Market Insights
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The Big Mac on Macro Regimes

The Market Paradigm Shift

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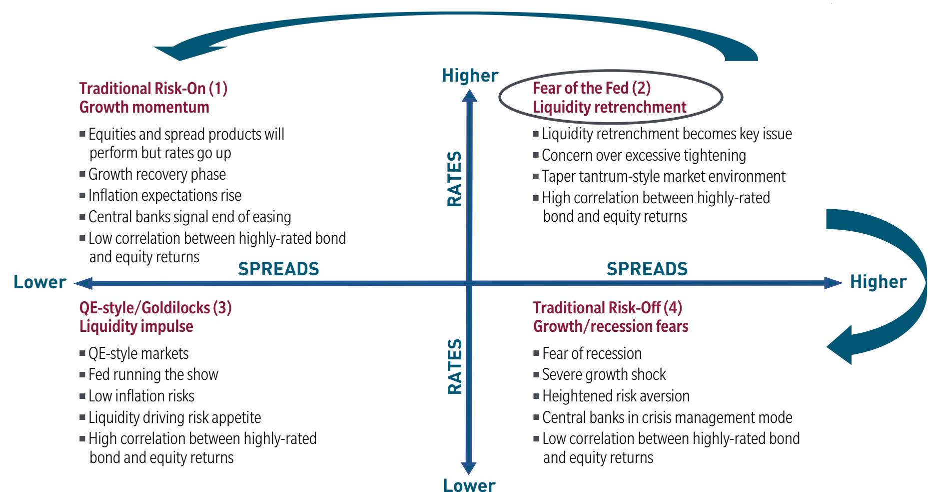
We are likely to witness a paradigm shift in global markets. The prevailing macro regime, the "fear of the Fed," is likely to end in the near future. We believe as we transition from this regime, the market narrative will shift from liquidity to growth. The fear of the Fed was the worst-case scenario for bonds. A shift away from it should bring better prospects for fixed income returns, and in our view it may be time to consider raising allocations to fixed income.

The fear of the Fed is over. The fear of the Fed macro regime took hold in late 2021, when it became clear that the beginning of the US Federal Reserve's tightening cycle was imminent. The dominance of this macro regime had devastating consequences for global markets, with many asset classes suffering their largest losses in decades as interest rates moved higher. Meanwhile, credit spreads widened and risky assets, including equities, sold off aggressively (see top-right quadrant of Exhibit 1).[1]

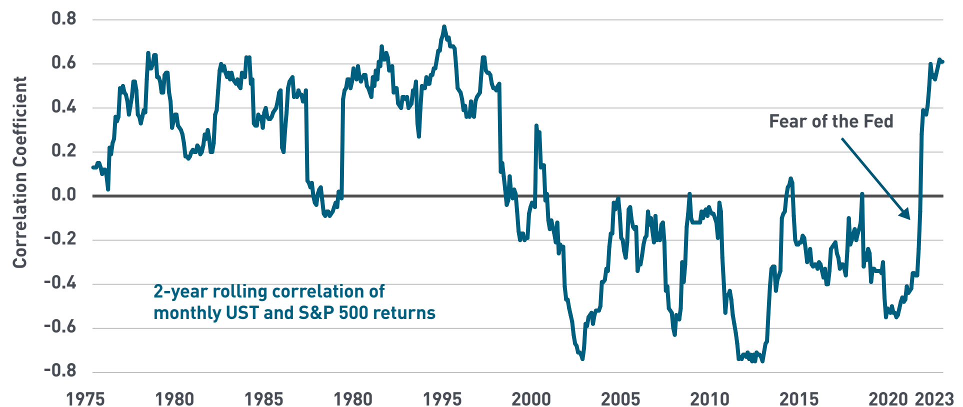
Exhibit 1: Four Global Macro Fixed Income Regimes



Source: MFS, for illustration purposes only.

