Market Insights
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The Big Mac[1] on Fixed Income Allocation: FIFOMO

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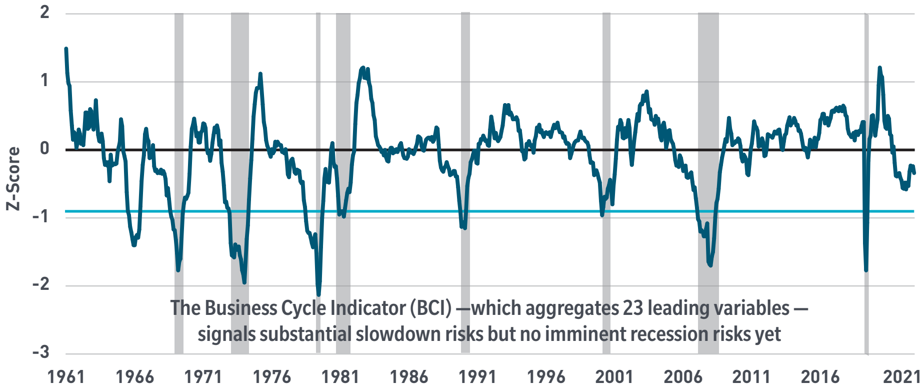
While there have been plenty of fears in global markets in the recent past, we believe that the fixed income fear of missing out (FIFOMO) is going to be the new fear that fixed income investors will soon be facing, and a positive one. Given the much improved macro backdrop, including stronger central bank signals and a favorable valuation landscape, this may possibly be an attractive opportunity to increase allocation to the asset class, in our view.

A Goldilocks macro outlook seems to be lining up. At this juncture, the risk of recession in the United States seems to have fallen, reflecting the resilience of the US consumer combined with the robust fundamentals of the corporate sector. The US economy is in slowdown mode, but the magnitude of the growth shock appears insufficient to warrant recession alarm calls. Our business cycle indicator — while signaling some slowdown risks — indicates no imminent recession. (Exhibit 1). On the inflation front, progress has been made, and it is now reasonable to think that core PCE, the inflation measure that matters most to the US Federal Reserve, will slow to around 2% next year. More important, the Fed is signaling that the tightening cycle is over. This means that we are finally ready to transition away from the dreaded fear-of-the-Fed macro regime, paving the way for a much more supportive backdrop for fixed income.

Exhibit 1: The business cycle indicator, which aggregates selected leading US indicators



Source: Data from Bloomberg. Monthly data from December 1961 to October 2023. The BCI aggregates z-scores of 23 variables. 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 -0.90, which signals a significant deviation from the mean.

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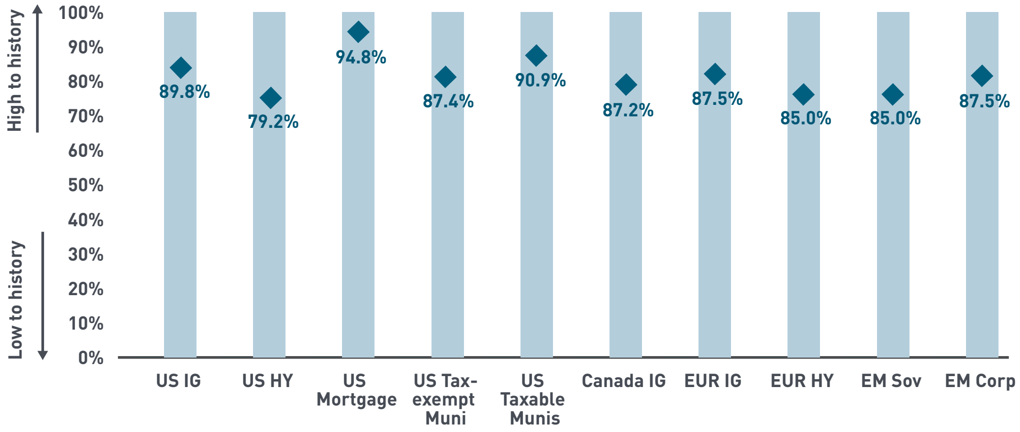
[1] The Big Mac, which is a hint at big macro, is a periodic global fixed income note that discusses relevant topics in the global fixed income/global macro environment.

