TD Asset Management

Investor Knowledge 10 Minutes

The slow crawl towards monetary policy easing

Thinking through the various macro scenarios that can unfold for fixed income

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At a glance

- **Since the U.S Federal Reserve (Fed) delivered its last hike in July 2023, further disinflation progress had enabled it to pare back its hiking bias by the beginning of this year.**
- **No one knows what will happen with any certainty, however, it is important to think through the most plausible macro scenarios and understand how they can impact Fixed Income investments.**
- **Our base case scenario is further disinflation and a moderation of growth in 2024, and the expectation that the Fed will deliver its first interest rate cut later in the second half of 2024 and 2 cuts by the end of this year.**
- **For investors, despite the appeal of the higher yields being offered by short-term bonds, longer-term bond yields remain far more compelling today than they have been in years.**

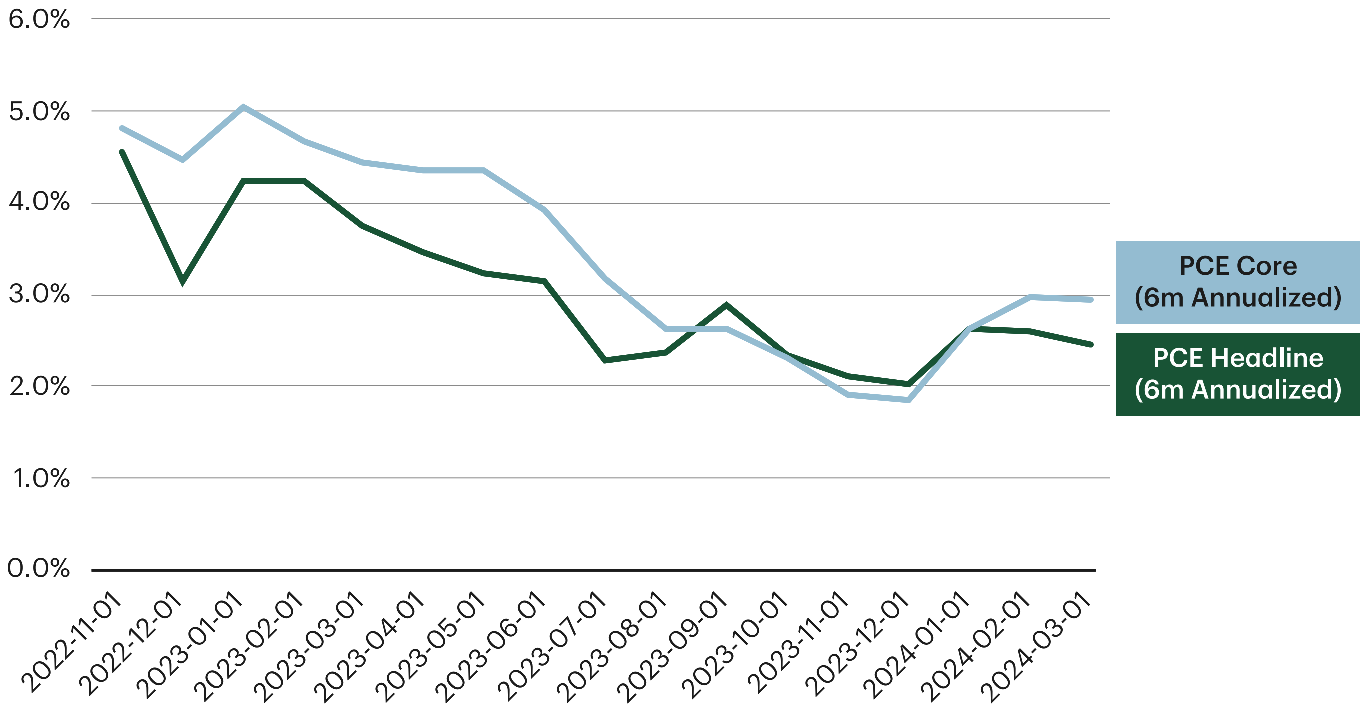
Since the Fed delivered its last hike in July 2023, further disinflation progress had enabled it to pare back its hiking bias by the beginning of this year. Since that time, U.S inflation has reaccelerated, but the Fed has continued to adopt a neutral policy stance and implicitly signaled policy easing (lowering interest rates) to be likely sometime in the coming months. This guidance from the Fed on monetary policy is a critical driver of financial market performance and is increasingly becoming an essential component to help successfully navigate these markets.

