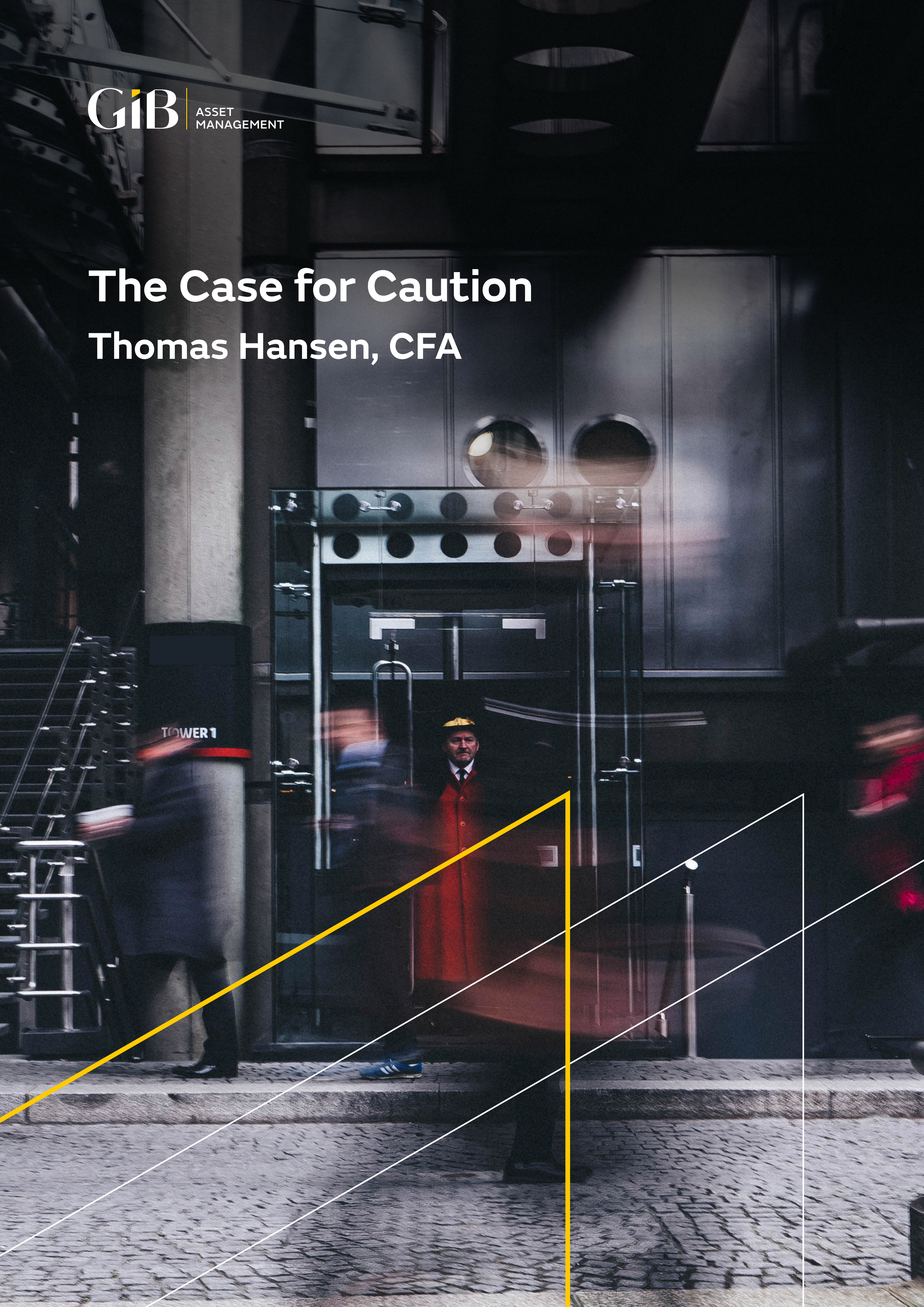
GIB ASSET MANAGEMENT

The Case for Caution

Thomas Hansen, CFA



By Thomas Hansen, CFA - Portfolio Manager, GIB Asset Management

The Case For Caution
Why we are aggressively neutral - and risks to the soft-landing immaculate disinflation narrative

Given tight credit valuations and aggressive forward pricing, we would tend to fade the recent immaculate disinflation/soft landing narrative. We believe that the recent rally in both rates and risky assets has probably run its course.