In addition, the correlation between bonds and equities turned positive, undermining fixed income's value proposition as a portfolio diversifier (Exhibit 2). But we now believe the days of the fear of the Fed as the dominant macro regime are numbered, largely because the Fed's tightening cycle is coming to an end. With this shift in the macro regime, we expect the bond-equity correlation to revert to the norm of the past two decades. The evidence for this is that the short-term correlation, which tends to be more responsive, has already corrected lower, with the 60-day rolling correlation between bonds and equities now turning negative.[2] We believe the two-year medium-term correlation illustrated below will begin to move lower throughout the year.

Exhibit 2: The fear of the Fed triggered the highest bond-stock correlation in decades



Source: Bloomberg. Monthly data up May 2023. Correlation coefficient is based on a 2-year rolling correlation of monthly returns for the US Treasury bond index and the S&P 500 index.

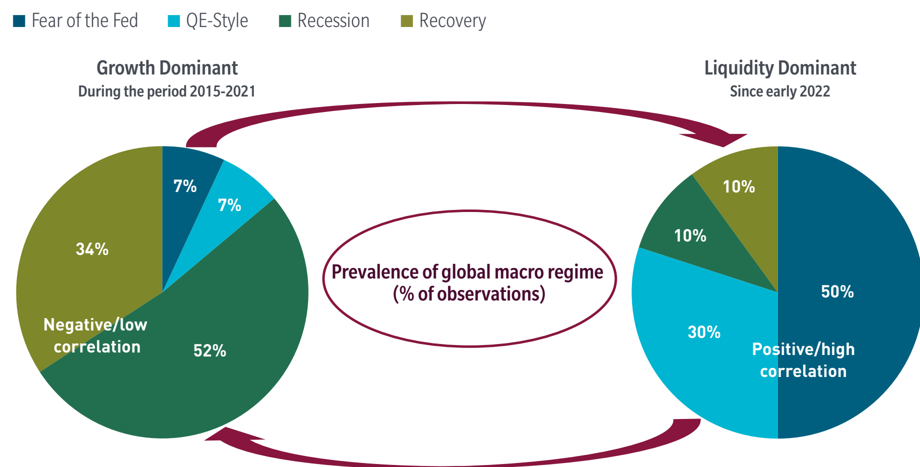
Sentiment should be bolstered. There is little reason to fear the Fed as the tightening cycle is about to be completed. Some market participants are talking about a "skip" in June — meaning the central bank will not raise its policy rate then — to be followed by a final rate hike in July. Others believe the tightening cycle is already over. Either way, the Fed is about to take a back seat as a global market driver. At this juncture, the implied pricing of the central bank's terminal rate stands at 5.42% for August 2023, suggesting an additional 17 basis points of tightening from the current level, or another almost-25-basis-point hike priced in (Exhibit 3). We believe the end of the tightening cycle will help bolster investor sentiment, albeit trigger some rate volatility normalization as the main cause of recent volatility, an aggressive policy cycle, is removed. For the time being, rate volatility continues to be elevated, with the MOVE index standing at 124, well above its five-year average of 77. We anticipate, however, that the MOVE index will decline in the period ahead.[3]

Exhibit 3: Fed's implicit terminal rate based on federal fund futures

Sources: Bloomberg. Daily data from 1 March 2022 to 2 June 2023. Data refer to upper bound. Implied policy rates based on federal fund future monthly contracts from May 2023 to December 2024, adjusted by 0.125% to reflect upper-bound federal funds.

The paradigm is likely to shift from liquidity to growth. The fear of the Fed regime has been observed 50% of the time since 2022 (Exhibit 4); we call it a liquidity-dominant regime, because liquidity acts as the main market driver. During such a regime, investors are most worried about the impact of liquidity retrenchment. We think the main market narrative will shift to growth in the period ahead, with recession concerns becoming the main market fear. There are two distinct regimes in the growth-dominant category: growth fears and growth momentum (see Exhibit 1). Under the growth/recession fear regime, rates decline while spreads widen as a higher risk of recession is being priced in. At the opposite end of the growth spectrum, the growth momentum regime tends to be characterized by higher rates and narrower spreads. It is a potential outcome in the near term, especially if the United States manages to avoid a recession. The key risk to our view is a prolonged hawkish bias on the part of the central bank, which would extend fear of the Fed and almost inevitably lead to a more severe recession.