High expectations

Investors came into 2023 with high expectations for rate cuts and strong financial markets. The Fed was expected to deliver no less than 6 cuts in 2024. Fast forward to today and now the expectation is 2 rate cuts or less over the remainder of the year. What happened?

A few things. To start, three consecutive unimpressive inflation reports in Q1 began to pump the breaks on rate cuts. To be fair to the Fed, for most of the second half of 2023, the U.S had seen excellent disinflation progress. The 6-month annualized core Personal Consumption Expenditures (PCE), which is one of the Fed's favourite inflation metrics, was already below 2% by December 2023 (undershooting the Fed's inflation target). Most investors expected the good story to continue, but so far it has not. Since then, this measure has climbed significantly higher (Chart 1). Another factor is that the Fed made it clear that they needed to see more "good" inflation data for it to gain "greater confidence" before cutting rates. As of now economic activity and labour data remains resilient.

Chart 1: After some softening, there has been a recent rise in inflation



Source: Bloomerg Finance L.P. Data as of March 31, 2024.

No crystal ball

While we do not have a crystal ball to predict what will happen with any certainty, we do like to formulate and think through the most plausible macro scenarios based on our assessment of macro drivers like leading economic indicators, monetary and government policies, and understand how they can impact Fixed Income investments. In this article, we will discuss and walk through what we feel is the base case scenario for interest rates and fixed income investment returns, as well as two other scenarios that can plausibly unfold for 2024.

Scenario 1

The base case of a soft Landing

Consensus economic and Fed forecasts expect further disinflation as well as a moderation of growth over the remainder of the year relative to 2023 (Table 1). By later this year, Core PCE is expected to deaccelerate to around mid-2%, while GDP growth slows to just slightly above the potential growth rate (latest Fed estimate at 1.8%). Additionally, labour market demand vs. supply is expected to continue to come into better balance, as the job openings to unemployed ratio continue to normalize without the unemployment rate rising meaningfully higher. We feel this is the base case (and most likely) scenario and see macro indicators and economic data trends broadly pointing in a similar direction.

Table 1: Forecasts expect further disinflation and moderating growth

	2023	2024	2025	2026
Change in Real GDP	2.6	2.1	2.0	2.0
PCE Inflation	2.8	2.4	2.2	2.0
Core PCE inflation	3.2	2.6	2.2	2.0
Federal Funds Rate	5.4	4.6	3.9	3.1

Source: FOMC Summary of Economic Projections, March 31, 2024.

Under these macro assumptions, we expect the Fed to deliver the first interest rate cut late in the second half of 2024 and deliver a total of 2 cuts by the end of the year. This is in line with Fed's latest forward guidance. As we approach the start of the rate cutting cycle, expect U.S rates to move slightly lower, led by the short-end rates.