We look back at a year with plenty of volatility and opportunities for active investors. Judging by market consensus, credit investors are in for a good 2024 as well. We find the optimism somewhat at odds with valuations, both in terms of the rates market, but in particular when it comes to pricing in the credit market.

- In this short article, we'll start by looking at what valuations are telling us across rates and credit
- Secondly, we'll review what risks might emerge in 2024 – i.e., what can threaten the soft-landing immaculate disinflation market consensus? (Spoiler alert: quite a few things it turns out).
- Finally, we'll look at what kind of returns we can expect from global credit in various market scenarios.

1. Valuations - we've come a long way

Since we published our latest piece "When Cash isn't King" in late October, fixed income has had an impressive run. We argued that "*history, maths and the Federal Reserve all tell us it's time to take the plunge and ditch cash.*" Indeed, since publishing on October 31st, the global aggregate has seen a total return of 8.2% and the US 30 year has rallied some 105 bps or 18.5% total return – all in just over 7 weeks. So it is perhaps prudent to take stock and evaluate market pricing at this stage (Figure 1).

The rates market might be getting ahead of itself: forward pricing is relatively aggressive.

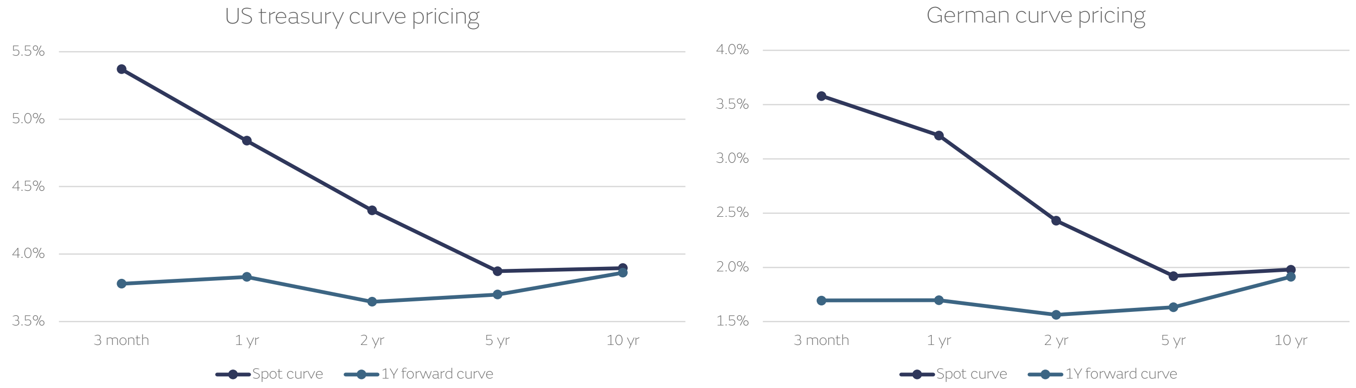


Figure 1: USD and EUR forward curvesas at 22.12.2023, Bloomberg

Current market pricing as of December 22nd 2023 is 150 bps of rates cuts in the US, a bit more for the ECB and a bit less for the bank of England. Front end forward pricing means that, for example, to make a positive excess return against cash in euros, the 2-year German bund needs to rally 87 bps from 2.43% to 1.56%[1]. Entirely possible, but quite a hurdle, nonetheless (Figure 1).

Long term valuations look stretched, and break-evens are thin in most areas of global credit.

