RBC BlueBay Asset Management

Benefitting from market dislocation

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Key points:

- Evidence of slowing inflation and a weaker economy will be required before the FOMC is likely to start cutting rates.
- The refrain of 'higher for longer' continues to be felt across financial markets.
- We have believed for quite some time that cuts are likely coming the second half of this year.
- Investors need to be prepared to go through periods of volatility.
- This is exactly an environment where active fixed income mangers can make a meaningful difference in client portfolios.

> "We're looking forward to taking advantage of market dislocations as they arise."

The first half of this year has been a puzzling one for investors, particularly for those in the fixed income space. 2024 began with the market expectation of several interest rate cuts which have not materialized, and prevailing investor consensus is now that rates will remain steady for the foreseeable future with 1-2 possible rate cuts on the horizon in the latter half of the year. For fixed income investors in particular, rate uncertainty means strategies will need to pivot to adaptable interest rate approaches.

When we look at the market data, investors now assume September to be the first cut in this cycle. From our perspective, it's evident that a series of inflation data disappointments means fewer, rather than more, rate cuts in this environment. It's clear to us that this trend of disappointing inflation cannot continue if the market can have any hope of cuts in the months ahead. We have believed for quite some time that cuts are likely coming the second half of this year.

Defying Skeptics

Despite concerns that disappointing inflation data and elevated interest rates might push the U.S. economy over the brink, we maintain that panic would be premature. The U.S. is not going through a recession. It's not going through an aggressive slowdown – it is in fact, defying skeptics and proving to be resilient and robust. Indeed, the economy ended 2023 strong, as both GDP and payroll employment ended the year higher than the Congressional Budget Office's pre-pandemic forecasts for 2023.

Additionally, in a press conference following the February 2024 meeting of the Federal Open Market Committee (FOMC), while Fed chairman Jerome Powell declined to state the economy was close to a soft landing, he did state that "let's be honest, this is a good economy." We contend that a strong U.S. economy is the reason that while we expect some cuts as inflation data moderates over the coming months, we do not believe there are a lot of further cuts in store in the years ahead if the relative strength of the U.S. economy persists.

Markets have changed pricing quite a lot from the beginning of this year. We are now getting back to levels where valuation, especially at the front end of the treasury curve could look relatively attractive. However, a lot depends on not having further disappointing inflation data.

Persistent Interest Rates, High Yield, and Passive Fixed Income

While persistently elevated interest rates might create volatility in some asset classes, it does not spell clear trouble for fixed income/high yield investments. Higher for longer is not necessarily a bad thing for your portfolio, especially if markets have already largely priced-in that outcome. If you look at forward curves, a fair amount of that has already been priced in. Indeed, when the Federal Reserve hikes interest rates, lower-quality bonds like high yield tend to perform better than their investment-grade counterparts.

U.S. high-yield bonds will feel the impact of rising (or in the current case, persistently elevated) interest rates like other higher-quality bonds, but with less severity as their coupons are higher and their maturities typically shorter. That being said, it's also not a reason to be complacent. You need to be prepared to go through periods of volatility. A lot of money has moved into intermediate core fixed income in the US over recent quarters, and some of that flow could be reversed and directed to shorter duration strategies. We can absolutely see a period of dislocation in the months ahead as investors are coming to terms with what will be the shape of future monetary policy.

Active management of risk and clear differentiation between credit and rate investment views might be the answer in a tough market.

In our opinion, passive fixed income could actually be quite a tricky choice ahead with so much at stake and so many different scenarios. This is exactly an environment where active fixed income mangers can make a meaningful difference in client portfolios in terms of returns and what we will see ahead. The best way to manage this period is by separating your credit view from your rate outlook and managing both risks separately within your portfolios.

Dislocation Can Be a Good Thing

Interest rates remaining elevated for this long was unexpected, and the result has been creating both vulnerabilities and opportunities for investors. Many investors had a long-duration bias across their portfolios, with meaningful inflows recorded into U.S. fixed income further out the duration curve in recent quarters. Much of this was attributed to the anticipation of what was thought to be inevitable rate cuts. While higher-for-longer interest rates might not be particularly painful for broader fixed income, it can create speed bumps. Just the move of money from further out the duration curve to more short duration or money market types of strategies can create some dislocation. The other area we have been seeing a lot of overweight positioning is agency mortgages.

Agency mortgages are quite long-duration assets. The combination of that long duration and very consensual long risk-positioning withing this segment of the fixed-income universe reveals a vulnerability to repricing if that higher-for-longer environment were to persist.

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If we end up in a situation where inflation does moderate and rate cuts are coming, then we wouldn't expect too much drama in terms of these consensual positions - but if higher-for-longer is the world we live in and inflation disappointments continue, then we would expect retrenchment from these consensual views in terms of long duration and long agency mortgages and some problems as that happens.

This dislocation, while exposing some longer-duration investors, might benefit others. From our perspective, dislocation is always a good thing for an active investor. You need to see some volatility to be able to generate alpha within the investment universe you operate.

Managing portfolios in such a way that when volatility spikes, portfolio managers can increase holdings rather than being forced to reduce risk might be the differentiating factor in weathering these types of storms successfully. Focusing on reducing risk will result in managers not taking advantage of opportunities as they appear.

"The key point is to manage risk accordingly and be in a position to take advantage of these rather than being forced into reducing risk when they appear."

We recommend that as uncertainty grows, flexibility within your portfolio will be paramount in taking advantage of dislocations. Whether that involves using derivatives, paring down risk and selling some of your bond exposures, it's important to be in a position where you can step into a dislocated market rather than worrying about taking risk down as volatility spikes.

Still, opportunities lie ahead in this environment.

We believe that even if rates are to stay elevated, level out, or rate cuts begin to materialize later this year, there are several areas of opportunities within the fixed income universe to be taken advantage of after periods of volatility.

The front-end of the treasury curve, around 5% looks quite interesting. We also look at opportunities like 2 year - 30 year treasury curve views benefitting from potential curve steepening that also seem interesting. However, you must be prepared to be patient with some of these because, for example, curve steepening trades are already pretty popular amongst some investors. Within credit, if there are dislocations, areas like senior US financials or TMT have looked really interesting to us compared to deep cyclicals and growth-sensitive sectors of the economy.

The key point is to manage risk accordingly and be in a position to take advantage of these rather than being forced into reducing risk when they appear.

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