Variations on a theme: Income opportunities in 2024

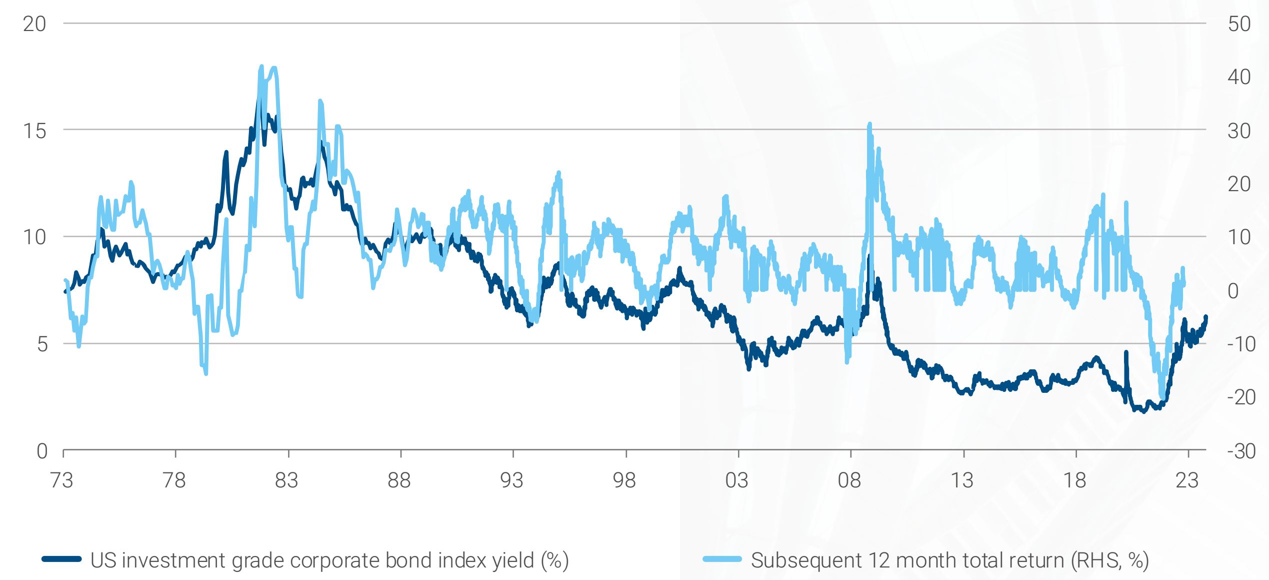
LGIM

Ben Bennett, Investment Strategist APAC, examines the extent to which three different macroeconomic scenarios may affect income opportunities for bond investors as we head into 2024.

The last two years have been difficult for most investors, but especially hard for those in fixed income markets. However, the beauty of bonds is that starting yields have a significant influence on future returns, and today's yields are much higher than we've seen for many years. If US policymakers successfully tame inflation without causing a recession, then we could see a sustained rally in bond prices. However, the macroeconomic backdrop remains difficult and there's a significant chance, in our view, that the US joins Europe and China in an economic downturn in the coming months. A third option is that we're stuck in the purgatory of higher for longer rates, a possibility that has weighed on sentiment in recent weeks.

Taking those three scenarios for 2024, we've looked at potential returns across a range of different bond markets. Depending on your outlook and risk appetite, we believe this should help guide allocation decisions for the coming year.

Figure 1: Bond index yield versus subsequent returns



Source: Barclays, as at 6 October 2023.
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Scenario 1: US recession (60% chance)

We, like many investors, worried that the US would slide into recession in 2023. But while other parts of the world struggled, the US has been a beacon of strength. Last year's toxic mixture of growth downgrades and inflation upgrades sent the line in figure 2. to the top left, but this then moved to the right in 2023 as economists upgraded their growth forecasts for the year.

However, we think drivers of this relative strength will prove transient, namely the surge in the US fiscal deficit, the drawdown of COVID savings by US consumers and the favourable unwind of the supply disruptions which has reduced inflation and raised real incomes. In addition, the recent increase in US real yields, alongside dollar strength, will be squeezing borrowers.

