Lazard Fixed Income Viewpoints

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The *Viewpoints* series gives investors Lazard's perspectives on the latest macroeconomic and fixed income news and trends. It reflects the views of the firm's dedicated specialists, who independently manage portfolios across the entire range of asset classes and sectors.

How High Will Bond Yields Go?

Bond markets delivered a jolt to investors in the waning days of summer: Long-term bond yields soared to their highest levels since the global financial crisis in 2008.

The 10-year Treasury yield hit 4.33% on 17 August, having crept up 45 basis points (bps) since mid-July[1]—and leaving startled investors to wonder, how high will it go?

The answer may be important to investors around the world. The 10-year yield is a reference rate for loans in the United States, notably mortgages, and it is used as the "risk-free" rate in many financial valuations. A significant rise in the 10-year yield now could put the brakes on what has so far been a resilient US economy, potentially affecting global growth.

That was the starting point of the conversation when Lazard's fixed income professionals met this month. While inflation and the Federal Reserve's course on interest rates in the months ahead figured prominently in the discussion, our experts uncovered other important market drivers—some that they believe should put a cap on Treasury yields for now.

The wide-ranging discussion included insights from Lazard's market strategy teams and China specialists.

US: Up, Up, and Away?

To explain the jump in long-term US Treasury yields, our investment experts focused first on inflation—or more precisely, the possibility of reflation.

Our US fixed income analysts saw some recent indications that inflation could be stabilizing or even inching up rather than falling. For one, the headline Consumer Price Index (CPI), which showed prices rising 3.2% for July, increased from the previous month for the first time in a year.[2] Also, inflation expectations have moved a little higher, reflected in a 20-bp increase in the market's 5-year 5-year forward breakeven inflation rate since the end of June to around 2.40% currently, based on Bloomberg data. Last but not least, oil prices have risen significantly. West Texas Intermediate (WTI) hit almost $80 per barrel by mid-August, an increase of more than 15% since

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late July, while gasoline futures jumped more than 25% over that time[3]—price increases that have yet to show up in the CPI, our analysts noted.

While all of these could be just fluctuations within a larger trend toward disinflation, they unfolded in the context of a very tight US labor market and faster-than-expected growth. So any signs that inflation was reigniting raised the concern for bond investors that despite 11 rate hikes, the Fed may not be done with this cycle.

Other concerns have also started to weigh on longer-term bonds over the past month or two, according to Lazard's investment teams.

One of the most striking: The US Treasury department reported that the federal deficit had more than doubled over the 10 months through July and the federal debt had ballooned to a record $32 trillion—potentially worrying developments for bondholders, especially as interest rates have continued to rise. In fact, the Treasury auctioned more than $100 billion in bonds over the second week of August, which proved difficult for the market to absorb at once and was a factor in rising yields, our US fixed income team noted.

Gravity's Pull

However, our team believes a strong force will likely pull bonds back in the other direction soon: demand for US Treasuries.

A very uncertain macroeconomic outlook and higher tail risk since the COVID-19 pandemic began have prompted many investors to return again and again to Treasuries as a defensive investment during bouts of volatility, according to our US analysts. That resilient demand has helped keep the 10-year yield below 4% for most of that time.

Uncertainty and tail risk are still high in the team's view, suggesting that demand for Treasuries should remain buoyant. Recession risk has drawn many investors to the relative safety of Treasuries, they noted, and recently, so has the strain on China's economy. In mid-August, a steady stream of weak economic reports from the country prompted many US firms to cut their GDP growth estimates below the Chinese government's 5% target in 2023.[4] (See below for more on China.)

Our investment professionals saw yield "caps" where waves of demand would likely kick in. The first was strong technical resistance in the 10-year yield at 4.30%, which is the high reached last October. Above that was the range of 4.5%–5%, where they believed many investors would shift money out of equities and into bonds. A return of nearly 5% for what has historically been seen as a "risk-free" asset would put yields on US investment grade corporate debt at more than 6% based on current spreads, which could lead pension plans, in particular, to sell riskier assets and buy corporate bonds that better align with their liabilities.

