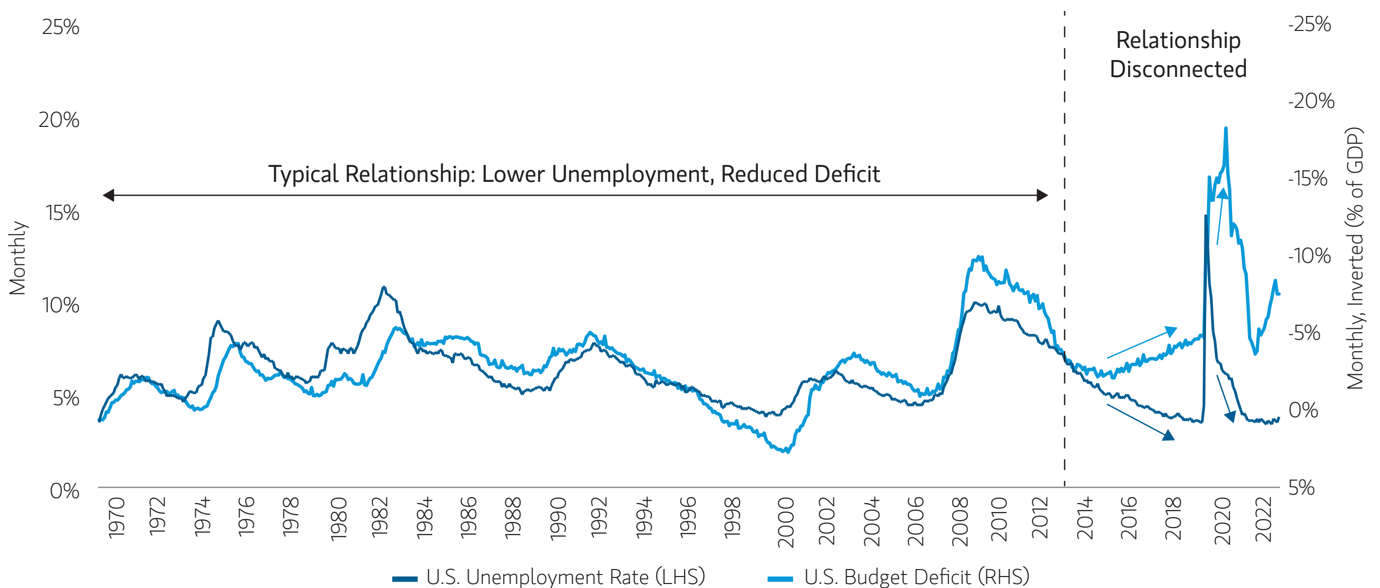
The break in the historical trends for fiscal policy and unemployment additionally supports our expectation for a reversion to long-term averages for inflation and Treasury yields. In the past, countercyclical fiscal policy has been used to spur economic activity and job creation when unemployment crept upward.

That relationship appears to have broken down *(Display 3)*. Unemployment remains at 3.5%, a historic low, while the budget deficit sits at 8.5% of GDP, near historic highs. Not only are fiscal stimulus and tight labor markets bad for bringing down inflation, but it also stands to reason that when the job market does eventually weaken, the government will spend even more.

What does this mean for U.S. Treasury yields? Well, when President Bill Clinton balanced the budget from fiscal years 1998 to 2001, public sector borrowing started to dry up, causing the yield curve to invert due to that lack of long supply. Today, we see the opposite situation, which suggests that upward pressure on the long end of the curve will increase from here.