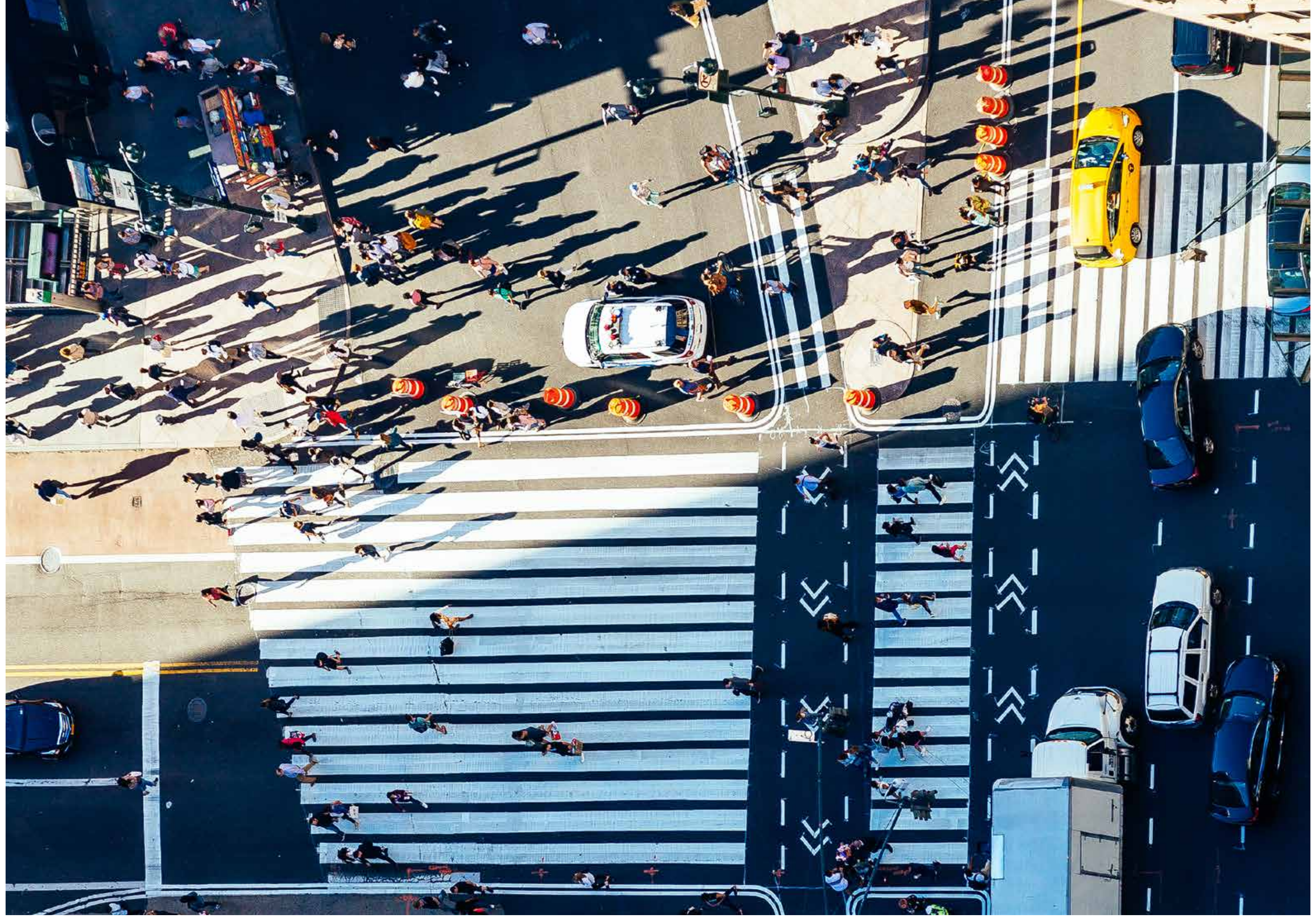
