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MARKETING DOCUMENT

Shifting Perspectives in Fixed Income: Focus on Carry Returns

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Shifting Perspectives in Fixed Income: Focus on Carry Returns

Key Points

- ECB poised to cut rates ahead of the Fed
- Fixed-income returns to derive from carry

UBP entered 2024 with expectations of slowing inflation, a soft landing, and central bank policy normalisation within the first half of the year. We kept an intermediate duration (4 years) and focused on intermediate investment grade bonds (with a focus on 3–5-year maturities) and short-dated high-yield bonds.

Our strategy on intermediate investment-grade bonds proved partially effective, outperforming longer maturities due to their lower sensitivity to rising rates, and government bonds, which did not benefit from spread compression. However, the 0.5% year-to-date performance fell short of our anticipated capital gains. In contrast, our selection of short-dated high-yield bonds was successful, delivering a solid 2.5% return and outperforming longer maturities.

Given persistent inflation and a robust macroeconomic environment, we are adjusting our outlook. We now anticipate that the rate-cutting cycle will start towards the end of the year in the US, and we have shifted our expectations on fixed-income returns primarily towards carry. Accordingly, we are positioning portfolios aiming at a relatively lower duration (3 years).

ECB TO CUT RATES BEFORE THE FED

US inflation remains above 3%, reflecting the resilience of the American economy. This trend is expected to continue over the coming quarters, with inflation likely to fall to the 2.0–2.5% range only towards the end of the year and into 2025, i.e. later than previously anticipated. This higher-than-expected inflation has led markets to adjust their overly optimistic forecast at the beginning of the year of six rate cuts to just one cut in December, a view supported by UBP. Essentially, rates are set to remain higher for longer.

In Europe, disinflation is the prevailing trend, with a credible convergence to the 2.0–2.5% range over the coming quarters. The ECB, while awaiting confirmation of waning wage growth and a resilient labour market, has widely telegraphed a rate cut in June. This move will decouple the ECB from the Fed, with the ECB cutting rates a full six months earlier.

Though the rate-cutting cycle is expected to continue into 2025, terminal rates should be higher than pre-Covid levels. With US economic growth projected to slow to 2% next year and inflation converging on the 2.0–2.5% range, we anticipate the Fed will settle rates in the 4.0–4.25% range by year-end. In Europe, despite some economic growth divergence, a progressive recovery in the second half of the year, coupled with similar inflation targets, suggests the ECB rates will settle in the 2.5–2.75% range.

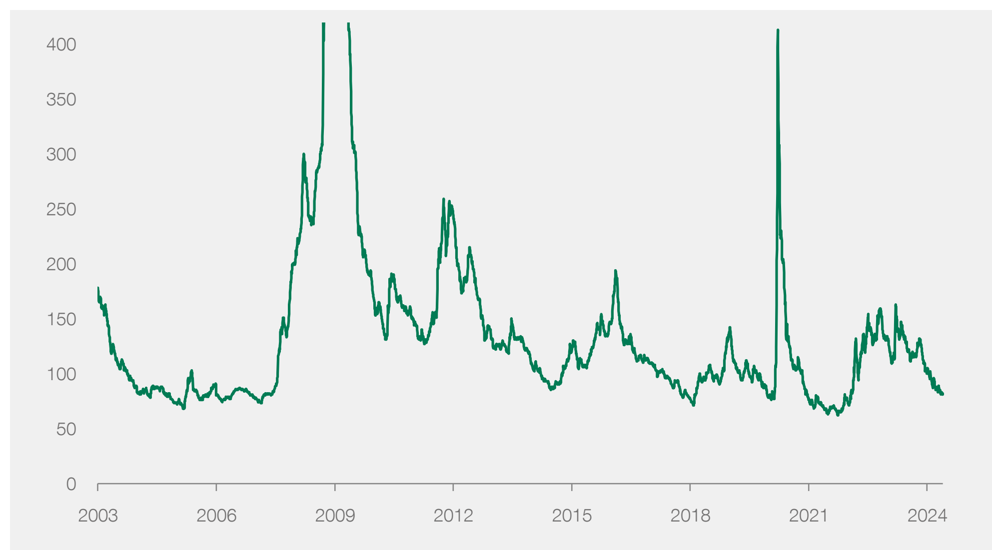
The rate-cutting cycle should act as a catalyst to restore a positive slope to the yield curve: rate cuts will put downward pressure on the short end of the curve, while firm growth and inflation of around 2% will put upward pressure on longer-dated government bonds into 2025.