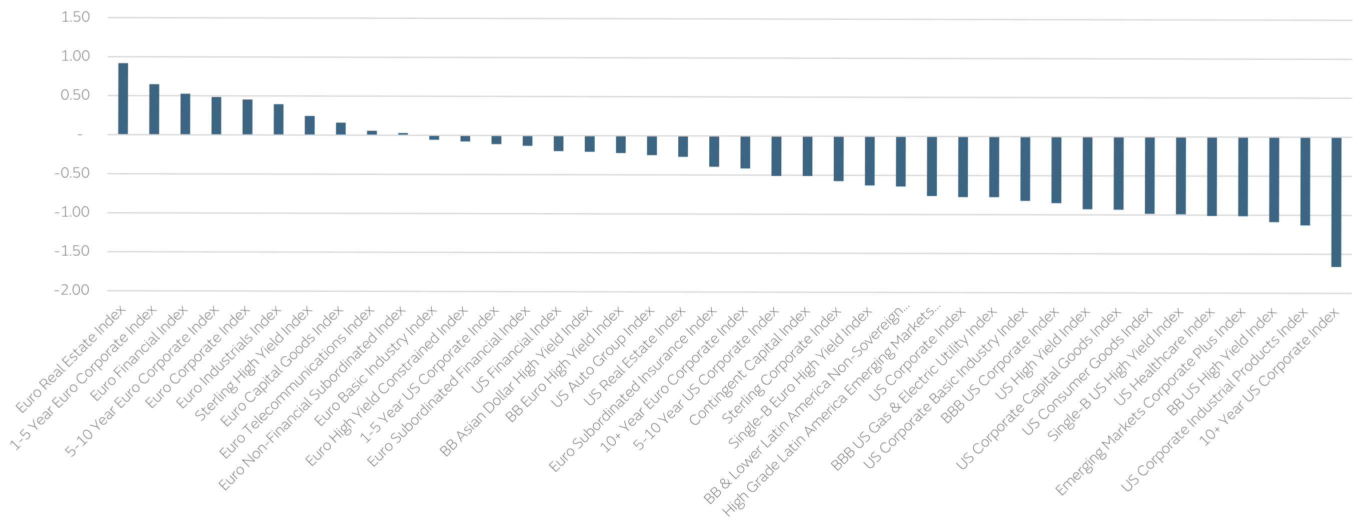


Figure 2: OAS spreads standard deviations from mean for selected indices as at 22.12.2023, Bloomberg

[1]Source: Bloomberg. As of 22.12.2023

We highlighted the relative attractiveness of AT1s and EUR real estate in mid-September in Where we are in credit - A long-term valuation-based approach. Despite a good run recently[2], we would repeat that call: when the subordinated debt of highly regulated and highly rated EUR-zone banks is trading significantly wider than US high yield[3], we think there is relative value to be had. We are, however, getting to levels where meaningful outright longs are no longer merited: AT1s are trading at -0.5 standard deviations to their 10-year mean and we only have a handful of European credit sectors trading meaningfully cheap to their 10-year mean; EUR Real Estate still stands out as cheap, however, with meaningfully worse fundamentals on average. At the expensive end, the US long end stands out; additionally, double Bs in the US are now trading more than 1 standard deviation on the expensive side.

Looking at credit spread break-evens we are seeing a similar story: break-evens have shrunk meaningfully since this time last year and some longer duration parts of the market such as the US long end only have a 9 bps cushion – if spreads widen more than 9 bps over the next 12 months this will eat up all the spread carry and you would be better off in government bonds (Figure 3).