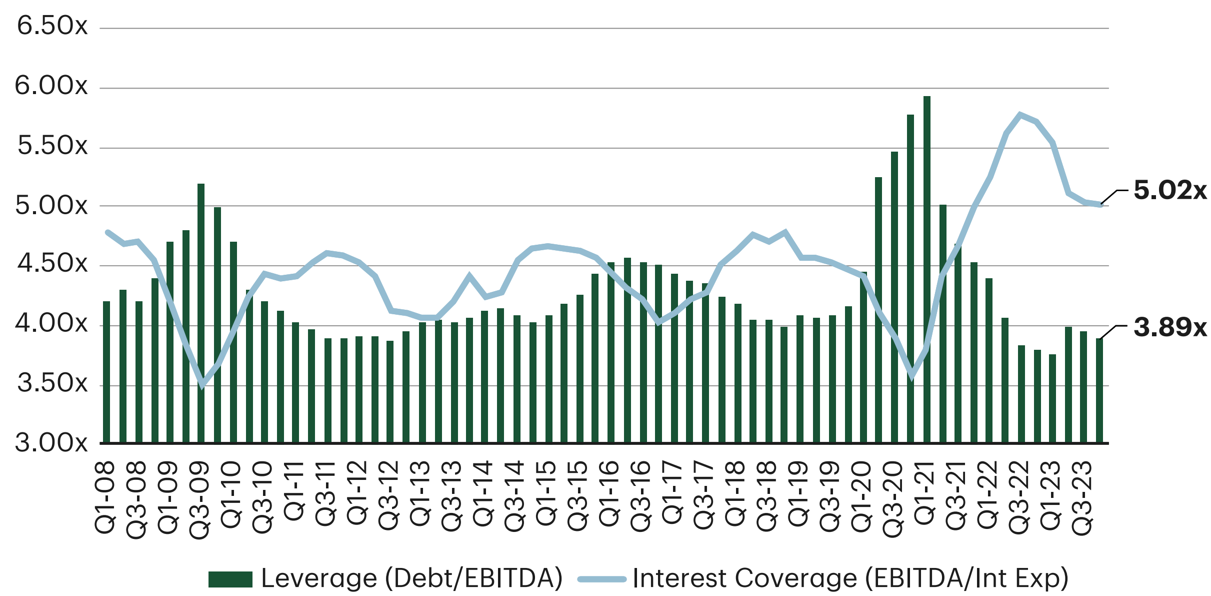
Fixed income implications

Investment Grade (IG) Bonds - Anticipation of the Fed to deliver interest rate cuts starting this summer could make IG bonds increasingly attractive. Typically, as interest rates decrease, bond prices increase, especially for those with fixed interest rates. IG bond issuers currently have strong financial positions with healthy balance sheets, so even if economic growth moderates, they should continue to perform well. Despite the recent tightening of spreads, we still see the all-in yields over 5.25% as attractive, which is over 50bps higher than the 20-year median 4.33%. In addition, the current IG universe is of better quality from previous cycles, with less BBB's and shorter maturities. Thus, we expect IG spreads to further rally by about 10-15bps from current levels in this scenario.

High Yield (HY) Bonds - In a moderating economic environment, we expect to see a continuation of the bifurcation of leveraged credit between low quality and high-quality companies. For example, the difference between CCC-BB spreads have widened to nearly 662bps, which is 95bps wider than the 20-year historical average of 567bps. This is driven by the quality of the BB, being stronger than in previous cycles and pushing down spread near historical lows of around 200bps. Like their IG counterparts, HY issuers generally have healthy balance sheets with manageable leverage and strong interest coverage ratios compared to the last 15 years (Chart 2).

We would expect low quality credits to continue to outperform as the economy only modestly weakens and lower quality companies find access to capital with improved financial conditions and the runway to address business challenges. We expect default rates to pick up slightly but still be below historical average of 3-4%. Overall, we expect the HY index to tighten 25-50bps on the back of narrowing spreads from performing lower quality single B and CCCs rallying 25-55bps, while high quality credit trade in a narrow 190-210bps range, while defaults remain 3-4%, consistent with the long-term average.

Chart 2: High Yield credit metrics remain relatively strong



Source: JP Morgan Credit Research. Data as of Dec. 31, 2023.

Scenario 2

Inflation reaccelerates, and we are "higher for longer"

While not the base case scenario, a reacceleration of inflation (i.e., further acceleration of inflation in Q2) could be possible if economic activities and/or the labour market remains stubbornly strong leading to further elevated wage growth and strong underlying inflation. Another potential factor could be if there is escalation of geopolitical risk that leads to a sharp rise in commodity prices and headline inflation. In this scenario, core PCE could remain around 3% or trend higher, while GDP growth could remain materially above 2% alongside a tight labour market.