Europe and Japan: Different Stories

In some ways, Europe appeared to be in the same boat as the United States. Government bond yields rose, mainly on expectations for more central bank rate hikes, and the labor market was very tight, complicating the outlook for inflation and monetary policy, our European specialists noted. However, one difference between the two regions stood out to them: the outlook for Europe's economy was more negative in the near term.

This outlook was reflected in Europe's inverted yield curves. Inversion occurs when short-term yields are higher than long-term yields and has historically been a harbinger of recession; our team pointed to weak economic activity of late, as measured by Purchasing Managers Indices (PMIs).

Our analysts expected yield curves in Europe to reverse and eventually steepen as a weak economy and resulting improved outlook on inflation should lead to a more accommodating monetary policy environment—making long duration positioning more attractive than it has been for some time in the region. They saw similar opportunities in Scandinavia, Australia, and New Zealand where bond markets seemed fairly priced for the interest rate moves that were most likely to come, in their view. One exception was the United Kingdom where the economy has been surprisingly strong, complicating the Bank of England's job of taming high inflation and thus making bonds there less attractive to our portfolio managers.

Japan's economy, meanwhile, has continued to expand, and the Bank of Japan loosened its yield curve control in late July, allowing the 10-year Japanese Government Bond yield to rise. It had reached 63 bps as of mid-August from 50 bps, based on Bloomberg data. What happens next with yields and policy is open to debate, in the view of our analysts: The central bank has still been purchasing significant amounts of bonds to hold yields down, but inflation has exceeded the bank's 2% target for some time and become a concern to some investors. For July, headline inflation sat at 3.3%.[5]

Credit: Less Alluring

The allure of rising sovereign yields was a theme throughout the developed credit markets over the past month. Investment flows into high-quality credit have tapered since early this year, based on EPFR data, reflecting in part the appeal of relatively high yields and low risk in money market and government bond funds, according to our analysts.

Credit overall was not compelling to our fixed income teams for other reasons as well. For one, the option-adjusted spread on the Bloomberg Global Aggregate Corporate Index was near its long-term average of 130 bps in mid-August, having tightened from around 175 bps during the US banking crisis in March and April.

Equally important, credit fundamentals have started to deteriorate, our teams noted. Net leverage among BBB credits in both the United States and Europe, for example, has started to rise in the past few quarters, based on data from Bloomberg. Our analysts attributed that primarily to inflation, which has put pressure on corporate margins and increased working capital intensity.

Also, the pace of rating agency upgrades in investment grade credit has slowed meaningfully, and the agencies' positive bias (in credit outlooks and reviews) has continued to decline. Meanwhile, US bankruptcies tracked by Bloomberg have jumped since April, and our experts expected the upward momentum to continue.

China: In the Thick of It

While US and European markets seemed concerned about the potential for serious credit difficulties, China has been in the thick of them.

The most significant over the past month—and the most puzzling to our specialists—was $22.5 million in missed offshore bond payments by Country Garden Holdings, which was until recently the country's largest private real estate developer. The company has a 30-day grace period to make the payment, at which point it would officially default, likely triggering cross-defaults on other debt.

To illustrate the magnitude of the problem, our analysts pointed out that Country Garden currently has about 4 times as many projects as China Evergrande, whose default in 2021 sent shockwaves through the global high yield market.[6]

Company management cited a cash crunch as the reason for the missed payment, and indeed, its financial difficulties have been widely known for some time; according to Bloomberg data, its bonds have zigzagged at distressed levels between 80 and 10 cents on the dollar since early 2022, our analysts noted. However, the company reported some $20 billion in cash at the end of last year and revenues coming due in the first half of 2023 as projects were completed, based on Lazard's analysis, so the reasoning behind missing the August interest payment specifically was not immediately clear to our experts.