Exhibit 4: The market paradigm shift



For illustrative purposes only. Notes and sources: Based on monthly data since January 2015 up to April 2023. Bloomberg. 10-yr UST yields. Bloomberg US IG Corporate Spreads. A Fear of the Fed observation is defined as the 10-yr rates rising by 10 bps or more for the month, while at the same time IG spreads rise by 5 bps. The QE-style regime is observed by the 10-yr rates decline by at least 10 bps for the month, together with IG spreads falling by 5 bps. Similarly, the recession regime is characterized by rates declining by at least 10 bps while spreads widen by at least 5bp. Finally, the recovery regime corresponds to a rate increase of at least 10 bps, combined with a spread tightening of at least 5 bps. The % of observations for each regime is simply the ratio of number of observations for a given regime to the total number of regime observations for a given period. The bottom arrow illustrates our view that the market paradigm will shift back to growth from liquidity.

This is likely the end of the business cycle. In our view, it is more likely than not that the US will enter a recession in the near future. The date commentators are predicting it will begin keeps getting later given the resilience of the US economy. While making the call on a recession is more an art than a science, a reasonable prediction is that a recession will begin in the fourth quarter of this year. Preliminary activity data observations suggest any US recession will be mild given the absence of obvious systemic balance-sheet imbalances. There is still uncertainty about the growth outlook in this base case, however, with risks on both sides. A soft landing — a slowdown that is not significant enough to qualify as a recession — cannot be ruled out. But a severe recession could also materialize if major financial excesses come to light, in the private asset universe for instance, or if financial stability risks escalate further.

Our recession risk monitoring points to a slow grind toward recession. There is still a wide disparity among the growth signals across the spectrum of leading indicators. The most alarming recession signals come from so-called soft data, in particular the surveys on business sentiment, consumer sentiment and lending conditions. Nevertheless, corporate profit margins remain elevated and the labor market continues to be strong, as illustrated by low initial job claims (Exhibit 5). In addition, our Business Cycle Indicator (BCI) is currently signaling the risk of a severe slowdown but not an imminent recession (Exhibit 6). In the past, the BCI level associated with severe recession risks has been closer to -1 than -0.47.