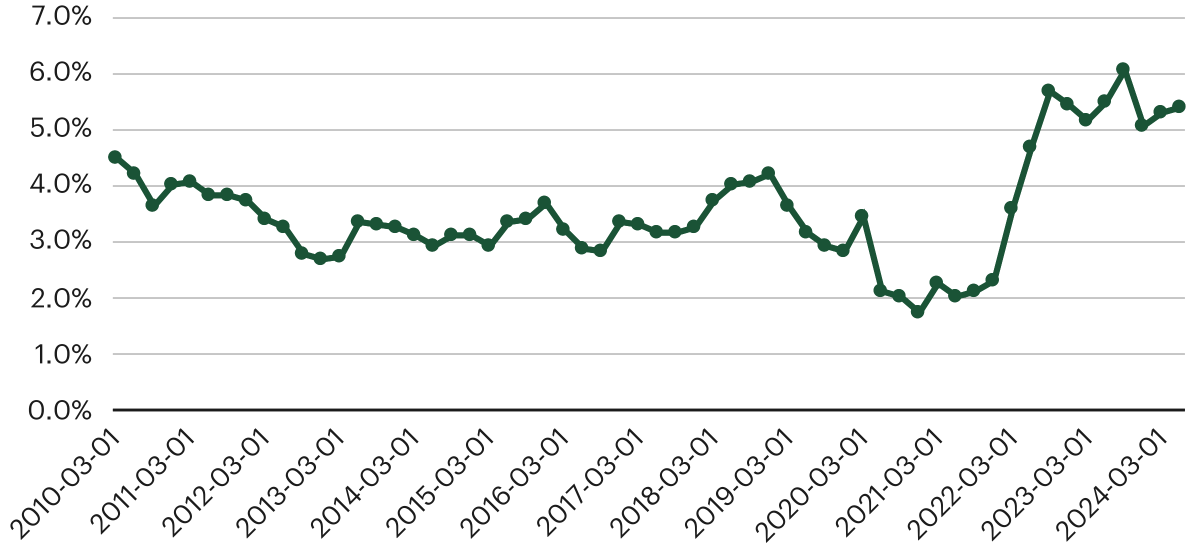
Elevated inflation will require the Fed to postpone the easing of policy rates as it may conclude that the current policy stance is less restrictive than previously expected. In this situation, the Fed will need to postpone the easing cycle to 2025 or even reinitiate further rate hikes. As the market is forced to reprice the policy rate path, U.S rates will directionally move higher.

Fixed income implications

IG Bonds - The return of a rate hiking bias is likely the worst-case scenario for IG bonds, and we see that as the case for most other risk assets as well. Although this scenario could create funding difficulties, strong economic growth will likely prevent corporate fundamentals from deteriorating too sharply. Sectors that are more interest rate sensitive like Financials, REITs, and Telecommunications would probably underperform, while less interest rate sensitive sectors like Consumer, Energy and industrials should be resilient.

With all-in yields likely at or higher than 5.25%, demand should remain well anchored as these levels. The all-in yield buyer has been a lynchpin in the resiliency of investment grade corporate bond spreads over the last 2 years (Chart 3). It should be noted that if Fed rate cuts are delayed but the expectation for the next move from central banks remains a cut, IG spreads should remain largely range bound in the 90-105bps range as strong demand technicals will help offset downside risks. In a situation where there is change towards a rate hike bias, we expect spreads to widen 20-30bps as primary markets dry up and interest rate sensitive sectors sell off. However, this will progressively be priced into spreads as new inflation and employment data are published and markets absorb the data throughout the remainder of the year.

Chart 3: U.S Investment Grade Corporate Yield



Source: Bloomberg Finance L.P. May 9, 2024.

HY Bonds – A higher for longer environment implies an environment where growth is positive, and inflation is still hot. Higher quality issuers, BB rated bonds and above, are in a relatively healthy financial position with strong earnings and strong balance sheets. We do not expect any meaningful erosion in interest coverage ratios for those issuers, given our expectation for stable earnings and higher interest rates are already baked into their calculations over the past year. However lower quality issuers, and especially floating rate - only issuers, will struggle more as they could see continued erosion of their debt servicing capacity.