DISPLAY 3

Stimulus Excessive for Strong Jobs Market



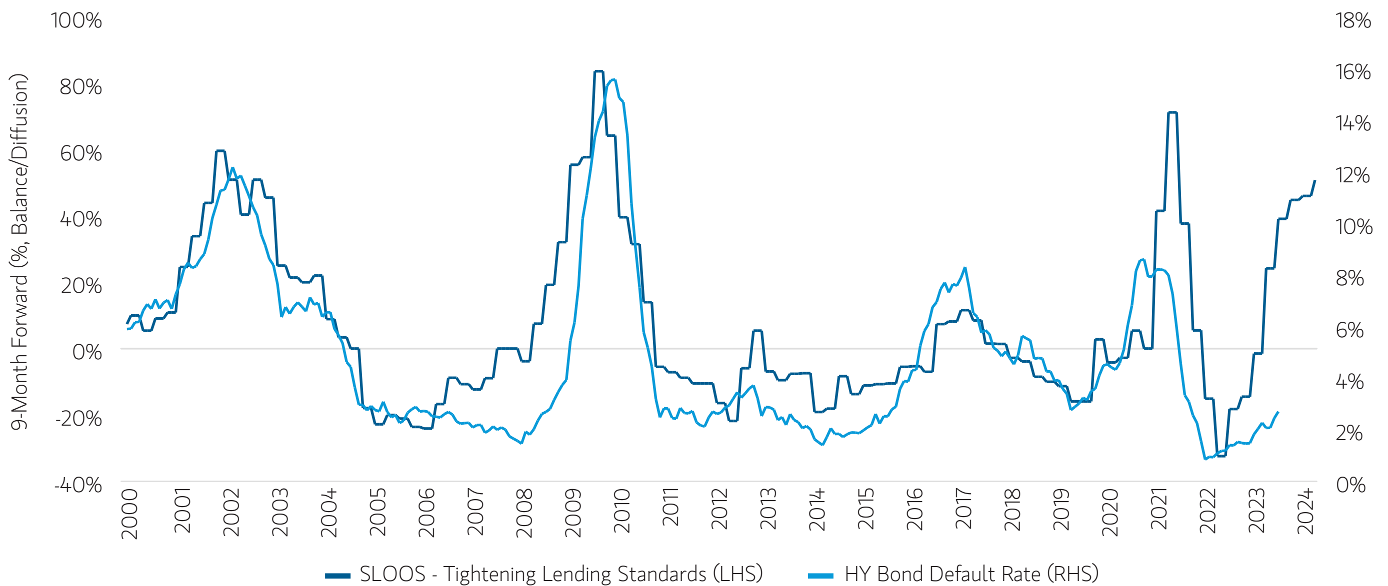
Source: Bloomberg, Bureau of Labor Statistics, US Treasury, MSIM. Data as of August 31, 2023.

Defaults Trending Up

If inflation and rates move higher and closer to historical averages, the challenging monetary environment should exert a strain on borrowers, contributing to a worsening in credit quality and a rising trend of defaults. As can be seen in the chart below, tighter credit conditions have historically corresponded to rising defaults in high yield bonds, a trend that is also consistent with other credit sectors such as loans and emerging markets (EM) debt.

DISPLAY 4

Hardship from Higher Rates



Source: Bloomberg, LSTA Morningstar as of May 31, 2023. Federal Reserve Board as of July 31, 2023. Moody's, Macrobond as of September 27, 2023. The index data is provided for illustrative purposes only and is not meant to depict a specific investment.