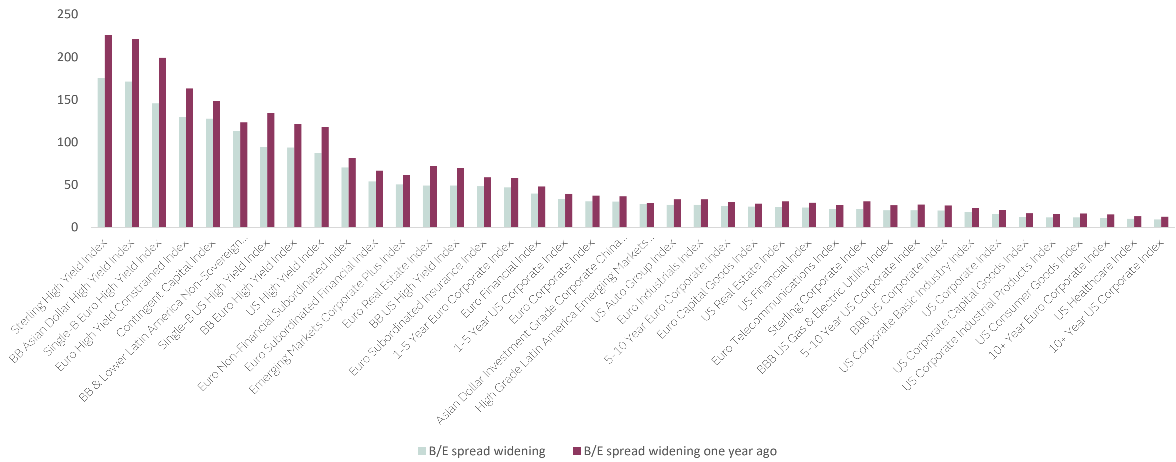


Figure 3: Break-evens for selected indices, as at 22.12.2023, Bloomberg

2. What can go wrong? Specific risks we are looking out for

In the spirit of the late Charlie Munger, we apply the principle of inversion: with upsides somewhat limited, we want to make sure to limit the downsides; we ask ourselves, what is most likely to go wrong and what can we do to protect the portfolio?

US debt sustainability crisis

The US is running a large deficit and larger US treasury supply will be hitting markets in 2024. This could put renewed upward pressure on the US long end and mean renewed positive correlation between risk-free and risky assets. JPM is forecasting a supply of 1.9 trn US Treasuries next year, this is almost double of the average of the last 5 years (1.04 trn)[4]. With the supply outlook more benign for other long duration sectors such as agency debt and investment grade, this would normally be manageable. However, given the debt sustainability dynamics currently in play, we're concerned that, barring a sharp and sustained drop in rates, we could see another sharp sell-off in the long end of the treasury curve. The ratio of money spent on interest payment to tax receipts has been trending upwards and stands currently at 35%. If we assume an average coupon of 4.25% (ramping up from around 3% currently) the deficit stays at 6.26% and tax receipts rise by 3%, we would be looking at 60% of tax receipts being spent on interest payments in 5 years. If the average cost were to go to 5% we'd be looking at almost 70% of tax receipts being spent on interest payments (Figure 4).

[2]EUR Real Estate (EJRE) has returned 2.28% in excess of governments vs 1.05% for EUR IG (ER00). AT1s (COCO) have returned 4.17% in excess of governments vs 1.97% for EUR HY (HEC0). Sept 15th to Dec 22nd 2023.
[3]The COCO index is currently trading at an OAS of 370 vs 339 for US High Yield (H0A0) as of Dec 22nd 2023
[4]Forecast for long-term (>1Y) net issuance, JP Morgan.