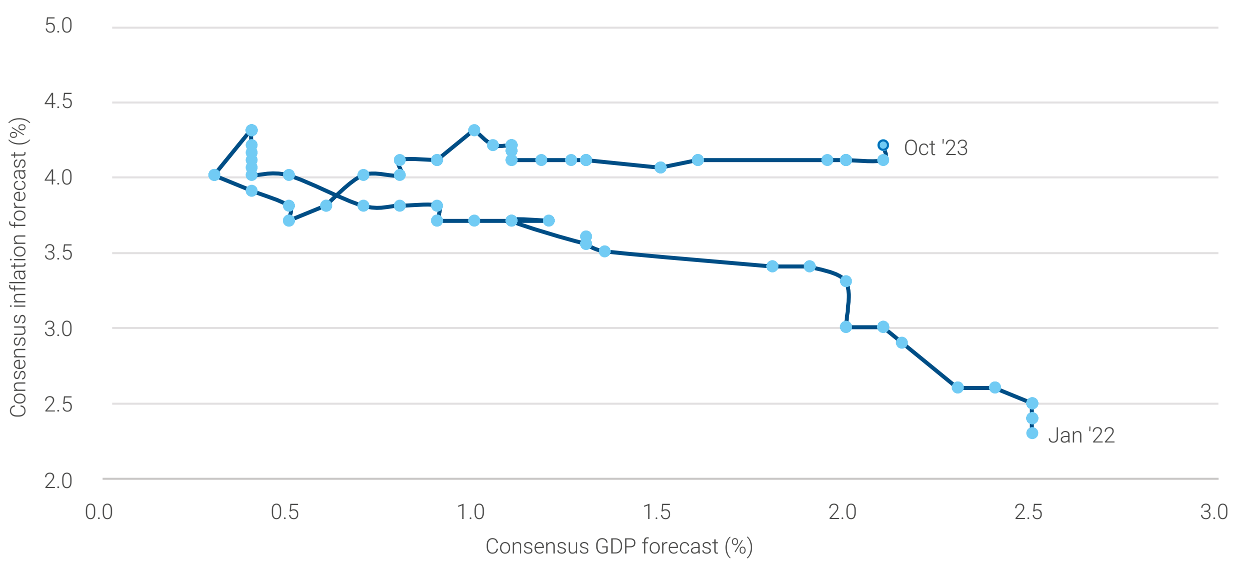