Investment Implications

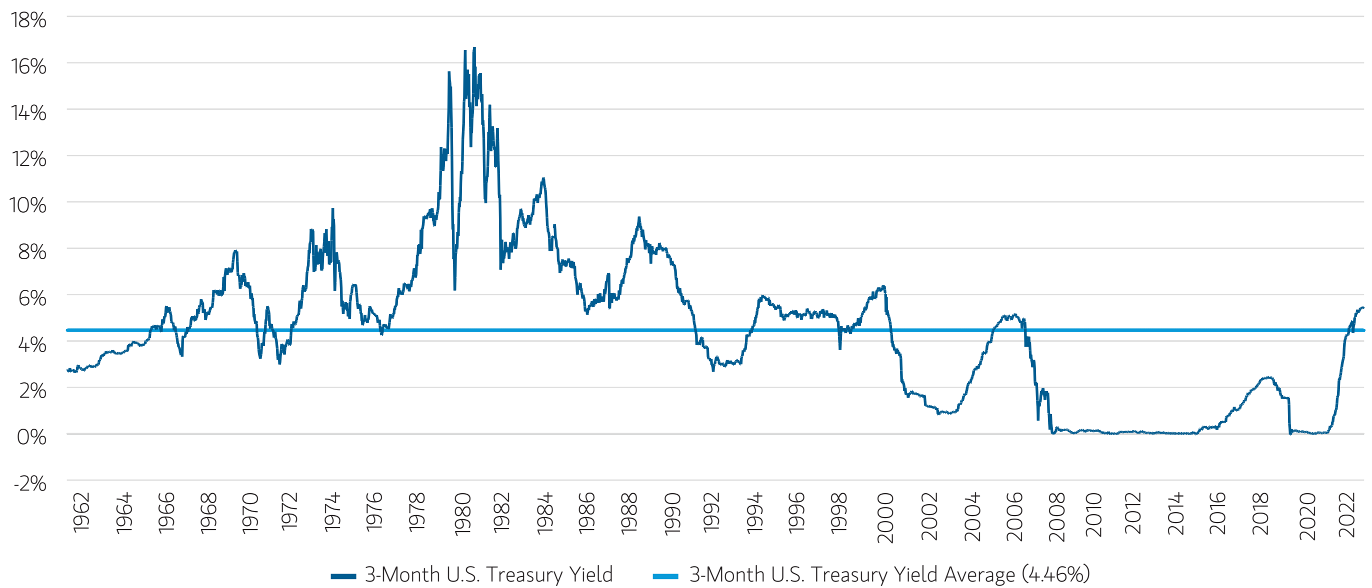
1. REDUCE RISK ON THE FRONT END

The front end of the curve continues to offer the opportunity for yield pickup, with 3-month U.S. Treasurys offering yields in excess of the long-term average of 4.5%. Investors can put cash into money market and short duration strategies to earn respectable returns without taking excessive duration and term risk, while keeping the option open to redeploy funds further up the curve as the rate environment gradually normalizes.

DISPLAY 5

Short-Term Yields Above Long-Term Average

Past performance is no guarantee of future results.



Source: Bloomberg, MSIM. Data as of September 8, 2023.

2. STAY ACTIVE IN HIGH YIELD AND LOANS

Credit conditions should become more challenging for high yield and loans, although high starting yields mean return conditions are still favorable. We believe the compensation for the level of risk remains compelling, given yields of 8.6% and 10.4% for high yield bonds and loans, respectively *(Display 6)*.

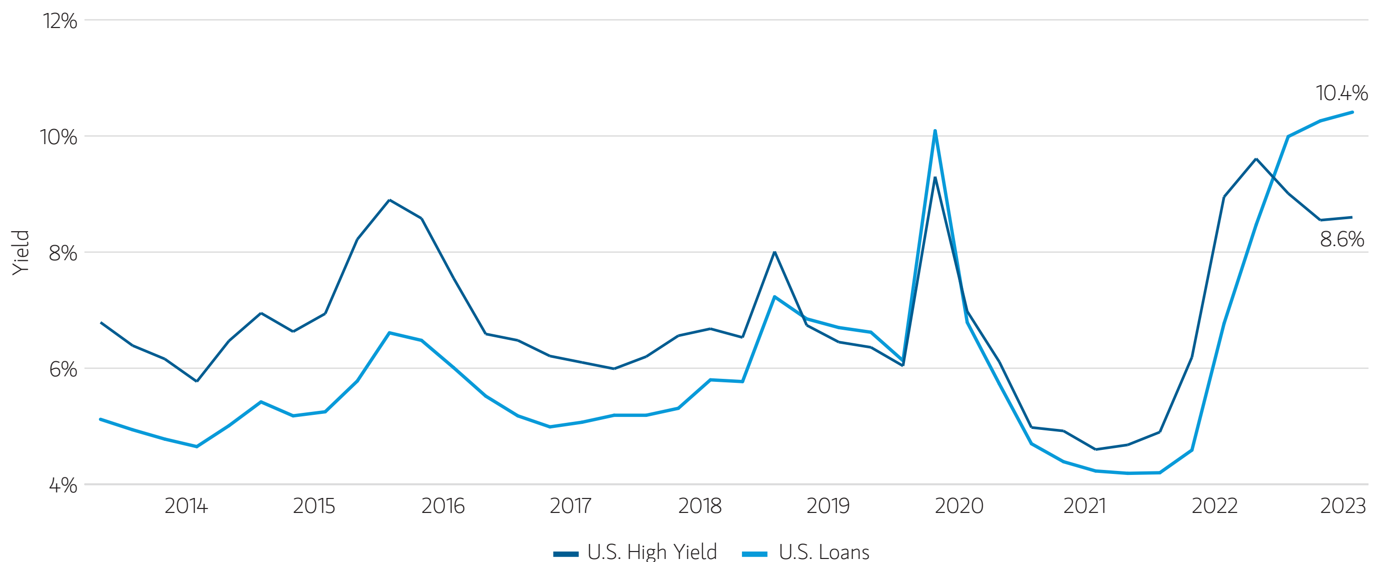
True, defaults should rise further, but we estimate returns would remain attractive at recovery rates in the 30-50% range. When we compare projected returns for bear and base-case scenarios, we estimate that the credit premium should more than compensate for expected losses, even in a bear market.