The fixed income valuation picture remains compelling. Fixed income valuations are relatively attractive for the investor with a long-term horizon, in our view. This is particularly true for total yields, which are attractive by historical standards, even after the recent rally. Looking at the percentile rank of current total yields over the past ten years, most asset classes rank in the high 80s or 90s (Exhibit 2). It is true that credit spreads in some sectors look stretched, but the total yield valuation, which includes both a rate component and a credit spread component, is important as it has been a primary driver of expected total returns. In addition, the spread valuation dispersion offers interesting opportunities for active asset managers to identify relative value strategies.

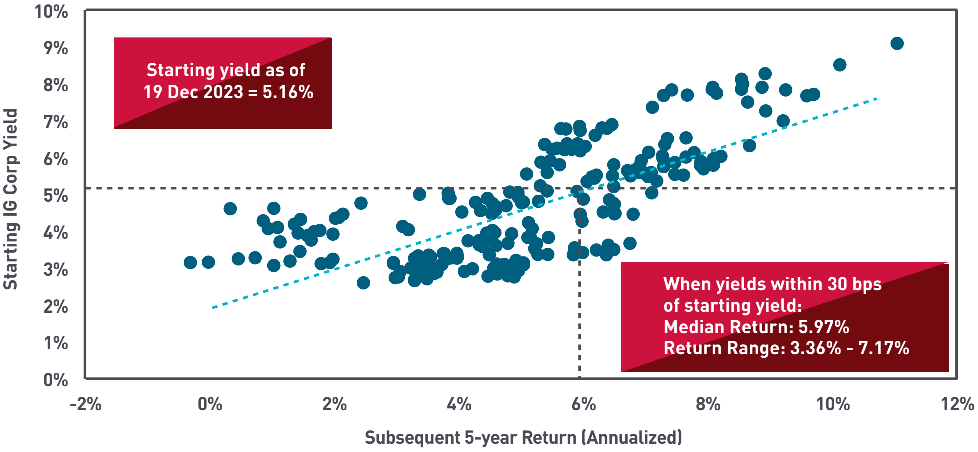
Exhibit 2: Yield percentile rank (current vs. past 10 years)



Sources: Bloomberg. Daily data from 18 Dec 2013 through 18 Dec 2023. US IG = Bloomberg US Aggregate Corporate Index. US HY = Bloomberg US Corporate High Yield Index. US Mortgage = Bloomberg US MBS Index. EM Sovereign = JPMorgan EMBI Global Diversified Index. EM Corporate = JP Morgan CEMBI Broad Diversified Index. Europe IG = Bloomberg Pan-Euro Aggregate Corporate Index. Europe HY = Bloomberg Pan-European High Yield Index. Canada IG = Bloomberg Canada Aggregate Corporate Index. US Agg-Eligible Taxable Munis = Bloomberg US Taxable Municipal Aggregate Eligible Index.

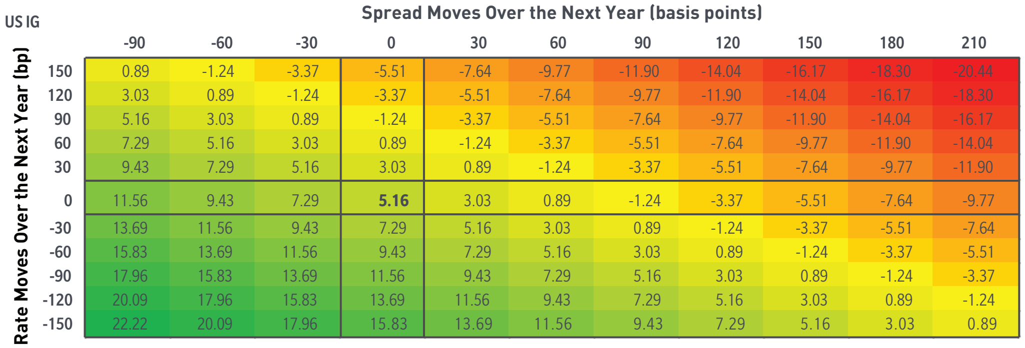
Entry points do matter in fixed income. Given the attractive level of current yields, the outlook for expected returns has improved considerably. This is because there has historically been a strong relationship between starting yields like today's and robust subsequent returns. For instance, at a starting yield of 5.16% for US investment-grade, the median return for the subsequent five years — using a 30-basis-point range around the starting yield — stands at 5.97%, with a return range of 3.36% to 7.17% (Exhibit 3). In addition, the prospects for fixed income expected returns have been strengthened by the recent signals of future rate cuts from the major central banks. Analyzing the heat map for US investment grade, it is clear that the likelihood of higher hypothetical returns has gone up, especially with the strong possibility of rate cuts in the pipeline based on recent Fed policy signals. Specifically, based on an entry yield of 5.16% and assuming no spread move over the next year combined with a drop in rates of 60 bps, a return of 9.43% in one year could be realizable (Exhibit 4). Specifically, the one-year hypothetical expected returns are simply computed as the sum of the starting yield minus the combined move in rate and spreads multiplied by the index duration. For example, based on a starting yield of 6% and an index duration of 7, if the combined spread and rate move is a decline of 50bp (*i.e.* 0.50%) over the next year, then the one-year expected return will be estimated to be 9.5% (6% - (-0.50% x7)).

