



The *Viewpoints* series gives investors Lazard's perspectives on the latest macroeconomic and fixed income news and trends. It reflects the views of the firm's dedicated specialists, who independently manage portfolios across the entire range of asset classes and sectors.

## Is the Bond Market Priced for Perfection?

Waves of good news on the US economy—showing it was not too hot and not too cold—helped drive a relentless rally in US Treasury bonds over the past month, culminating in what appeared to be the official end to the Federal Reserve's rate-hike cycle.

Following its meeting in mid-December, the Federal Open Markets Committee (FOMC) left interest rates unchanged and released its new policy-rate projections, or "dot plot," revealing that members expected no more rate hikes and three rate cuts in 2024. The "pivot" added fuel to the rally that began in late October and sent the benchmark 10-year yield below 4.0%—a plunge of more than 110 basis points (bps) over that time.<sup>1</sup>

The Fed's news fit well into the market's predominant narrative that the economy would achieve a soft landing. Reflecting this view, the 10-year inflation expectation (breakeven) rate dropped to an impressive 2.2% by December, only slightly more than the Fed's inflation target of 2%.

Amid all the positive news, however, came one surprising development: The inversion of US and European yield curves increased during the bond rally—and yield curve inversion has historically been a precursor to recession. The difference, or spread, between 2-year and 10-year US Treasury yields, which had reached a recent peak of nearly -15 bps in October, slid back to more than -50 bps by mid-December. The inversion between 3-month and 10-year yields was even greater at more than -140 bps.

When Lazard's fixed income professionals met this month, increased inversion of the yield curve served as a reminder that a recession in the United States is still possible—even as much of the bond market looked "priced for perfection," in their view. In fact, nine out of the past 12 Fed rate-hike cycles ended in recessions, our analysts observed; out of the three cycles that did not, two involved preemptive tightening by the Fed, unlike the latest round.

How can bond investors reconcile this contradiction?

Steering toward higher quality bonds has been one approach to mitigating recession risk over the past year—and it continues to be, according to our bond teams. But as they discussed at this month's meeting, there are additional ways to invest prudently while also seeking attractive yield and capital appreciation.

## US: Too Far, Too Fast?

One solution to our US team was investing in Agency mortgage-backed securities (MBS), which were attractive on both an absolute historical basis and relative to US Treasuries and corporate credit. Since the second quarter of this year, the team has been overweighted Agency MBS and underweighted investment grade credit.

Agency MBS carry virtually no credit risk because they are backed by high quality assets and ultimately guaranteed by government-sponsored housing agencies; as a result, they should have the potential to outperform corporates in a recession or sharp slowdown in economic growth. Following the first-quarter regional banking crisis and subsequent bank bond portfolio sales managed by the FDIC, spreads on Agency MBS had widened significantly, especially for lower-coupon securities, which carry positive convexity and the potential for very favorable returns in lower-rate/higher-prepayment environments. This made them an attractive alternative to corporate credit, in our specialists' view.

By comparison, high quality credit appears “fully priced,” with seemingly no negative outcome scenarios factored into valuation levels, and the lower tiers of the high yield sector—single-B and below—could be vulnerable to losses in the event of a recession or sudden slowdown. The Treasury market has also come very far very fast, our analysts noted. They saw fair value for the 10-year yield at 4.50% and higher, making current yields unattractive indeed.

The team saw more opportunities than agency MBS, however. Yield curve positioning was one—specifically, preparing for a re-steepening of the curve. As Fed rate cuts come into view, our specialists expect the yield curve to “normalize,” with short-term Treasury yields dropping, a move known as a “bull steepener.” In a taste of what may come, the 2-year yield dropped 30 bps on the day that the Fed released its forecasts for easing.

Though credit and Treasuries were deemed expensive by our team in mid-December, they had a memorable November in terms of performance. The Bloomberg US Aggregate Bond Index posted an astounding 4.53% return in November, its best monthly performance since 1985.

High quality credit securities, as measured by the Bloomberg US Investment Grade Corporate Index, gained almost 6% for the month.

## Europe: Moving Ahead

While the US economy proved surprisingly resilient over 2023, things have turned out differently for Europe. The deterioration in the economic picture has been so thorough that a recession for the region was a distinct possibility, the fixed income team observed.