In any event, a discerning approach to security selection will remain key. Active managers with the research prowess, skills and experience investing through the cycle will be best placed to add value for clients in this market. Passive strategies, in contrast, will tend to assume indiscriminate and undue risk.

DISPLAY 6

Credit Attractive Even in Bear Market

Past performance is no guarantee of future results.



Sources: MSIM, Bloomberg, LSTA Morningstar as of June 30, 2023. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment.

3. U.S. DOLLAR WEAKNESS A BOON FOR EM ASSETS

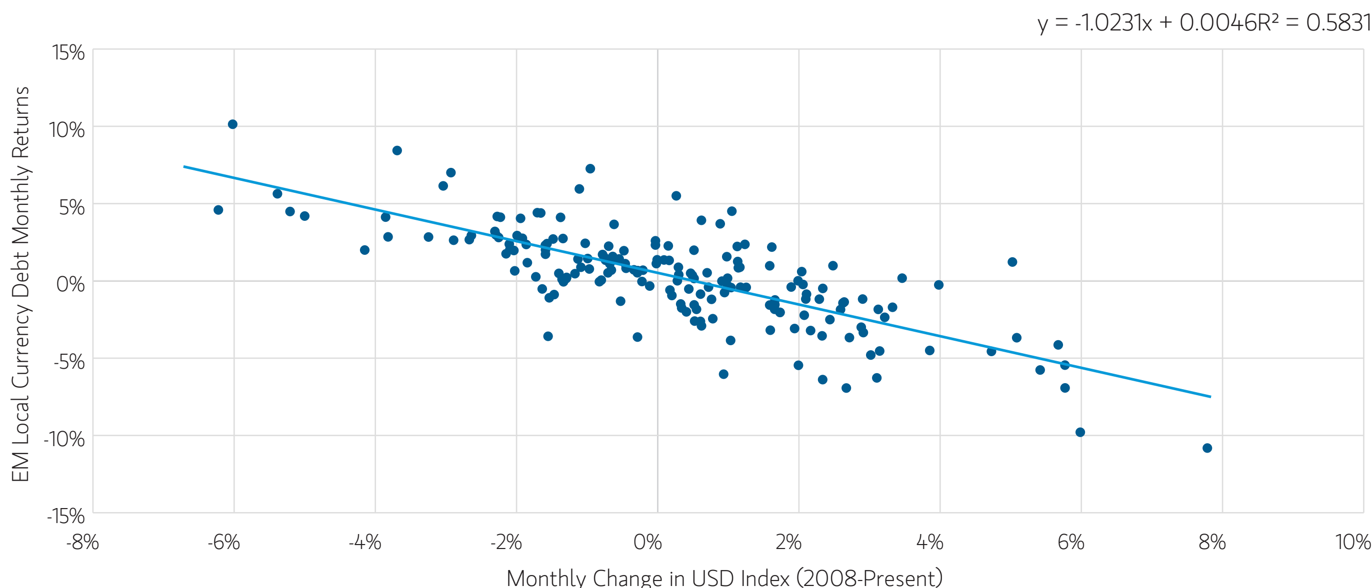
The EM debt asset class was punished by investors, as risk-off sentiment gripped markets post-pandemic. That said, a number of EM central banks have maintained credible monetary management in recent years, which is paving the way to improved outlooks for inflation and growth.

We see scope for some upside in EM currencies vis-à-vis the U.S. dollar, which may weaken if our outlook for higher inflation, an unsustainable budget deficit and weaker growth dynamics in the U.S. is correct. As evidenced in the top left quadrant of the chart below, EM local currency debt has outperformed during past periods of U.S. dollar weakness. In combination, we believe that the prospect of both rate cuts and FX appreciation should bode well for the asset class.

DISPLAY 7

Currency Comparisons: USD vs EM Local Debt

Past performance is no guarantee of future results.



Source: Bloomberg, MSIM. BBG EM Local Currency Government Bond Index used for EM Local Currency Debt. As of August 31, 2023. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment.

Bottom Line

The market view for inflation to dissipate and rates to decline is too sanguine, as we expect a combination of slowing globalization, tight labor conditions and ballooning government debt to result in higher U.S. Treasury yields. We see attractive relative value on the short end of the curve and in sectors rated below investment grade. But with an outlook for rising defaults, we believe active management is key for adding value.

Risk Considerations

Diversification neither assures a profit nor guarantees against loss in a declining market.

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in a portfolio. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, and correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

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Basis point: One basis point = 0.01%.

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