Country Garden's predicament does make clear that the real estate crisis in the private sector has continued to deepen as housing demand has slowed, though state-owned enterprises (SOEs) have held up better than privately owned firms, according to our China specialists. Defaults and bankruptcies by private developers also help explain why consumer confidence has remained low even after pandemic restrictions were lifted in China late last year. Cancellations and delays on new (often prepaid) homes are coming at a time when consumers are already facing high unemployment, and many may have depleted savings after three years of lockdowns, our analysts noted.

Low consumer confidence was of particular concern to Lazard's investment teams because it does not bode well for overall demand in the economy—the heart of China's current economic difficulties, in their view.

Unintended Effects

So far, China's government has not undertaken large-scale fiscal stimulus to boost the economy after the pandemic hit, and our investment professionals focused on one possible reason at this month's meeting: Pouring cash into an economy can have unintended effects. China experienced this firsthand after injecting almost $600 billion into its system during the financial crisis, our emerging markets specialists pointed out.

Today, the United States and Europe may be seeing some unexpected consequences of their own massive stimulus during the pandemic. These effects are not necessarily negative; extra cash in US consumers' pockets, for instance, has boosted retail sales overall and helped keep the economy stronger than many expected through the Fed's rate hikes. But they do make the financial markets difficult to predict, our analysts agreed, which has contributed to the uncertainty and volatility in the bond markets.

Fixed Income Platform

Investment Teams	Investment Strategies
Global Fixed Income	The Lazard Global Fixed Income team manages the Global Core, Scandinavian & Euro High Quality, Euro Covered Bonds, Euro Corporate, Nordic High Yield and Euro Total Return Balanced strategies. Within these strategies the team seeks to generate performance through active management in Global capital markets.
US Fixed Income	The Lazard US Fixed Income team manages the US Short Duration, US Core, US Tax Exempt, and US Corporate Income strategies. The team seeks to derive benefits from the mispricing of securities based on various factors, including but not limited to, their assessment of credit quality, structure, and market sponsorship.
Emerging Markets Debt	The Lazard Emerging Markets Debt team manages the Emerging Markets Debt – Blend; Emerging Markets Debt – Core; Emerging Markets Debt – Corporate; Emerging Markets Debt – Local Debt; and Emerging Markets Debt – Total Return strategies. These strategies offer exposure to emerging markets bonds in local and/or hard currencies across regions.
Emerging Income	The Lazard Emerging Income team offers the Emerging Income and Emerging Markets Income strategies, which seek to invest in local emerging markets instruments, including currency forwards and local currency debt.
Lazard Frères Gestion	The Lazard Frères Gestion (LFG) Fixed Income team provides a range of strategies covering the full credit spectrum: Investment Grade, High Yield, Subordinated Debt. The team seeks to generate alpha through an active and flexible approach of interest rate and credit risk. The team also manages Fixed Income Credit Maturity strategies.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 All Treasury yields, issuance, US deficit and US debt figures in *Viewpoints* were sourced from the U.S. Treasury Department as of 17 August 2023. Resource Center | U.S. Department of the Treasury

2 Bureau of Labor Statistics, 10 August 2023. CPI Home : U.S. Bureau of Labor Statistics (bls.gov)

3 Oil and gasoline futures prices: CNBC: Stock Markets, Business News, Financials, Earnings - CNBC.com, accessed 17 August 2023

4 Bloomberg, 15 August 2023. JPMorgan, Barclays Cut China 2023 GDP Forecasts on Weak Economic Data - Bloomberg

5 Financial Times, 18 August 2023. Japan's core inflation slows as energy prices fall | Financial Times (ft.com)

6 Bloomberg, 9 August 2023. Country Garden Is in Danger of a Default Rivaling Evergrande - Bloomberg

Important Information

Published on 23 August 2023.