With inflation falling rapidly (November headline CPI for the eurozone dropped to 2.4% from 2.9% in October<sup>2</sup>), the European Central Bank held the policy rate steady at its December meeting, and as our analysts noted, the bank could begin easing before the Fed does—possibly as soon as the first quarter of 2024. If a recession materializes, they expected it to be shallow and followed by a quick recovery, putting Europe “ahead” of the United States in the economic cycle.

Investment strategy in Europe has been different in some ways from that in the United States as a result. Our European analysts had a more favorable take on investment grade credit, for example. Although they predicted some pressure on credit spreads in early 2024 due to an increase in issuance, if the economy bounces back over the year, as they expect, credit should also recover nicely.

In addition, our European team leaned more toward increasing duration strategically—as a medium- or long-term position—although they took a cautious approach tactically because of current high government debt levels that could drive yields up at any point. Our European analysts were closely watching developments in Italy, where deficits were projected to widen and the debt-to-GDP ratio has been on the rise.<sup>3</sup>

Credit yield overall has been higher than the equity dividend yield in both Europe and the United States in 2023—reversing a 10-year trend.<sup>4</sup> In our team's view, that strongly supports the case for not only remaining invested in fixed income but also adding to holdings when the opportunity arises. Investment flows into European bonds have been positive for most of this year, recovering from the steep outflows of 2022, according to research from EPFR and Barclays.

As in the United States, the recent rally in government bonds seemed overdone to our analysts in Europe. Also similarly, European portfolio managers were busy positioning for a re-steepening of the yield curve, which they expected to be a big theme in 2024.

Outside of Continental Europe, the UK was looking at a challenging macroeconomic picture, and the Bank of England left interest rates steady at its last meeting of 2023. But opportunities beckoned to our global fixed income team in Asia: In the team's view, the outlook for fixed income was bright in Australia and New Zealand for both currency-hedged and unhedged investments.

## Emerging Markets: Beginning the Descent

If Europe was slightly ahead of the United States in the economic cycle, emerging markets were in the lead—and that was generally good news for bond investors.

Thanks to central bank rate increases that began in 2021, the resolution of supply chain bottlenecks, and favorable base effects, emerging markets inflation has dropped from its peak of more than 9% in 2022 to 4.5% as of early December.<sup>5</sup> Although prices for services have been slow to drop, the overall downward trend will likely continue, with inflation sliding to 4% in the months ahead, according to Lazard's emerging markets specialists. That should allow investors to shift their focus from tracking CPIs to considering important fundamentals, such as fiscal health, they added.

Our analysts expected some variations in inflation among regions and countries in the coming year: an uptick in Asia but a rate still below 3%; a struggle with tight labor markets and wage pressures in EMEA; and persistent disinflation in Latin America, where interest rates have been the most restrictive.

With inflation under control, central banks are expected to begin—or in some cases, continue—cutting interest rates, creating the potential for investors to capitalize on rate divergences as well as opportunities for capital appreciation in local bond markets. At this point in the cycle, real rates can also be attractive, our analysts noted. Brazil and Mexico have been the standouts to them lately.

So far, six developing countries have lowered rates: Brazil, Chile, Hungary, Peru, Poland, and Uruguay. Countries such as Brazil that have taken a measured approach to cuts, communicated their plans well, and left plenty of yield “cushion” in case of unexpected volatility were the most attractive to our analysts, particularly as the Fed has continued to hold the US policy rate at its peak. A few central banks, including those in Chile and Hungary, have slowed their pace or backtracked after starting to ease aggressively.

## Staying Balanced

Showing restraint could also be the way forward for investors. As the US economy has cooled and Fed officials have signaled the end of their tightening cycle, much of the bond market appears to be driving without guardrails, according to our fixed income experts.

By their calculations, current bond pricing, especially in the credit market, does not take the possibility of recession into account even as a left-tail risk. In their view, the exuberance over the Fed's pivot and the possibility of a soft landing needs to be weighed against the downside risks.