Figure 2: Consensus 2023 growth and inflation forecasts for the US since January 2022

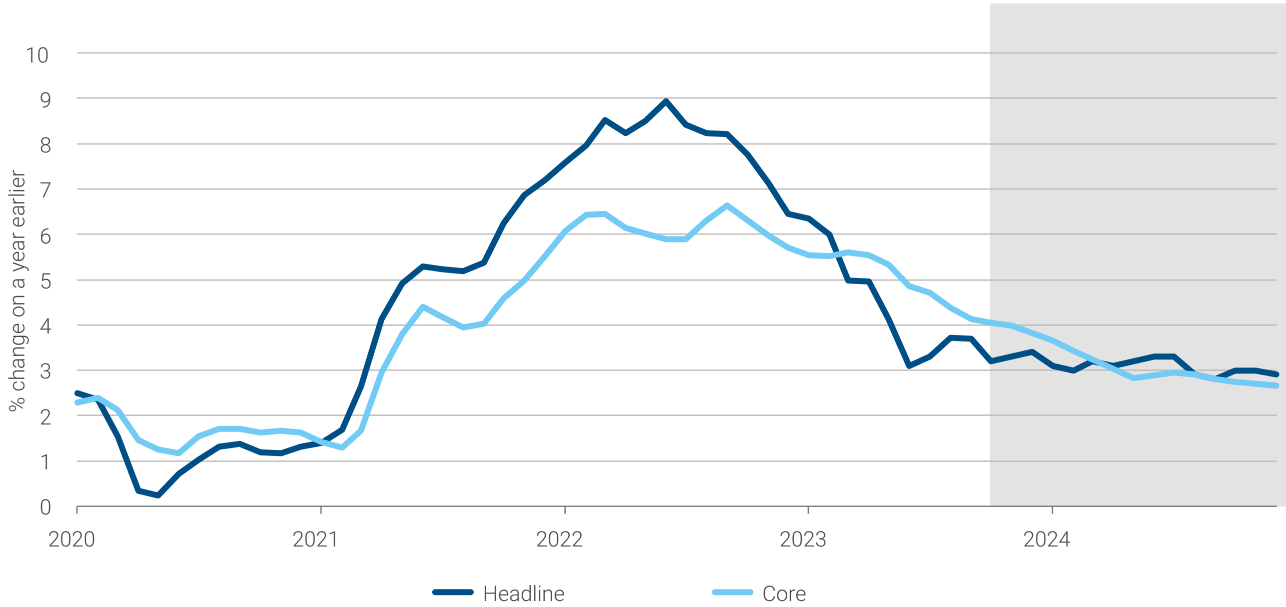


Source: LGIM, Bloomberg L.P. as at 13 October 2023.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Headline inflation is falling, but as figure 2. shows, economists did not revise down their 2023 core inflation forecast this year, and figure 3. shows it has been sticky in recent months. We don't believe the US Federal Reserve (Fed) can ease monetary pressure before inflation is sustainably heading back to target. Unfortunately, we believe the most likely way that happens is by loosening the labour market, risking an economic contraction – our inflation forecast in figure 3. assumes a mild recession in 2024.

On average, economists have been too cautious on the US economic outlook, but they have been right to be worried about growth elsewhere. China's post-COVID rebound has been disappointing, and European growth has stagnated. In the absence of significant fiscal and monetary support, both regions are unlikely to offset a US slowdown in the coming months, in our view. There are pockets of strength across broader emerging markets, notably India, but we believe these are still idiosyncratic stories rather than representing hope for global growth.

Figure 3: US inflation, historical plus LGIM forecast



Source: LGIM, Macrobond, as at 13 October 2023.
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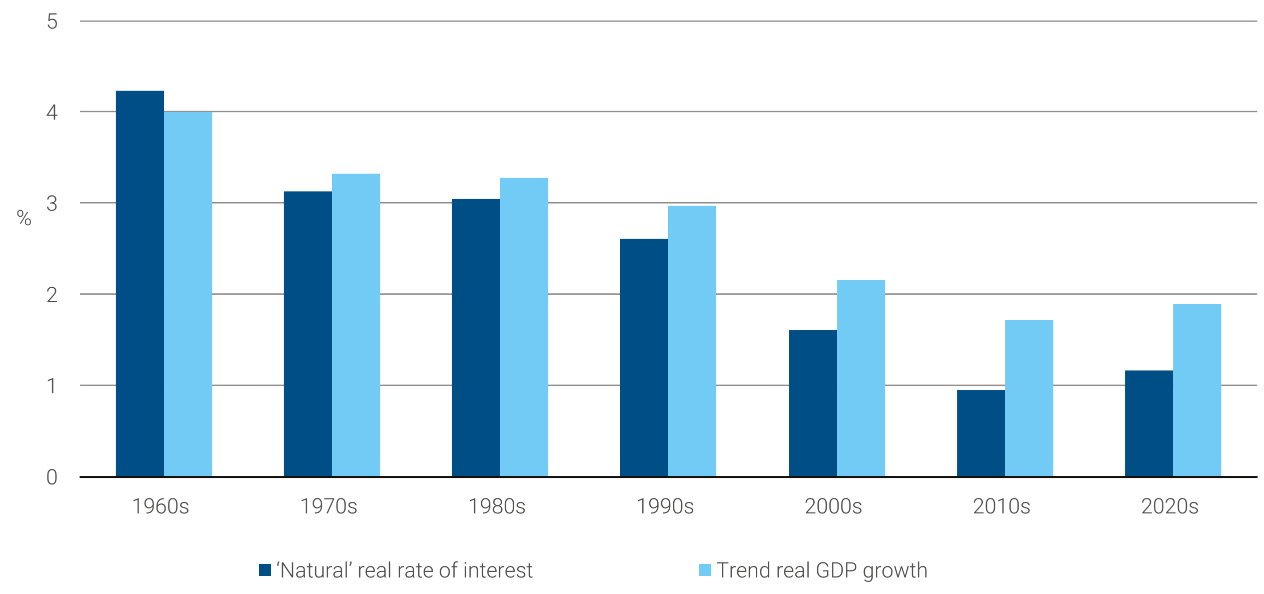
Scenario 2:
Higher for longer (10% chance)