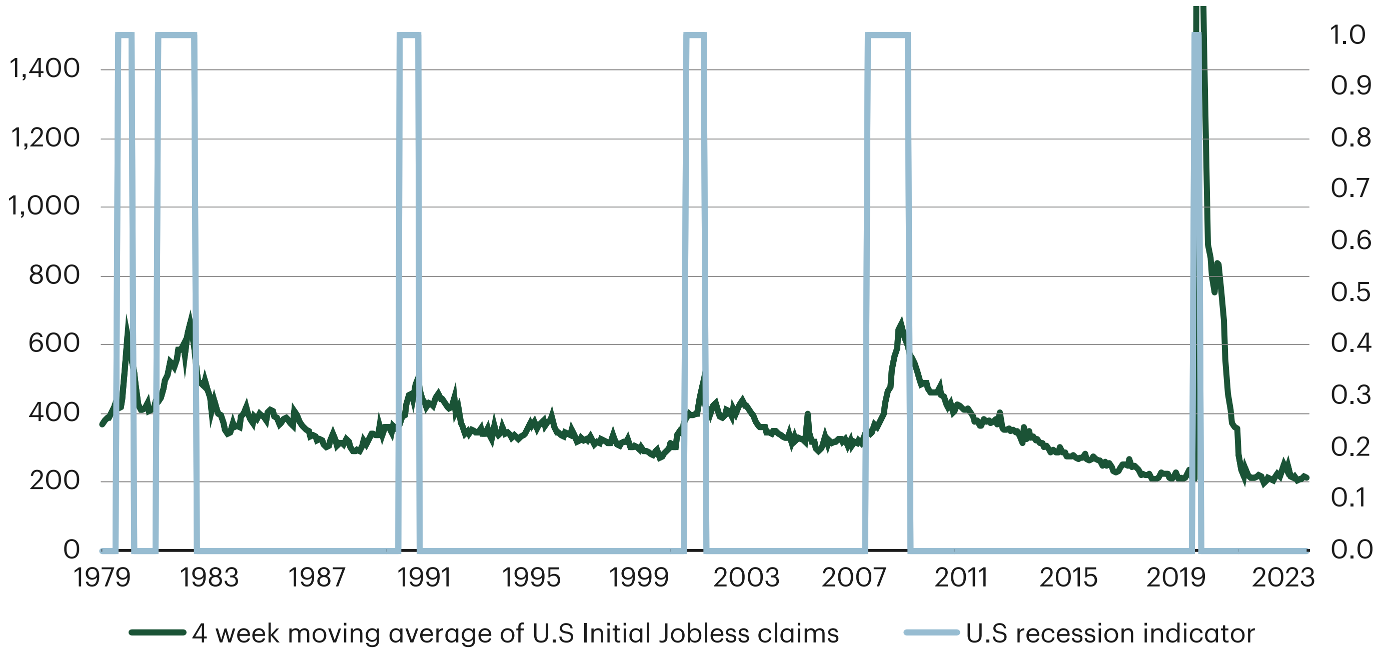
Overall, we expect spreads to widen for interest rate sensitive issuers with limited cash flow generation capacity either due to significant floating debt burden or have a large capital structure in a secular declining sector. These companies are typically B-/CCC rated issuers and either loan only issuers or concentrated in secular declining subsectors within the Healthcare or Telecommunications and, Media and Technology space. We expect these lower quality credits to widen out 100-150bps, while BB stay flat, which would put pressure on the index level spreads and widen by 30-50bps. However, the all-in yield of the asset class of >8.0% and the positive growth environment, should limit BB from widening too much and enable lower quality credits without interest rate sensitivities and over levered capital structures to perform well. In a situation where there is change towards a rate hike bias, we expect spreads to widen 50-100bps driven by limited primary market activity and challenges for the interest rate sensitive issuers and sectors mentioned above.