Exhibit 3: US IG: starting yields vs. subsequent five-year returns



Bloomberg. US IG = Bloomberg US Agg Corporate Index. Monthly data from January 2000 through November 2023. Past performance is no guarantee of future results.

Exhibit 4: US IG hypothetical expected returns over the next year, based on spread and rate moves

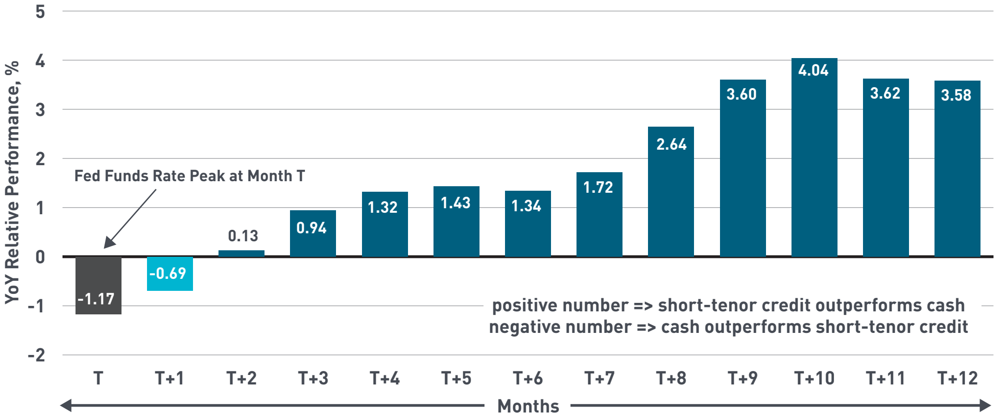


US IG	Spread Moves Over the Next Year (basis points)										
Rate Moves Over the Next Year (bp)	-90	-60	-30	0	30	60	90	120	150	180	210
150	0.89	-1.24	-3.37	-5.51	-7.64	-9.77	-11.90	-14.04	-16.17	-18.30	-20.44
120	3.03	0.89	-1.24	-3.37	-5.51	-7.64	-9.77	-11.90	-14.04	-16.17	-18.30
90	5.16	3.03	0.89	-1.24	-3.37	-5.51	-7.64	-9.77	-11.90	-14.04	-16.17
60	7.29	5.16	3.03	0.89	-1.24	-3.37	-5.51	-7.64	-9.77	-11.90	-14.04
30	9.43	7.29	5.16	3.03	0.89	-1.24	-3.37	-5.51	-7.64	-9.77	-11.90
0	11.56	9.43	7.29	**5.16**	3.03	0.89	-1.24	-3.37	-5.51	-7.64	-9.77
-30	13.69	11.56	9.43	7.29	5.16	3.03	0.89	-1.24	-3.37	-5.51	-7.64
-60	15.83	13.69	11.56	9.43	7.29	5.16	3.03	0.89	-1.24	-3.37	-5.51
-90	17.96	15.83	13.69	11.56	9.43	7.29	5.16	3.03	0.89	-1.24	-3.37
-120	20.09	17.96	15.83	13.69	11.56	9.43	7.29	5.16	3.03	0.89	-1.24
-150	22.22	20.09	17.96	15.83	13.69	11.56	9.43	7.29	5.16	3.03	0.89

Bloomberg: US IG = Bloomberg US Agg Corporate Index. Current yield as of 18 Dec 2023. Current duration as of 18 Dec. 2023. One-year return projection is estimated as current yield + net change between rate and spreads times 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 for or 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, and are they indicative of, actual results that may be achieved in the future. Individual investor performance may vary significantly.