Risks to this scenario include an unexpected rise in unemployment, which could prompt the Fed to cut rates faster given its dual mandate, or an unexpected rise in inflation due to higher oil prices, delaying any rate cuts.

SPREADS TO MOVE SIDEWAYS

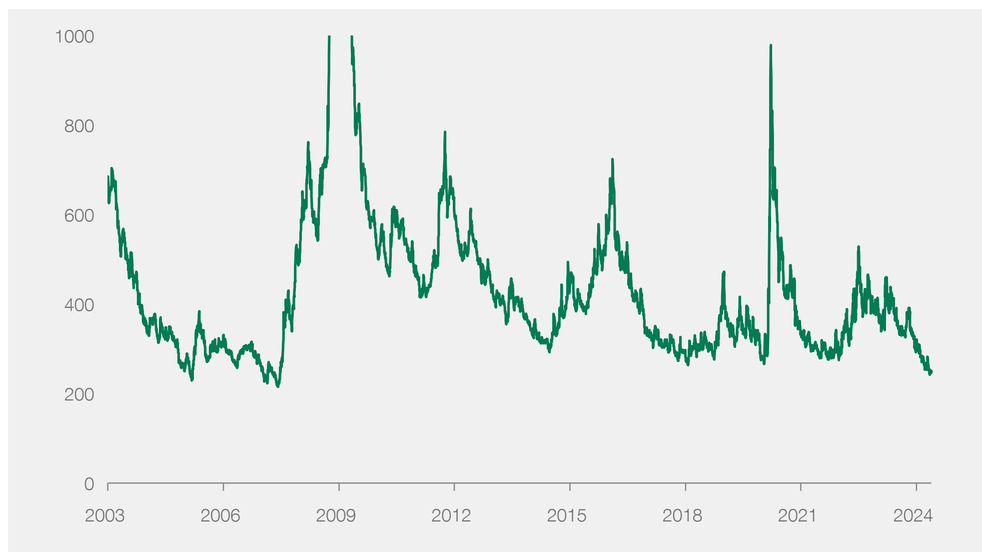
Investment-grade and high-yield spreads are historically tight. However, given the favourable macro outlook, the resilience of corporate balance sheets to higher rates, and higher profitability in the banking sector, we expect spreads to remain at current levels. There is a historical precedent, with spreads remaining tight during extended periods in 2003–2006 and 2017–2019.

INVESTMENT GRADE SPREADS (BPS)



Sources: ICE BofA 1–10 Year US Corporate Index & ICE BofA BB-B US High Yield Index

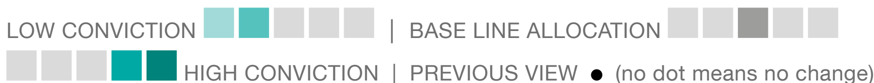
HIGH YIELD BB-B SPREADS (BPS)



Sources: ICE BofA 1–10 Year US Corporate Index & ICE BofA BB-B US High Yield Index

NARRATIVE SHIFTS FROM CAPITAL GAINS TO CARRY

With expectations of elevated rates and limited potential for spread compression, we have moderated our outlook for returns on fixed income, as they are as poised to derive from carry rather than capital gains. Our conviction on high yield and emerging markets has also improved recently.



Tactical view (1–6 month). This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular fund, strategy or security. Past performance is not a guide to current or future results. Any forecast, projection or target, where provided, is indicative only and is not guaranteed in any way.