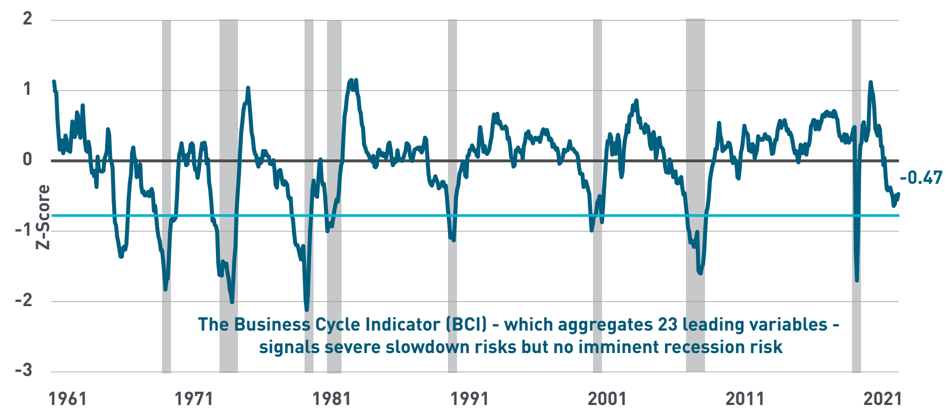
Exhibit 5: Monitoring recession risks

Recession Risk Watch	latest	6 months earlier
NY Fed Empire State Manuf. Survey	-2.47	-0.24
Senior Loan Officer Opinion Survey	-2.10	-1.39
Univ of Michigan Consumer Sentiment	-1.97	-2.20
NFIB Small Business Optimism Index	-1.83	-1.40
Conf. Board LEI	-1.79	-0.98
ISM New Orders	-1.67	-1.14
Housing Starts	-1.12	-0.52
Housing Building Permits	-1.07	-0.59
Philly Fed Business Outlook	-1.03	-1.32
Unit Labor Cost	-0.98	-1.19
ISM Manuf.	-0.98	-0.65
ISM Services	-0.76	-0.12
Capex Outlook	-0.75	-0.39
Corporate Profit Growth	-0.24	0.15
National Assoc Home Builders Market Index	-0.12	-1.07
Profit Margin Change	-0.08	-0.14
Compensation Ratio Change (% of GDP)	-0.01	0.55
Investment Ratio (% of GDP)	0.18	-0.19
Output Gap (% of Potential GDP)	0.23	0.06
Conf. Board Consumer Sentiment	0.25	0.22
New Home Sales	0.46	-0.85
Initial Jobless Claims	0.50	0.57
CPI Energy Component	0.90	-1.18
Profit Margin Level	1.12	1.35

High Recession Risk
Low Recession Risk

Source: Bloomberg. Based on individual z-scores since January 1960 or inception of the data series, whichever came first. As of most recent monthly data observation for each variable. See end note for full source details.

Exhibit 6: No imminent risk of recession



Source: Data from Bloomberg. Monthly data from Jan 1962 to April 2023. The BCI aggregates z-scores of 23 variables.[4] The shaded areas designate official US recessions as defined by the National Bureau of Economic Research (NBER). A Z-score is the number of standard deviations a given data point lies above or below mean. The horizontal line designates a z-score of minus 0.85, which signals a significant deviation from the mean.

The market paradigm shift is set to support fixed income. The fear of the Fed regime was the worst-case scenario for fixed income. A shift away from this regime is likely to induce better prospects for fixed income returns, in our view. Under fear of the Fed, both rates and spreads rose, thereby acting jointly to hurt total return. This is why we observed returns in negative double-digit territory for most global fixed income asset classes in 2022. In contrast, under growth-dominant regimes, spread and rate moves are expected to offset each other, which means the potential shock to returns is no longer amplified. Looking at the matrix of potential outcomes for rate and spread moves for US investment-grade credit, one can see that the projected return over a one-year horizon will turn negative only in the event of significant market moves. For instance, under the growth fear regime, the US investment-grade one-year return projection will fall into negative territory only if the net change of combined rate and spread moves reaches at least 90 basis points — a spread widening of 120 basis points with a rate drop of 30 bps for a net 90 bps move. While a move of such magnitude cannot be ruled out, it would tend to be associated with a severe recession scenario. Overall, we believe that the probability of negative returns for fixed income is likely to be lower going forward after the recent upward rate correction. This is because of the higher income arising from higher yields, which then acts as a higher bar against negative absolute returns.

Exhibit 7: 1-year return projections for US IG under various rate and spread move scenarios (%)