It may raise eyebrows that we assign a low probability to the scenario that actually played out in 2023. We believe that running real interest rates significantly above real potential growth is unsustainable (see figure 4). The Artificial Intelligence (AI) revolution has the potential to raise productivity in the coming years, but we don't believe this will happen quickly enough to offset the squeeze from current elevated real yields. The question is how long this squeeze takes to have a negative economic impact.

As mentioned earlier, the US economy has been boosted in 2023 by various transitory factors that have offset tighter funding conditions. While we don't believe these will persist throughout 2024, they could represent some boost. Perhaps Europe and China can rebound in 2024, providing a growth offset? Perhaps the global manufacturing sector can rebound after its post-COVID slump? And we may be underestimating the immediate productivity impact of AI?

All this is possible, but we still return to the negative impact of higher yields on the global economy. Monetary policy acts with long, and variable lags, but there is already evidence that interest-rate sensitive areas are feeling the bite, with commercial real estate probably the best example. Another year of elevated funding costs will surely cause these cracks to widen? We believe the US economy will have to land one way or another in 2024.

Figure 4: US trend growth and the 'natural' rate of interest



Source: NY Fed Laubach-Williams model, two-sided estimates as at 30 August 2023.
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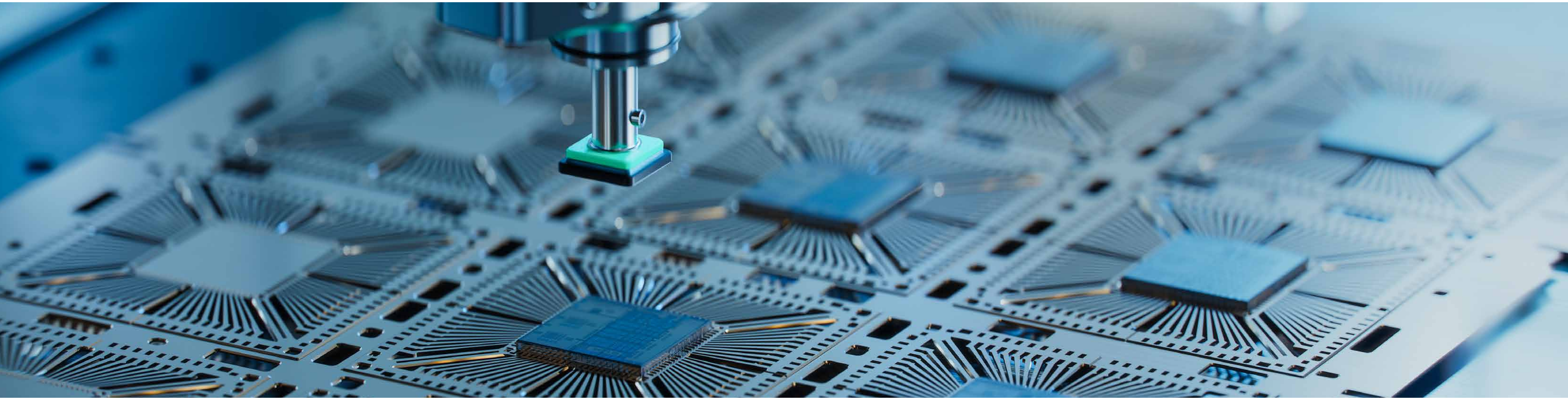

Scenario 3: US soft landing (30% chance)

A problem with the US soft landing scenario is its definition. It's perhaps a little circular, but the key is an absence of a negative impact on credit and equity markets, at the same time as economic imbalances are resolved.