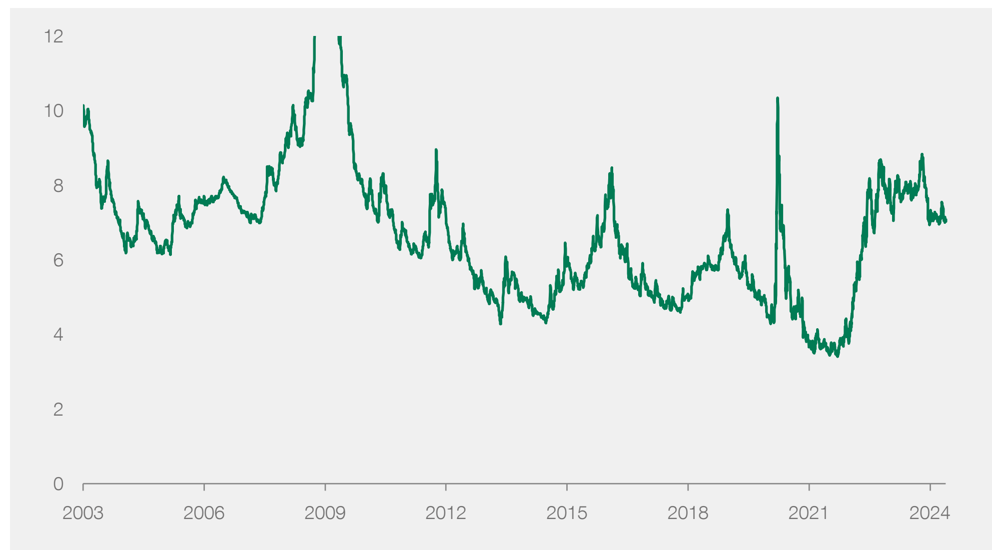
Fixed Income
Governments
Investment Grade
High Yield
AT1
Emerging Market Debt
Convertible Bonds

Today's fixed-income markets offer historically high absolute yields, surpassing most levels seen over the past two decades, excluding crisis periods like the global financial crisis and the Covid-19 pandemic.

INVESTMENT GRADE - YIELD (%)

Sources: ICE BofA 1–10 Year US Corporate Index & ICE BofA BB-B US High Yield Index

HIGH YIELD BB-B - YIELD (%)



Sources: ICE BofA 1–10 Year US Corporate Index & ICE BofA BB-B US High Yield Index

PORTFOLIO ADJUSTMENTS REFLECT CARRY FOCUS

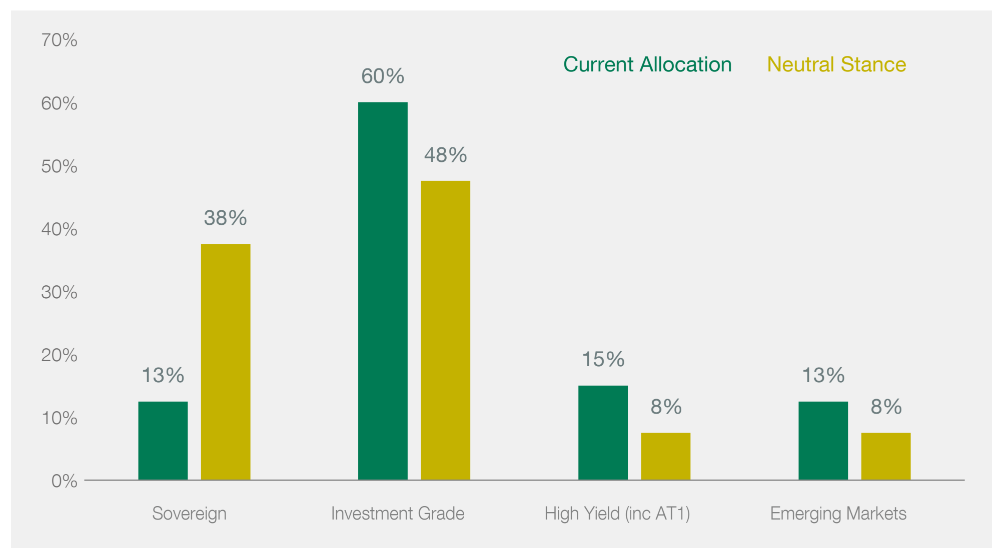
To align with the carry-over-capital-gains narrative, we have made several strategic portfolio adjustments:

- **Increasing credit duration in high yield**, funded by short-dated high yield. We remain poised to continue this shift, awaiting a more attractive entry point.
- **Adding exposure to AT1s of major European banks** again funded by short-dated high yield. AT1s have an average rating of BB+ but offer a yield level similar to a single-B with relatively low overall duration given the call/coupon reset feature.
- **Increasing exposure to emerging markets** with a focus on sovereign bonds.
- **Keep a relatively lower duration** (3 years versus 4 years at the start of the year).

Additionally, we have maximised carry by maintaining a relatively low exposure to sovereign bonds, favouring investment-grade bonds and flexible funds.

As a result, our portfolio holds an average investment-grade rating, attractive carry (USD 6.5%, EUR 5%) and relatively low duration (approximately 3 years).

FIXED INCOME ALLOCATION



Source: UBP

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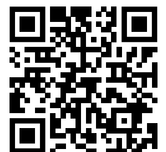

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