The good news, as our bond experts discussed at this month's meeting, is that as the world emerges from the long shadow of the COVID-19 pandemic, rates and credit have started to diverge in some markets, reflecting other, idiosyncratic concerns—and creating new opportunities for active fixed income investors.

## Fixed Income Platform

Investment Teams	Investment Strategies
Global Fixed Income	The Lazard Global Fixed Income team manages the Global Core, Scandinavian & Euro High Quality, Euro Covered Bonds, Euro Corporate, Nordic High Yield and Euro Total Return Balanced strategies. Within these strategies the team seeks to generate performance through active management in Global capital markets.
US Fixed Income	The Lazard US Fixed Income team manages the US Short Duration, US Core, US Tax Exempt, and US Corporate Income strategies. The team seeks to derive benefits from the mispricing of securities based on various factors, including but not limited to, their assessment of credit quality, structure, and market sponsorship.
Emerging Markets Debt	The Lazard Emerging Markets Debt team manages the Emerging Markets Debt – Blend; Emerging Markets Debt – Core; Emerging Markets Debt – Corporate; Emerging Markets Debt – Local Debt; and Emerging Markets Debt – Total Return strategies. These strategies offer exposure to emerging markets bonds in local and/or hard currencies across regions.
Emerging Income	The Lazard Emerging Income team offers the Emerging Income and Emerging Markets Income strategies, which seek to invest in local emerging markets instruments, including currency forwards and local currency debt.
Lazard Frères Gestion	The Lazard Frères Gestion (LFG) Fixed Income team provides a range of strategies covering the full credit spectrum: Investment Grade, High Yield, Subordinated Debt. The team seeks to generate alpha through an active and flexible approach of interest rate and credit risk. The team also manages Fixed Income Credit Maturity strategies.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

## Notes

- 1 Treasury yields and spreads in this Viewpoints are sourced from the U.S. Treasury Department. [Resource Center | U.S. Department of the Treasury](#)
- 2 Reuters, 30 November 2023. [Euro zone inflation tumble pits ECB against markets | Reuters](#)
- 3 Bloomberg, 15 November 2023. [Meloni's Italian Deficit Outlook Isn't So Rosy in EU View - Bloomberg](#)
- 4 Credit yield based on iBoxx Corporate and equity dividend yield based on STOXX 600 and S&P 500 indices.
- 5 Based on data from JP Morgan Global Bond Index (GBI) Emerging Markets Headline CPI

## Important Information

Published on 19 December 2023.

An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Emerging markets securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in these countries. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

The indices referenced in this document are included merely to show general trends in the market during the periods indicated and are not intended to imply that investments made pursuant to the strategy are or will be comparable to any index in either composition or element of risk. The strategy is not restricted to securities comprising any index. The strategy may use various investment techniques not reflected in an index. The indices referenced herein are unmanaged and have no fees. One cannot invest directly in an index. There is no guarantee that the strategy's performance will meet or exceed any index.

Certain information contained herein constitutes "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "intent," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events may differ materially from those reflected or contemplated in such forward-looking statements.

This document reflects the views of Lazard Asset Management LLC or its affiliates ("Lazard") based upon information believed to be reliable as of the publication date. There is no guarantee that any forecast or opinion will be realized. This document is provided by Lazard Asset Management LLC or its affiliates ("Lazard") for informational purposes only. Nothing herein constitutes investment advice or a recommendation relating to any security, commodity, derivative, investment management service, or investment product. Investments in securities, derivatives, and commodities involve risk, will fluctuate in price, and may result in losses. Certain assets held in Lazard's investment portfolios, in particular alternative investment portfolios, can involve high degrees of risk and volatility when compared to other assets. Similarly, certain assets held in Lazard's investment portfolios may trade in less liquid or efficient markets, which can affect investment performance. Past performance does not guarantee future results. The views expressed herein are subject to change and may differ from the views of other Lazard investment professionals.

This document is intended only for persons residing in jurisdictions where its distribution or availability is consistent with local laws and Lazard's local regulatory authorizations. Please visit [www.lazardassetmanagement.com/globaldisclosure](http://www.lazardassetmanagement.com/globaldisclosure) for the specific Lazard entities that have issued this document and the scope of their authorized activities.