The main symptom of such imbalances is elevated core inflation, alongside high wage inflation. So, we need to see wages falling and core inflation reduce such that interest rates fall without worrying about a destabilising economic contraction.

If US unemployment starts to rise over several months, would investors cheer a soft landing, or worry about an approaching recession? How quickly would the Fed decide that we're on a sustainable path to target inflation and loosen monetary conditions? All this has yet to be tested. History suggests that when unemployment starts to rise, it often leads to a recession, and even if it doesn't, investors will worry about it. But for all the reasons discussed earlier, today's post-COVID macroeconomic backdrop is unique. At the very least, the fact that interest rates have moved by such a huge amount across large areas of the globe while, so far, avoiding a growth discontinuity suggests we should be humble about our recession forecast.

Market implications

Why do our three macro scenarios focus on the US economic outlook? One reason is that the US economy is the world's largest and influences broad asset classes like no other. Second, while the European and Chinese economies have both slowed this year and are starting to resolve imbalances, the US economic landing is still uncertain. And third, for the purpose of this outlook we are focusing on bond markets. To have the most relevance for investors, we have looked at US dollar-

denominated asset classes – investment-grade and high-yield bonds, leveraged loans and emerging market debt. We have also looked at local currency emerging market debt, but here the influence of the US dollar is also very strong, and we have estimated future returns in US dollar terms.

The probabilities assigned to each scenario indicate our macro forecast bias as we head towards 2024. Individual investors will have different weights, and these can change significantly over time. But hopefully we have described most investors' three main scenarios for the coming twelve months, and therefore the implications for bond market returns will have universal relevance.

One final note – it's very difficult to forecast returns for the US recession scenario, as markets will be very volatile. In other words, credit spreads would spike and then be very sensitive to policymaker interventions. The returns in the following tables represent the potential returns over twelve months, but they could be much worse at times during that period.

To put context around the bond returns we forecast, table 1. sets out roughly how US short rates, 10-year Treasury yields and the S&P 500 index could react under each scenario.

Table 1: Scenario assumptions

	Start	US recession	Higher for longer	Soft landing
3-month US$ OIS	5.4%	2.0%	5.0%	3.0%
10-year Treasury yield	4.7%	3.0%	5.0%	4.0%
S&P 500 index return	4374	-25%	5%	15%

Source: LGIM, as at 13 October 2023.
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Note that a US recession would lead to lower government bond yields, which could be a relief for credit and equity markets in the short term, but we believe this will eventually lead to weakness as earnings expectations decline and default risk increases. The higher for longer scenario could be volatile given we do not believe it to be sustainable, but the lack of a recession probably allows equity markets to provide modest positive returns, while credit spreads could ease a little wider as some companies struggle with the backdrop of elevated financing costs.

The US soft landing scenario would be universally positive in our view. However, we think the absolute S&P 500 index upside is less than the recession scenario's downside. Given their underperformance in 2023, equity indices in Europe and China could benefit more from a US soft landing, in our view.

Figure 5: Credit spreads tend to spike wider in recessions

Source: Barclays, NBER, LGIM, as at 13 October 2023.

How, do we believe, this translates to bond market returns?

- It is striking that there are not very many negative numbers in table 2., particularly for longer-dated US dollar denominated assets. As discussed at the beginning, high starting yields play a significant role. But it must also be noted that risk free rates are currently elevated, with three-month US$ Overnight Index Swaps (OIS) above 5% at the time of writing. Fixed income investors have been satisfied with positive returns during the era of ultra-low bond yields, but perhaps the new hurdle for success should be 5% following the recent hiking cycle. This dampens the appeal of the returns in table 2. and is perhaps one reason why fund flows into high-yield and emerging market credit have been weak despite high yields (as reported by EPFR).

