Fixed income under the spotlight

Exploring tail risks and what-if scenarios in the Year of the Dragon

Pilar Gomez-Bravo

In a year marked by geopolitical uncertainties, economic policies, and potential market volatilities, 2024 presents a landscape fraught with challenges and opportunities.

The Year of the Dragon is supposed to bring good luck, and 2024 certainly seems to have started this way. Following healthy market performance in 2023, a soft landing in the United States and elsewhere is now the consensus view. While risk markets have priced in this scenario, we see three tail risks that could derail this soft landing scenario. In this article we share our thoughts on how our global fixed income strategies are positioning exposures given these tail risks.

In brief:

- Geopolitics is particularly challenging this year due to elections, wars and macro policies.
- A no landing scenario could be a worse outcome for markets than a soft landing one.
- A rapid unwind of leverage, while difficult to assess, would have a material adverse impact on credit markets and risky assets in general.

Tail risk 1: Geopolitics

Geopolitics always presents a risk, but the large number of elections, ongoing wars and evolving macro policies make this year particularly challenging.

As we move through the year, the US presidential election will be a major focus. Whoever wins, there will be broad implications for security risks, global trade and fiscal policy. If Donald Trump wins, the long-term path of the US dollar should be the focus, especially if there are questions around the rule of law or the institutional strength of the United States. In addition, there could be significant adverse outcomes for certain sectors or asset classes, and in particular for emerging markets.

The path of US fiscal policy is also high on our radar. Usually in election years, the incumbent president loosens fiscal policy. This time the fiscal deficit is quite stretched already, and we do not expect a material change in the overall fiscal deficit this year. Regardless of who wins, we expect a sizable deficit to persist, but the fiscal contours would be different as Democrats would likely continue to focus on spending while Republicans would likely focus on tax cuts. With that in mind, we will continue to discuss debt sustainability issues in the US and the path of term premia in the yield curve. Outside the US, European Parliament and Commission elections in June could introduce fiscal or policy friction, which again may impact currencies and local bond markets.

Discussing the market impact further, the ongoing wars in Ukraine and the Middle East bring a renewed focus on energy and commodities. Europe is better prepared today for energy shortages than when the Ukraine conflict started. However, the energy market could still unravel, particularly if troubles escalate in the Middle East. We are already seeing impacts on supply chains and the cost of commodities, so understanding how the price of oil impacts risk in portfolios is important. In terms of tail risks, potential conflagrations of tensions in other geopolitical hotspots like North Korea and Taiwan bear watching.

The final geopolitical element is the development of macro policies and the economic environment in China and Japan but in each for different reasons. With China, we worry that the country could end up exporting deflation if its current stimulus program does not yield sufficient growth, which would be a negative for Germany and emerging markets as they exhibit the high levels of trade with China. With Japan, the tail risk would be a disorderly move away from its negative interest rate policy. A strong, sharp appreciation in the yen could lead to an unwind of foreign assets by Japanese investors. This profitable carry trade has existed for many years, and its unwind could potentially trigger higher yields in global core rate markets and bear steepening of yield curves.

Tail risk 2: Which landing?

While the chances of a hard landing have fallen, the tail risk of no landing in the US has become more apparent this year. The consequences of no landing could be significant, in particular the risks coming from potentially higher inflation. Stagflation is the scariest scenario for equity and fixed income investors, but a no-landing scenario presents its own issues. In a no-landing, the economy reaccelerates, continuing to grow above its potential, which would likely cause inflation to rise again. Should this tail risk happen, any rate cut cycle would be short-lived, if it occurs, and it would present a difficult scenario for central bankers and investors. We see a no-landing as detrimental to all asset classes because higher inflation would likely lead to an aggressive reaction from the US Federal Reserve. Although this scenario is unlikely, its impact would be significant, so it is worth watching for.

Tail risk 3:Unwind of leverage

Our final tail risk is more difficult to measure and exists because we live in a world with crowded trades. Most investors have coalesced around a soft landing scenario and consequently have similar investment theses and positions in their portfolios. Given the rate rises, leverage is no longer free. Therefore, we need to consider systemic risk coming from entities that rely on significant leverage as part of their business model, such as financial institutions. Even though their capital ratios are better today, in particular in Europe, we believe another idiosyncratic bank failure headline, due this time to commercial real estate exposures, is possible. Hedge funds also present a tail risk. In a world where leverage is expensive, some of their business models may not work. While private credit may also present a risk (if they have to crystallise losses), the risk isn't as systemic given its small size compared to the overall size of public bond markets or the magnitude of the impact a potential unwind of leverage could have.

With this tail risk, investors have to be early not to be late, and a strong valuation discipline is key. In other words, we believe it is best to be a provider of liquidity rather than trying to exit crowded trades in an illiquid market. Being nimble, diversified and focused on security selection makes sense in such an uncertain environment.

Navigating tail risks: Portfolio positioning and market view

In the current environment there are likely to be winners and losers. Given the ongoing uncertainty, our focus is on diversification and liquidity in portfolios. Our goal is to take advantage of dislocations and collect risk premia from security selection and conviction views around rates and currencies.

Interest rates and duration

We have significantly reduced our duration this year based on the market rally at the end of last year and the persistently strong macro data in the US.

We have focused on markets where the macro dynamics between growth and inflation are more conducive for rate cuts. For example, Europe and some emerging markets still present attractive opportunities from valuation and rate cut expectations. In addition, US-dollar-based investors may potentially benefit significantly from investing outside of the country and hedging exposures back to US dollars.

We are also utilising yield curve trades more actively in portfolios. In our view, whether we see a soft or hard landing, curves will likely steepen at some point, and as a result we are looking to efficiently express curve steepening trades, particularly in the US, which allows us to add duration if yields increase significantly again.

Currencies

We have reduced our exposure to the US dollar but are still overweight due to continued uncertainty. Given the macro and geopolitical risks, markets may still experience periods of risk-off sentiment.

Spread sectors

Due to the potential unwind of leverage, security selection remains important in spread markets. Listening to analysts' best ideas and having conviction on them is key for us.

In high yield, we are focusing on shorter-duration and higher-yielding securities, seeking higher total return per unit of exposure given that our current allocation is low relative to our historic range due to overall tight spreads in this market.

With regard to investment grade, we have reduced our position in the US given the significant year-to-date rally. While investment grade remains attractive from a fundamental perspective given a solid economy and robust, though weakening, balance sheets, overall spreads are tight. Even though spreads can remain tight for an extended period of time, we continue to prefer European credit on a valuation basis.

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Pilar is co-chief investment officer of Fixed Income at MFS Investment Management. She oversees MFS' global fixed income team and is a portfolio manager for the firm's Global Aggregate and Global Credit portfolios. Based in London, Pilar joined MFS in 2013 and has held various leadership roles. She has extensive experience from previous positions at Imperial Capital, Negentropy Capital, Marengo Asset Management, Neuberger Berman, and Lehman Brothers. Pilar holds degrees in Law, Economics, and an MBA from MIT.

The quote

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Within emerging markets, we continue to prefer the crossover space as idiosyncratic opportunities arise from risk premia without the need for large hard-currency exposure.

Securitised assets appear an overcrowded trade, especially in the mortgage sector. We still have some exposure to the securitised market, focusing on areas we think banks will buy if they re-enter the market. This provides some downside risk management in case technicals remain challenging for mortgages.

In navigating the ongoing complexities of 2024, the focus remains on prudent portfolio positioning, with an emphasis on diversification, liquidity, and rigorous risk management. **FS**

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