‘Peak rates’ and opportunities for credit selection in 2024

After two years of declines, 2023 proved to be another tough year for bond investors. However, a powerful rebound towards year end helped the global bond index end the year in positive territory for the first time in three years. Below, **Jim Leaviss, CIO Fixed Income at M&G Investments**, shares his views on the prospects for bond markets in today’s ‘peak rates’ environment, while **senior credit portfolio manager Richard Ryan** looks at the opportunities presented by fundamental credit selection.

Jim Leaviss
CIO Fixed Income at
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Peak rates?

The backdrop to the turbulent performance of the last few years has been ongoing monetary policy tightening by major central banks in an attempt to bring persistent inflation under control. Interest rates have subsequently reached levels last seen before the Global Financial Crisis of 2008/2009.

The rate hikes have brought the era of ‘cheap money’ to an abrupt end – except in Japan which has persisted with its negative rate policy. In response, sovereign bond yields have continued to climb: at one point the US 10-year Treasury yield reached a 16-year high of 5% before retreating to a level broadly in line with its long-term average.

While there is indeed a plethora of worries that has fuelled the negative sentiment towards bond markets, we believe that the major change in valuations that has taken place has created an opportunity for investors in government bonds. In particular, we think that, for the first time in many years, duration is now attractive, and we started to increase duration in a number of our portfolios in 2023.

The rationale for this was underpinned by our belief that both the timing and valuations are favourable for investing in government bond markets. Historically, the 10-year US Treasury yield has tended to rally after the Federal Reserve (the Fed) ends its hiking cycles.

Investing in US Treasuries at the peak of the cycle therefore has the potential to deliver a healthy capital gain from a credit risk-free asset. However, timing this decision is extremely difficult as it is hard to establish when peak rates have been reached. The challenge is that policymakers rarely announce when they have reached peak rates.

While there is a widespread belief that we have reached the peak in this rate-hiking cycle, at least in the US, there is still uncertainty about the path they may take in the coming months. One narrative in markets is that we are in a ‘Table Mountain’ scenario – referring to the distinctive flat top of South Africa’s iconic landmark. This suggests that we stay on a plateau for the foreseeable future before any rate cuts – a view that has been encouraged by some policymakers, notably in Europe and the UK.

As we enter 2024, one of the biggest debates in financial markets is whether interest rates will remain elevated. Are we really in a ‘higher for longer’ environment or are we close to a turning point? Although the US economy was extremely resilient in 2023 – GDP growth in the third quarter was 5.2% annualised – it is worth remembering that monetary policy works with a lag. This hiking cycle began at a historical low of near zero, which is one reason why the impacts may be taking longer than the usually cited 12-18 months.

How long higher rates take to feed through to the real economy can vary. For example, within the mortgage market, which has further knock-on impacts in the real economy, there are big dispersions. The US has 30-year fixed mortgages, whereas Sweden has 18-month long mortgages and in the UK 5-year fixed mortgages have become increasingly common.

As a result, the impact of higher borrowing costs on consumers and companies feeds through at different speeds. Several factors helped US consumers in 2023, such as the excess savings built up during the pandemic, a healthy jobs market and higher wages.

However, there are signs that the real economy may feel pain in due course, particularly after such a long period of very low rates. The Table Mountain scenario would be welcome as it suggests that we are heading for a soft landing in the global economy. However, we believe that this is unlikely.

History shows that this type of extended rate-plateau rarely happens and generally we do not get soft landings in economic cycles. If we look back at previous rate cycles, on average, the Fed hikes and then a few months later it starts cutting rates aggressively because it hasn’t managed to achieve a soft landing and the economy starts to weaken. There are a few outliers in history but that tends to be the pattern.

It could be different this time. However, we think that it is much more likely that central banks will be cutting rates aggressively at some point in 2024 rather than keeping them elevated at current levels. This view is dependent on whether we have reached peak rates yet. We don’t know for certain, but it looks like we are nearly there.

Richard Ryan
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Opportunities for credit selection

Against this backdrop of macroeconomic uncertainty and potential market volatility, we believe that vigilance, patience and diversification are essential. However, as active bond investors, we firmly believe that a value-based and research-driven approach to credit selection can deliver long-term outperformance for investors.

Active credit investing involves looking through the noise to undertake rigorous assessment of the risk of lending to companies, in order to answer two simple questions – if we lend to this company do we believe we will be repaid, and secondly, are we being paid enough to take this risk?

In our view, there are two ways to add value: relative value opportunities and fundamental opportunities. The wide dispersion of pricing within rating bands is structural and persists through the investment cycle, giving us plenty of opportunities to buy or sell securities where we disagree with the market pricing.

The fundamental opportunities are where our analysts’ internal rating disagrees more meaningfully with the rating agencies. These differences are less frequent but can be important – for example, a source of capital preservation, where we identify declining credits before they are downgraded, or significant opportunities for outperformance where we identify early-on credits that may be improving in quality.

Exploiting these mispricing opportunities requires careful analysis and our selective approach relies on the expertise of a large and experienced credit research team. By digging deeper and doing the in-depth research we believe we can identify attractive opportunities across the market.

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