- Unlike equity markets, credit investors face lower downside risk in a recession than upside potential in a soft landing, in our view. This is a function of credit spreads that are some way off their lows, as well as underlying government bond yields providing a natural hedge.

- This recession hedge is particularly strong for longer-duration assets such as investment-grade corporate bonds that would benefit the most from falling government bond yields.

- The potential downside risk in a recession for short-duration credit, like leveraged loans, is more acute.

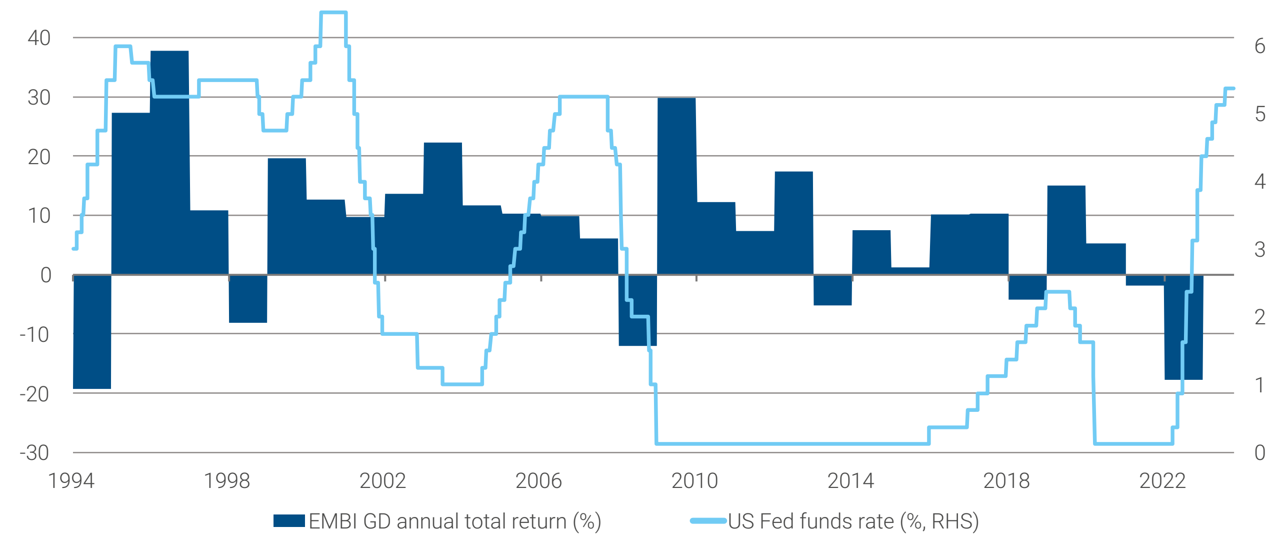
- Lower-rated credit, like high yield and leveraged loans, faces significant default risk in a recession. We have also modelled elevated defaults in the higher for longer scenario as weaker companies struggle under tighter lending conditions.

- The absolute return credit outcomes appear poor as we've assumed very little interest rate duration, but significant credit risk. In reality, such benchmark-agnostic funds are likely to be run with active hedges which could include being long duration.

- As figure 6. highlights, emerging markets have suffered when US monetary policy has tightened for a prolonged period of time, particularly when followed by a US recession. However, our outlook is more benign this time thanks to higher starting real yields across emerging markets and a relatively strong growth outlook. China's economic performance will be an important variable for next year.

- Within emerging markets, we believe local currency bonds face more downside risk in a recession scenario based on lower starting yields and sensitivity to a rising US dollar. This could be mitigated by aggressive easing from the Fed.