It may be time to move away from cash and back to fixed income. Cash allocations continue to be significant given the investor fear of deploying risk, especially after the past two challenging years for global markets. We stand at an important inflection point, however. Typically, shortly after the peak of the central bank policy rate has been reached, cash starts underperforming credit. This is precisely where we are right now (Exhibit 5). Going forward, the probability of cash outperforming credit is likely to drop, especially given the expected rate cuts in the pipeline.

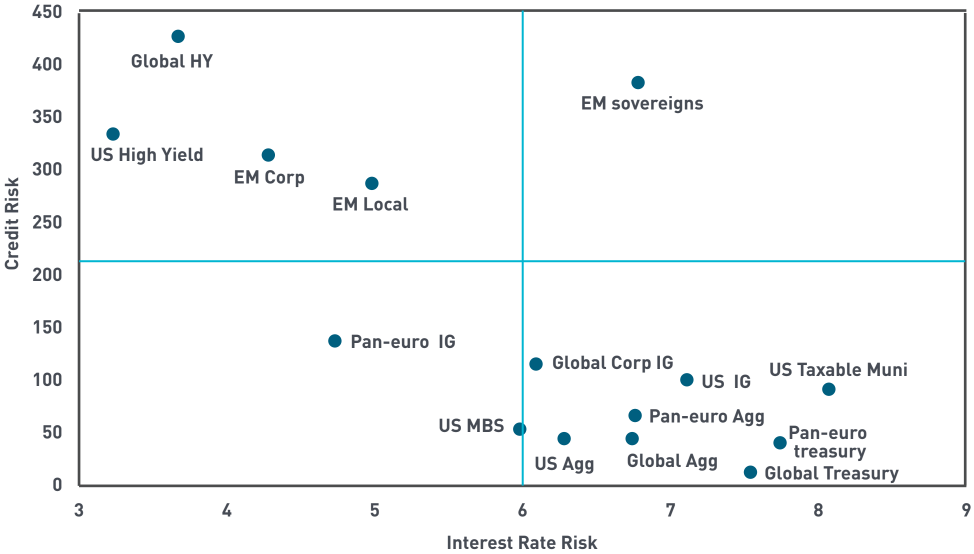
Exhibit 5: Magnitude of short-credit relative performance against cash following Fed rate peaks



Source: Bloomberg, Fed Fred database, ICE BofA. Federal funds rate: Cash = 3-Month or 90-day Rates and Yields: Certificates of deposit for the United States, percent, monthly, not seasonally adjusted. Credit = ICE BofA, 1-3 year US IG corporate credit (C1A0 index). Monthly data from January 1982 to July 2023. YoY returns. Based on the average of the six rate peak episodes since 1982.

We believe the opportunity set in fixed income is extensive. There is something for everyone in fixed income, depending on the investor's risk appetite, investment needs or other objectives. Fixed income, of course, involves both duration risk and credit risk. The combination of the two gives us a highly diversified map of sub-asset classes (Exhibit 6). We are now constructive both on duration and credit, and we therefore favor the riskier end of the fixed income spectrum, especially emerging market debt and European high yield. This is because of the more favorable macro outlook and the attractive entry levels.

Exhibit 6: Fixed income: Duration risk vs. credit risk



Source: Bloomberg. Data as of 19 Dec 2023. Spreads are expressed against US Treasuries. EM Local spreads measured against a theoretical global treasury comprised 33% of a 5-year Bund and 67% 5-year UST. US Agg = Bloomberg US Aggregate index. Global Agg = Global aggregate index. US IG = Bloomberg US Aggregate Corporate Index. US HY = Bloomberg US Corporate High Yield Index. EM Sovereign = J.P. Morgan EMBI Global Diversified Index. Europe IG = Bloomberg Pan-Euro Aggregate Corporate Index. Europe HY = Bloomberg Pan-European High Yield Index. Global credit = Bloomberg Global Aggregate Corporate Index. Canada IG = Bloomberg Canada Aggregate Corporate Index. US Agg-Eligible Taxable Munis = Bloomberg US Taxable Municipal Aggregate Eligible Index.

Overall, we believe that fixed income is back as an attractive asset class, especially as recession risks have gone down and the valuation backdrop is attractive by historical standards.

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