Scenario 3

A hard landing

An alternative risk scenario could unfold if demand weakens faster than expected and labour market conditions rapidly deteriorate. While moderation in labour market strength has been very gradual so far, a sharper trajectory higher in jobless claims will be a serious warning sign, and historically such a sign has closely preceded an economic slowdown (Chart 4). Indeed, the effect from a restrictive monetary policy stance has continued to pass through to the real economy as evidenced by some moderation in economic activity. In this scenario, GDP growth could decelerate quickly to below trend, contributing to disinflation as Core PCE moves towards or below the Fed's 2% target.

Chart 4:
A rebound from trough of initial jobless claims typically precede a U.S recession



Source: National Bureau of Economic Research, Bloomberg Finance L.P. Data as of April 30.

A sharp deterioration in economic activity, together with continued disinflation progress, will incentivize the Fed to ease aggressively given the restrictive level of the current policy rate. In this scenario we could expect the Fed to deliver at least 3 cuts by end of this year and possibly more to support the economy. This is the least expected scenario by market pricings and U.S interest rates should fall materially, led by short-end rates if this scenario materializes.

Fixed income implications

IG Bonds - In this scenario, where the economy makes a harder landing than anticipated leading to swift deterioration in economic activity and labour market strength, IG bonds are expected to experience an initial shock. We expect an initial broadening of credit spreads of 50-60bps as the market adjusts to the heightened credit risk and less favourable economic backdrop. Fear of heightened corporate downgrades could further widen spreads for a short period of time.

However, despite a severe initial adjustment, IG bonds should benefit from their inherent attributes that make them relatively more attractive compared to other asset classes during periods of economic uncertainty, namely being higher quality compared to most other risky assets as IG issuers are typically large and well diversified operators with stable earnings. Because of this, the investment grade corporate market can often experience inflows in a market downturn due to a flight to quality. Moreover, the fixed coupon payments provided by IG bonds offer a steady income stream, dampening portfolio volatility in times of stress. Consequently, despite the initial widening of spreads the allure of IG bonds is likely to be sustained, if not enhanced, due to their safety and income characteristics in a lower interest rate environment. We would expect all-in-yield buyers to eventually step in once volatility subsides and the fed signals aggressive easing. IG spreads would move towards 125bps spread levels by year end.

HY Bonds - We expect HY bonds to be much more challenged if the economy weakens quickly, as credit fundamentals fall moderately by year end but there will be expectations for further deterioration through 2025. We see spreads widening 150-200bps, driven by higher defaults rates, limited access to capital, and cash flow pressures for more cyclical issuers. This environment makes HY bonds less attractive relative to IG, however, BB rated are relatively stronger today and make up a bigger portion of the high yield market versus previous cycles. We expect that strength to anchor the market to an extent, even as more individual distressed and default credit stories arise. Active portfolio management with strong credit research will help navigate such a challenging environment.

A fluid environment

Predicting what will happen in the economy, and by extension in markets, with full certainty is a precarious game. And while a crystal ball would be ideal, it is important to map out different scenarios (Table 2), think about what is most likely to happen and act accordingly. For now, the markets are keeping a close eye on the timing of the first Fed rate cut, which we expect will be driven by the need to gradually loosen monetary policy rather than the desire to stimulate the economy.

Table 2: 2024 Year end change in spread expectations

	5-yr Treasury	10-yr Treasury	High Yield	Investment grade	BBB	BB	B	CCC
Soft Landing	modestly lower	modestly lower	modestly lower	neutral	neutral	neutral	modestly lower	modestly lower
Inflation Reacceleration	higher	higher	modestly Higher	modestly higher	modestly higher	neutral	modestly higher	higher
Hard Landing	Lower	Lower	higher	higher	higher	higher	higher	Significantly higher

Source: TD Asset Management Inc., JP Morgan Research. Data as of May 1, 2024.

For investors, despite the appeal of the higher yields being offered by short-term bonds, longer-term bond yields remain far more compelling today than they have been in years. Investors with a long-term time horizon would be well served to build diversified bond portfolios to benefit from the returns that corporate bonds can potentially provide over the long run. ■

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