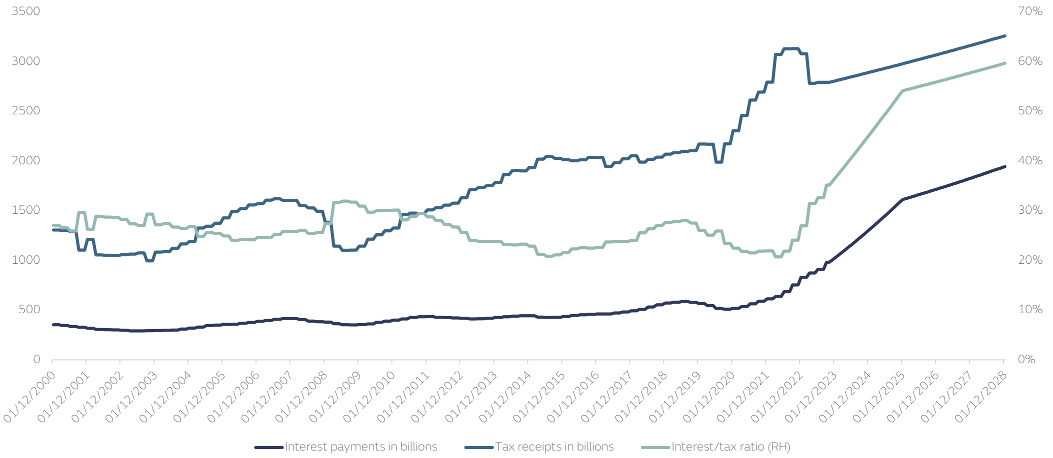


Figure 4: US interest payments, tax receipts and interest payments as ratio of tax receipts. Source: Bloomberg

Sustained wage inflation

Disinflation is finally happening and probably has a little way to go. Was it all transitory after all? There are reasons to believe we've entered a world of higher inflation compared to the last 15 years, and most likely, a higher volatility of inflation world. For now though, it is clear that we are not facing a 1970-80s style inflation cycle in the US. As noted recently by Exante Data[5], the US economy is significantly more open today, Unions play a much smaller role (wage growth is not determined in the same way it once was), AI will have deflationary effects and China's influence on global markets today makes the current situation unique. The near-term surprise could be an undershoot. It is also clear that the bigger picture for the labour market is most likely inflationary. As explained brilliantly by Charles Goodhart and Manoj Pradhan in 2020[6], the world is undergoing a meaningful demographic reversal: the positive labour supply shock we saw as China entered the world economy and the Berlin Wall fell, is reversing and has been for a few years. The developed world and some large emerging economies are getting older, and labour will be more scarce. Elevated wage inflation compared to 2008-2021 is likely here to stay. The simplest way to intuitively demonstrate this is the dependency ratio: the number of individuals aged 65 and over per 100 people of working age, defined as those at ages 20 to 64[7]. The dependency ratio started deteriorating in most developed countries from 2000 onwards but has accelerated in the last 15 years or so. All things equal, this should lead to a higher equilibrium of wage inflation (Figure 5).

