

Rethinking fixed income



The massive tightening of financial conditions since late 2021 has produced a fixed income market vastly different from the stimulus-fueled environment during and following the pandemic. The cross-currents generated by these changes will challenge investors again in 2024.

Heading into the year, we think the best way to describe the macro environment is that we have reached or passed peak everything—inflation, liquidity, fiscal support, China growth, housing, credit availability, and labor market strength. In other words, most of the one-off tailwinds that defined the post-pandemic environment are fading away.

Although global economies—the U.S. economy in particular—have held up relatively well so far despite higher rates, a hard economic landing is not out of the question, especially following the spike in bond yields. Even if a recession is avoided in 2024, we are likely to see economic growth concerns intermittently elevated.

Higher for longer

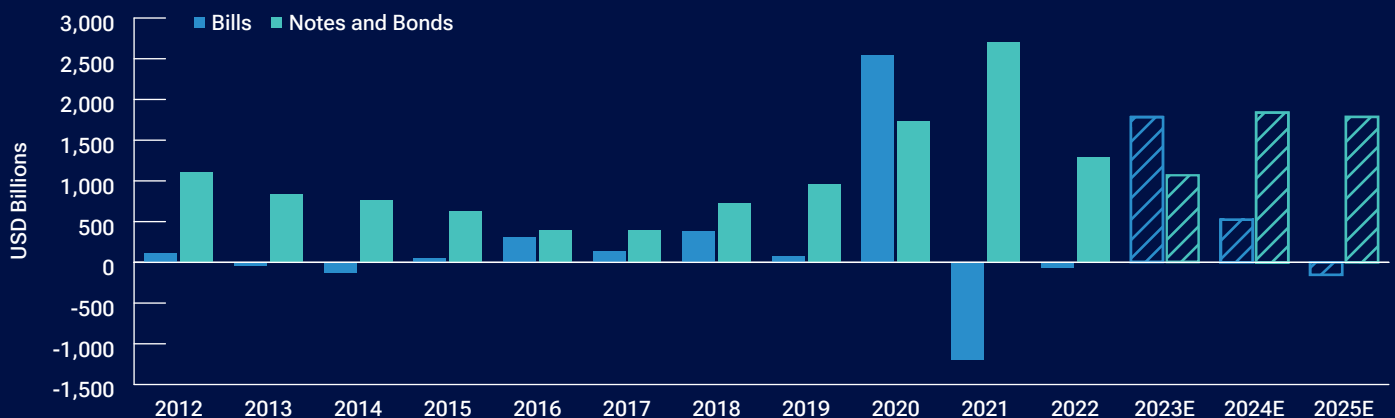
As of late November, futures markets were pricing in four Fed rate cuts in 2024, anticipating that the U.S. central bank will ride to the rescue if the U.S. economy falls into recession. However, we believe the failure of the Fed and most other developed market central banks to get ahead of inflation following the pandemic makes them more likely to keep policy rates at relatively high levels through much of 2024.

Structural forces such as deglobalization, lower labor force participation rates, and energy price pressures also could make inflation stickier than in past economic slowdowns, further discouraging central banks from easing monetary policy.

Of course, a major episode of financial volatility could prompt monetary policymakers to look beyond stubborn inflation and cut rates or pause quantitative tightening—the contraction in central bank liquidity as bonds purchased in pandemic

U.S. Treasury debt issuance is shifting to longer maturities

(Fig. 4) Net new Treasury issuance.



As of November 18, 2023. 2023 through 2025 are estimates.

Sources: U.S. Treasury, Securities Industry and Financial Markets Association, Morgan Stanley. Estimates by Morgan Stanley.

Actual outcomes may differ materially from estimates.

stimulus efforts are allowed to run off their balance sheets.

Potential “canaries in the coal mine” warning of such a correction might include a more severe banking crisis, a collapse in commercial real estate, a significant sell-off of the mega-cap tech stocks that led U.S. equity markets higher in 2023, or deteriorating conditions in private equity markets.

However, our base-case outlook is that central banks will remain on hold for an extended period into 2024. This stance is likely to shift volatility to the longer end of the yield curve, as opposed to the exaggerated upward moves in shorter-term rates seen as the Fed tightened in 2022 and early 2023.

