Looking across ETF fixed income markets

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For ETF fixed income investors, 2024 continues to be a positive year: most companies have managed to weather a backdrop of macro uncertainty; investors have continued to have access to attractive levels of yield; inflation, while sticky, has been moving in the right direction. Meanwhile, the volatility experienced at the start of August proved to be a storm in a teacup.

Now, with a bumper 50 basis points rate cut kicking off the Federal Reserve (Fed) easing cycle, and less promising economic cycles still a reality, what is the outlook for fixed income ETFs?

For European credit, all-in yields are still well above the average over ten years, even though the fundamentals of some of these issuers are very solid and resilient. However, if we look at the credit spread or credit premium, the situation is a little different. This is because we have seen a tightening of these credit spreads over the last twelve or so months. Even after the recent volatility pushed spreads wider in early August, the investment grade (IG) market offers an average asset swap spread broadly in line with the 10-year historical average, while the European high yield market (HY) is even slightly tighter versus the 10-year historical average[1].

While economic growth across many European countries continues to slow, this isn't necessarily negative for fixed income investors. If central banks can carefully navigate the much discussed 'soft-landing' scenario, investors could benefit from credit spread remaining contained, a rates rally, and the healthy carry provided by the asset class.

The new issuance market also continues to provide attractive opportunities for investors, with nearly €500 billion issued year-to-date across different sectors and seniorities.

Many US issuers are also issuing EUR-denominated debt to take advantage of the buoyant environment in the European market. This influx of new issuance across a diversified base continues to give us comfort in the liquidity and overall functioning of the market.

On the other side of the Atlantic, there has been a similar story of strong fundamentals and strong, positive returns year-to-date (YTD). On a YTD basis, the US HY market has continued to outperform other areas of the US fixed income market.[2]

We expect the US economy to cool but without significant declines, partly helped by inflation moving back to the 2% target. This has been the case so far and enabled the Fed to begin cutting rates and thus support companies through a slowdown in rising interest expense. We believe this macroeconomic backdrop should continue to provide positive tailwinds for both the US IG and US HY markets as the anticipated soft landing should be supportive of sentiment and corporate spreads. We continue to believe that the default rate of the US high yield bond market is unlikely to increase to a level significantly higher than its long-term average. Therefore, we maintain that this market can deliver an attractive carry-driven total return over the coming months.

Looking at the rest of 2024, central banks and their monetary policies are an obvious factor that could influence markets. This is particularly true in the US where recent macroeconomic data, particularly around the labour market has often been contradictory, leading to concerns that the Fed has made a mistake keeping rates too high for a long time. For now, we expect two further rate cuts before the end of the year. In the US the upcoming election clearly has the ability to impact markets both through pre-emptive volatility and the diverging economic policies of the candidates. We continue to monitor this situation carefully and the impact it could have on ETF fixed income portfolios.

Further afield

For ETF investors looking for greater diversification across their fixed income portfolio, emerging market debt may worth considering. Emerging markets have taken a back-seat lately due to several factors, including China's property crisis and concerns over far tighter US monetary policy which has bolstered the attraction of cash.

However, better market returns, an improving economic backdrop and the prospect of lower US interest rates suggest now might be the time to reassess their potential. Indeed, a soft-landing scenario for the global economy could translate into attractive returns for emerging markets (EM) in 2024, continuing the year-end positive trend.

So, while many EM countries still have their challenges and may experience volatility this year with a number of elections scheduled, rebounding EM GDP growth in the third quarter versus the second quarter and resilient external balances point to EM macro strength.

Earnings growth YTD for EM corporate bonds has been healthy and revised higher for 2024 as disinflation has helped temper input costs. We also expect the default rate to be significantly lower in 2024 versus the last two years.

For ETF investors, there has never been as much choice for fixed income investing as there is today. With both active and passive investment approaches on offer, ETF investors have options across different geographies and themes to meet their needs.

[1]Source: AXA IM, Bloomberg as of 19th September 2024

[2]Source: AXA IM as of 19th September 2024 – US HY return 7.6%, US IG return 5.9%, US Treasury return 4.4%

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