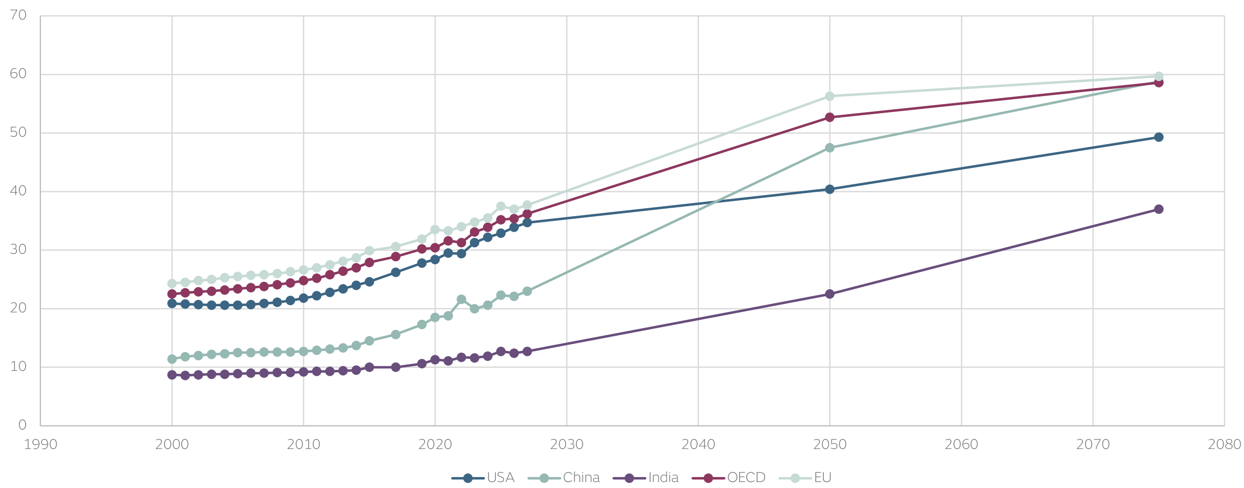


Figure 5: Dependency ratios for selected regions/countries. Source: OECD

[5]Inflation in 2023: How Does It Compare to What We Know? | LinkedIn
[6]The Great Demographic Reversal
[7]Demography - Old-age dependency ratio - OECD Data

Much worse outcome in Europe than anticipated.

Europe faces a plethora of challenges in 2024: sluggish growth, political uncertainty with multiple elections and waning unity around Ukraine, an export sector tied by the hip to China and uniformly poor forward-looking macro data. You might be thinking, what else is new? We think the combination of the following factors makes 2024 particularly perilous:

- The EUR-zone credit impulse is lingering at levels not seen since the global financial crisis. Barring aggressive rate cuts, this is unlikely to change, and growth looks to plummet further.
- The ECB is behind the curve again: too late to start hiking and most likely will be too late to start cutting.
- Leadership in Germany and France look weak, and right-wing parties are winning elections again elsewhere: European unity is under pressure again.
- Could Russia win the war in Ukraine?

And then, of course, there is Donald Trump. As noted by The Economist in November[8], the cheerful response from the markets in 2016 is unlikely to be repeated this time around. The world is in a different place in terms of China, Russia and the economy: 'this time, America is running budget deficits on a scale only seen in war and the cost of servicing debts is higher. Tax cuts would feed inflation, not growth.'

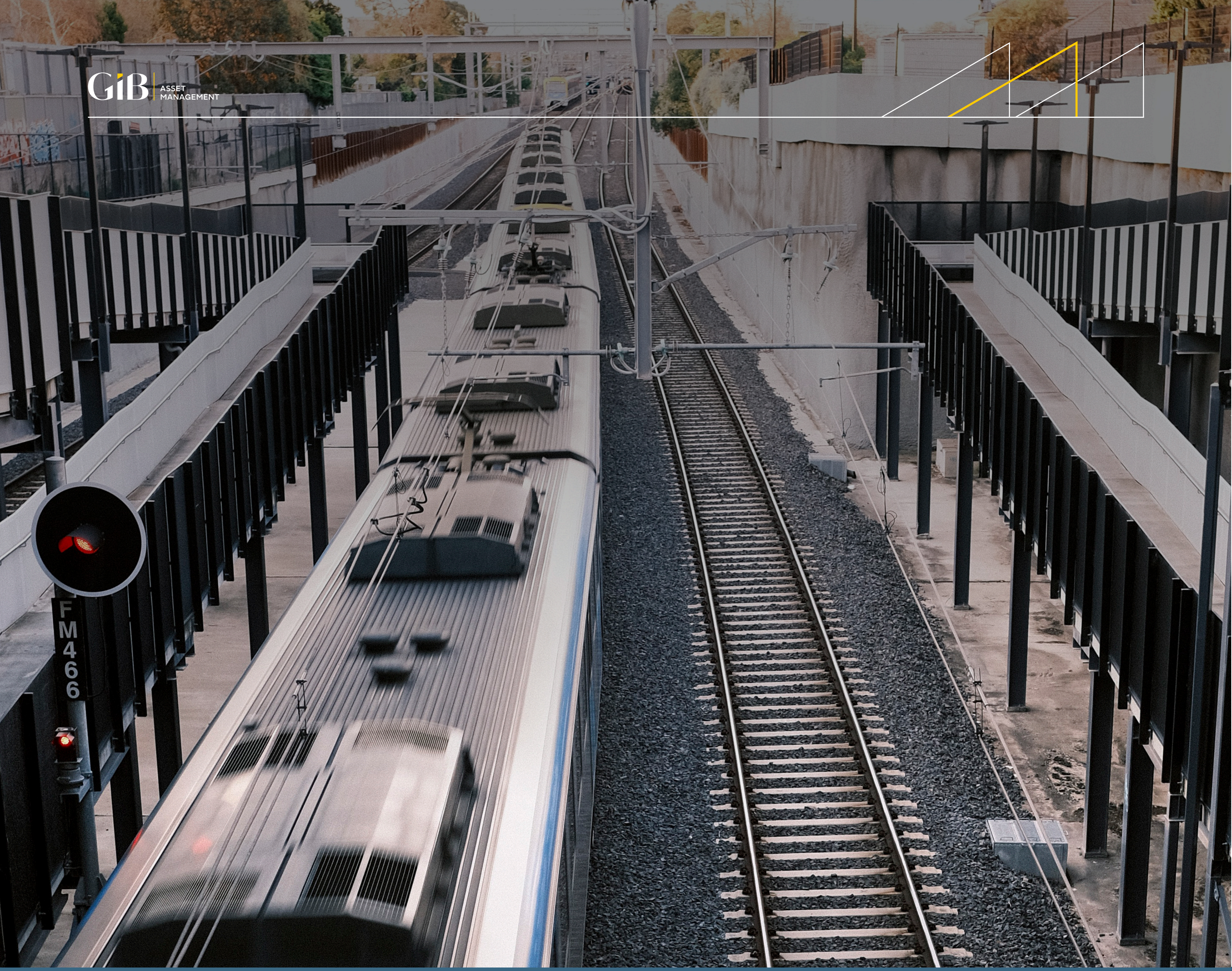
3. Five scenarios for global credit in 2024