Sovereign issuance is surging

With fiscal deficits ballooning, we expect governments to continue flooding the market with new sovereign debt. This is particularly true in the U.S., where the Treasury is shifting the bulk of new issuance away from short-term bills and into longer-term notes and bonds (Figure 4).

This issuance shift is the basis for one of our highest-conviction calls: that yield curves will steepen in 2024. Although yields on high-quality sovereign debt may have peaked in late 2023, they still could move higher. Accordingly, we think curve steepening is likely to be a more significant factor than the outlook for interest rate levels.

Another implication of the surge in government bond issuance is that it could crowd corporate borrowers out of the market—or at least force up their funding costs. This could make companies less likely to spend on capital projects or hire more employees, reducing support for the global economy.

High yield credit quality has improved

Looking more closely at the corporate bond market, attractive yields should continue to support demand for high yield bonds, even though credit spreads—the yield differences between bonds with credit risk and high-quality government bonds with similar maturity dates—appear less compelling, trending near historical averages as of late November.

Obtaining attractive yields doesn’t require investors to accept as much credit risk as in the past because the quality of the high yield bond universe overall has improved (Figure 5).

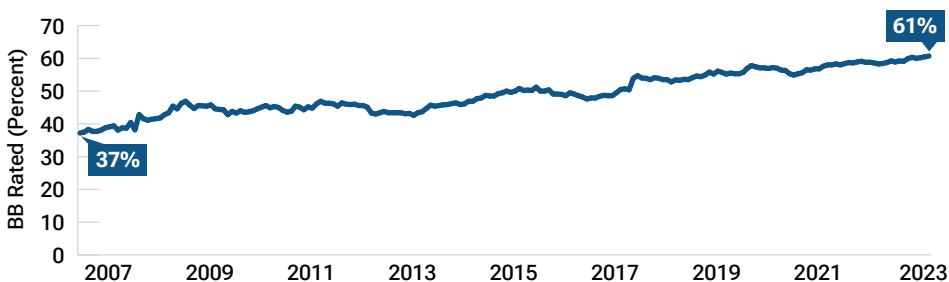
We also see attractive opportunities in shorter-term IG corporates. While these instruments carry some credit risk, short maturities reduce their exposure to an economic downturn. As of late November, shorter-term corporates provided a meaningful yield premium over money market funds and bank savings deposits, leaving investors better positioned if short-term rates decline in 2024.

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High yield ratings quality has “migrated up”

(Fig. 5) Percent of Credit Suisse High Yield Index that is BB rated.



As of October 31, 2023.

Source: Credit Suisse (see Additional Disclosures).

Going into 2024, credit spreads on longer-term IG corporates aren't wide enough to compensate for the additional risk stemming from their extended maturities, in our view. However, spread widening could create more attractive opportunities in these bonds as the year progresses.

We expect correlations between returns on high-quality sovereign debt and the performance of risk assets such as equities and corporate bonds to remain volatile as markets adjust to the new environment of higher interest rates and as global economic growth decelerates. However, we believe duration exposure should reward investors in the event of major downturns in equities and credit.

Non-core fixed income assets, such as high yield or EM bonds, also should provide diversified sources of return even if equities perform well or move in a sideways trend.

In 2023, many investors seemed inclined to wait for a clear peak in yields before meaningfully raising their fixed income allocations. In 2024, we think a more attractive option will be to take advantage of some of the highest yields available over the past two decades in many fixed income sectors. As always, in-depth analysis of credit fundamentals—for both IG and high yield issuers—will be essential.

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Investment Idea	Rationale	Examples
Interest rates have likely peaked, but volatility could persist as yield curves steepen.	Easing inflation and diverging central bank policies should keep rate volatility elevated. Curve steepening is expected. This environment should favor short- to intermediate-term bonds and strategies with the flexibility to navigate volatility as interest rates reset.	— Dynamic/flexible bond strategies
Take advantage of higher yields and supportive fundamentals.	Recession remains a risk, but we expect only a modest uptick in defaults. High yield offers a compelling risk/reward profile, as credit quality has improved. Higher yields and reduced bank lending should be positives for private credit.	— High yield bonds — Private credit

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