US IG — Rate Moves Over the Next Year (bps)	Spread Moves Over the Next Year (basis points)												
	-150	-120	-90	-60	-30	0	30	60	90	120	150	180	210
150	5.49	3.35	1.21	-0.94	-3.08	-5.22	-7.36	-9.50	-11.65	-13.79	-15.93	-18.07	-20.21
120	7.63	5.49	3.35	1.21	-0.94	-3.08	-5.22	-7.36	-9.50	-11.65	-13.79	-15.93	-18.07
90	9.77	7.63	5.49	3.35	1.21	-0.94	-3.08	-5.22	-7.36	-9.50	-11.65	-13.79	-15.93
60	11.92	9.77	7.63	5.49	3.35	1.21	-0.94	-3.08	-5.22	-7.36	-9.50	-11.65	-13.79
30	14.06	11.92	9.77	7.63	5.49	3.35	1.21	-0.94	-3.08	-5.22	-7.36	-9.50	-11.65
0	16.20	14.06	11.92	9.77	7.63	5.49	3.35	1.21	-0.94	-3.08	-5.22	-7.36	-9.50
-30	18.34	16.20	14.06	11.92	9.77	7.63	5.49	3.35	1.21	-0.94	-3.08	-5.22	-7.36
-60	20.48	18.34	16.20	14.06	11.92	9.77	7.63	5.49	3.35	1.21	-0.94	-3.08	-5.22
-90	22.63	20.48	18.34	16.20	14.06	11.92	9.77	7.63	5.49	3.35	1.21	-0.94	-3.08
-120	24.77	22.63	20.48	18.34	16.20	14.06	11.92	9.77	7.63	5.49	3.35	1.21	-0.94
-150	26.91	24.77	22.63	20.48	18.34	16.20	14.06	11.92	9.77	7.63	5.49	3.35	1.21

Source: Bloomberg: US IG – Bloomberg US Agg Corporate Index. Current yield as of 1 June 2023. Current duration as of 1 June 2023. 1-year return projection is estimated as current yield + net change between rate and spreads x duration. References to future expected returns and performance are not promises or estimates of actual performance that may be realized by an investor and should not be relied upon. The forecasts are for illustrative purposes only and are not to be relied upon as advice, interpreted as a recommendation, or be guarantees of performance. The forecasts are based upon subjective estimates and assumptions that have yet to take place or may occur. The projections have limitations because they are not based on actual transactions but are based on the models and data compiled by MFS. The results do not represent nor are indicative of actual results that may be achieved in the future. Individual investor performance may vary significantly.

Overall, we believe this may be an opportune time to consider increasing allocations to fixed income in anticipation of this positive market paradigm shift.

Endnotes

[1] The four-quadrant diagram describes the four possible macro fixed income regimes based on the moves of rates and spreads: the fed of the Fed, growth/recession fears, quantitative easing, and growth momentum. Under the fear of the Fed regime, for instance, both rates and spreads rise. Under the growth fears regime, spreads widen but rates decline.

[2] Source: Bloomberg. Short-term correlation is calculated as the 60-day rolling correlation of daily UST and S&P 500 returns. UST = Bloomberg US Treasury index. The data as of 2 June 2023 show a correlation coefficient of -0.48.

[3] Bloomberg. ICE BofA Move index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. Data as of 2 June 2023.

[4] The BCI incorporates the following variables: Initial jobless claims (Department of Labor), Building permits (US Census Bureau), Philadelphia Fed business outlook survey diffusion index (Philadelphia Fed), New home sales (US Census Bureau), Consumer sentiment index (University of Michigan), Consumer sentiment index Conference Board), Capex expectations index aggregated from the Fed regional surveys (New York, Richmond, Dallas, Kansas City, Philadelphia), ISM new orders (Institute for Supply Management), Corporate profit margin changes (Bureau of Economic Analysis), Corporate profit growth (Bureau of Economic Analysis), Corporate profit margin level (Bureau of Economic Analysis), Output gap (Congressional Budget Office), US Consumer Price Index (Bureau of Labor Statistics), Empire State manufacturing survey (New York Fed), National Association of Home Builders Market Index (NAHB), NFIB Small Business Optimism Index (NFIB), Housing starts (Census bureau), Senior Loan Officer Opinion Survey, Net % of Domestic Respondents Tightening Standards for C&I Loans for Small Firms (Fed), ISM manufacturing (Institute for Supply Management), ISM Services (Institute for Supply Management), Investment ratio: Fixed investment as % of GDP – transformed into monthly series through interpolation (Bureau of Economic Analysis), Compensation Ratio change. Personal Income Compensation of Employees Received as % of GDP. 12-month change in the ratio (Bureau of Economic Analysis), Unit labor cost (Bureau of Labor Statistics).

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