We have created 5 objective scenarios (to the extent possible) for 2024 using the global corporate aggregate (LGCPTRUH) as our global credit proxy. The scenarios range from a deep recession to re-acceleration of inflation. If we assume each of these scenarios is equally likely, we find that the simple average comes to 5.3% while the average federal funds rate for 2024 is 4.1%. Judging by these numbers, we are paid to hold global credit, but not by a wide margin, and the comparison to cash is before adjusting for volatility.

Scenario	Total return	Assumptions
Deep recession	10.3%	Rates -200 bps, front end outperforming, spreads +100
Mild recession	6.4%	Rates-50 bps, spreads +25 bps
Muddle through	2.1%	Rates +50 bps, spreads stable
Re-acceleration	-5.0%	Rates +150, spreads +50 bps
Immaculate disinflation	12.6%	Rates -100 bps, front end outperforming, spreads -25 bps

Our scenarios generally feature a lower rate path and we do believe rates are more likely than not to be lower in 12 months' time, however, the real question is really whether rates will outperform cash (the forwards). We see limited scope for generic spread tightening from here, absent of the immaculate disinflation/soft landing scenario. We see a steeper or stable curve in all our scenarios (especially in the US).

[8]Donald Trump poses the biggest danger to the world in 2024 (economist.com)



Conclusion and implications for the portfolio

Given tight credit valuations and aggressive forward pricing, we would tend to fade the recent immaculate disinflation/soft landing narrative. We believe that the recent rally in both rates and risky assets has probably run its course. Thus, in terms of the portfolio, we want to be defensively/neutrally positioned in term of credit beta and focus our attention on relative value opportunities in sectors that still offer attractive spread levels. We are wary of long end duration and are running a slight curve position. In terms of sectors, we are cautious on weaker names in European cyclical sectors and will look to limit our exposure to the US long end credit.

Contact

info@gibam.com
T: +44 (0) 20 7259 3456
Follow us: in

ASSET MANAGEMENT