Figure 6: Emerging market bond returns can be impacted by US monetary policy



Source: JP Morgan, Bloomberg L.P., Eikon, LGIM, as at 13 October 2023.
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Table 2: Bond market total returns

	US recession	Higher for longer	US soft landing	Probability adjusted return
Starting yields in brackets	60%	10%	30%	
US$ investment-grade corporate (6.2%)	5.4%	5.6%	14.0%	8.0%
US$ high-yield corporate (9.1%)	0.5%	5.2%	15.4%	5.5%
US$ leveraged loans (10.1%)	-6.4%	6.8%	11.4%	0.3%
US$ emerging market sovereigns (9.3%)	-0.3%	4.9%	17.7%	5.7%
Local currency emerging market sovereign* (6.8%)	-6.5%	1.8%	15.6%	1.0%
Absolute return credit**	-8.8%	6.3%	9.0%	-2.0%

Source: LGIM, Bloomberg L.P. indices, JP Morgan Emerging Market indices, as at 13 October 2023.
* Returns for local currency emerging market sovereign are in US dollar terms.
** Cash plus the excess return of 50% US$ investment-grade corporate, 25% US$ high yield corporate and 25% US$ emerging market sovereigns.
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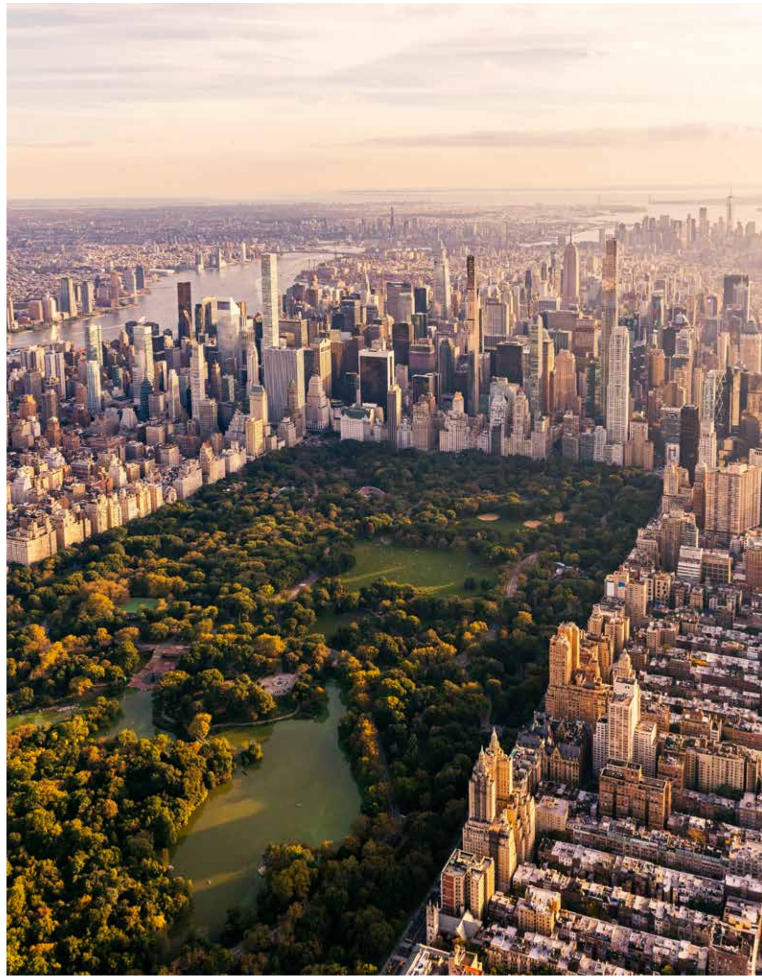
The bottom line

Two years of rising bond yields have been bad for fixed income returns, and, we believe, the macroeconomic backdrop for 2024 remains difficult given the elevated risk of a US recession. However, with high starting yields, we feel fixed income investors now have significant protection against further volatility. We believe returns under a US soft landing scenario could be unusually high, while even under a US recession, or higher for longer scenarios, downside risk should be less than experienced during previous downturns, in our view. In particular, investors should not discount the hedging power of interest rate duration, which, we believe, makes the return profile for investment-grade corporates attractive.



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