



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 Tight Is Too Tight?

The Federal Reserve may have begun the job of tightening financial conditions 19 months ago, but the bond markets have taken up the cause. Between late July, when the Fed last raised interest rates, and mid-October, the benchmark 10-year US Treasury yield rose more than 90 basis points (bps) in a prolonged sell-off of Treasury bonds.¹

The 10-year yield rose high enough at one point in early October that Fed Vice Chair Philip Jefferson and several Fed governors publicly stated another rate hike may not be necessary. After these remarks, the 10-year yield pulled back, and the surprise attack on Israel by Hamas on 7 October prompted some “safe-haven” buying. However, the bond rally was short-lived: A steady flow of strong US economic data and concern over the potential impact of a wider Middle East conflict on oil prices sent yields higher once again.

When Lazard’s fixed income professionals met in mid-October, they agreed that the Fed could be done with *its* tightening, but they debated whether the bond market had finished its part—and what higher long-term US rates would mean around the world.

US: Tight and Tighter

Aside from the comments from Fed officials, two market developments signaled to our US fixed income team that the central bank’s rate-hike cycle was near the end.

First, the two-year Treasury yield, which has historically had a strong record as a predictor of Fed policy, fell from a peak of 5.15% on 3 October to trade below 5%. In addition, the US yield curve has steepened significantly—another typical indicator that a rate-hike cycle is over. The spread between two-year and 10-year Treasury yields had narrowed to roughly -40 bps by the middle of October from around -110 bps in March.

However, most of the yield curve steepening was the result of rising long-term rates—a move known as a bear steepener—rather than falling short-term rates. This was concerning to our US team because, even if the Fed had finished raising the policy rate, the higher cost of long-term borrowing was tightening

financial conditions further: for governments and companies issuing bonds and for individuals taking out new mortgages and other loans.

It was also not clear to our US team that the rise in long-term Treasury yields was over. Although the 30-year Treasury bond appeared to meet with strong demand at 5%, the team noted several developments that could still drive long-term yields higher:

- the climbing US deficit (with the debt level at a record \$33.5 trillion as of mid-October), which should translate into higher Treasury bond supply,
- increasing risk premiums for Treasuries with maturities of five years and longer,
- rising real yields, and
- the likelihood of more loosening in yield curve control by the Bank of Japan, which would allow rates to continue rising on Japanese Government Bonds and make Treasuries less attractive to Japanese investors.

So far, the US economy has withstood the Fed's rate increases as well as the latest run-up in long-term yields. Over the past month, the labor markets and the Atlanta Fed's GDPNow indicator—showing a 5.1% growth rate as of 10 October—have been surprisingly strong. And US credit markets have shown little evidence of concern over the economy: Spreads have remained relatively tight, in the view of our US experts, and returns buoyant. Indeed, returns on triple-C rated bonds averaged 13% for the year through September, based on the ICE BofA CCC & Lower US High Yield Index.

Nevertheless, our US portfolio managers were cautious, pointing to rising corporate bankruptcies and credit card delinquencies, as well as rising mortgage rates, now approaching 8%, their highest level in more than two decades.² They continued to underweight corporate bonds, overweight mortgage-backed securities, and position for more yield curve steepening.

Emerging Markets: Immediate Impact

Rising long-term rates in the United States translated to higher funding costs for emerging markets borrowers that issue bonds in US dollars—and exacerbated a difficult situation for many high yield entities, according to our specialists. Emerging markets governments and corporates alike typically need to roll over debt every six-to-12 months, and so the impact of higher US yields is immediate, they pointed out.

Already, bonds from 33 of the 76 developing countries that the team monitors have been trading at yields of 9.5% or higher, and issuing new bonds at those levels would not be financially viable, in our analysts' assessment—which means those countries are effectively “shut out” of the bond markets.

Of particular concern to the team were Argentina, Egypt, Kenya, and Nigeria, but a significant number of other high yield issuers have also come under pressure lately. In addition to rising US interest rates, the recent jump in oil prices has hurt importing nations, mainly in Asia; and the US dollar, which embarked on a weakening trend in late 2022, reversed course in late June and has been strengthening since then, pressuring many emerging markets currencies. The potential for the war between Israel and Hamas to escalate into a regional conflict has also raised left-tail risks for emerging markets overall.

Not helping matters, investors have pulled some \$25 billion from emerging markets debt year to date, based on EPFR data in early October—most of that in the past few weeks—increasing the vulnerability of the weakest credits, which tend to be those with both fiscal and current account deficits, according to our analysts.

In light of all these developments, our emerging markets debt team has become even more cautious over the past two months and has kept risk allocations unusually low, underweighting high yield and overweighting investment grade credits.

There may be a sliver of light at the end of the tunnel, though: Debt restructurings have restarted recently, which could put some troubled issuers on a sustainable path. Zambia announced an agreement with investors in mid-October, Ghana is believed to be close to one, and Ukraine is reportedly sounding out bondholders to begin restructuring talks soon.³

Global Fixed Income: High-Quality Yield

Though issuers pay the price, bondholders can potentially reap the benefits of higher yields. Our global fixed income team has been keeping an eye out for the best opportunities recently.

The team has been extending duration overall while seeking out yield in high-quality bonds. For example, our portfolio managers found the 30-year US Treasury bond attractive, especially as the yield climbed over 5% briefly. US municipal bonds offered opportunities as well, in the view of our global analysts, illustrating that in the current environment, it has not been necessary for investors to go far afield for yield.

Hedging transactions in other currencies back to the US dollar has also offered a cushion of yield that the team has found attractive.

Currencies: Putting the USD in Perspective

Relatively high rates and economic growth in the United States have increased the dollar's appeal over the past few months, but our analysts believe the US currency is still within the overall weakening trend that began late last year.

Although the US dollar made a U-turn in June as the economy began outperforming expectations, our team noted that the currency is still weaker over the last 12 months, notably against the euro. At this point, the team sees the possibility of greater gains for the euro going into 2024—especially if the Fed begins to cut rates in the second half of next year as many expect.

By contrast, the Japanese yen will likely remain flat-to-weak against the dollar over the next year, in the team's view. Despite small changes in yield curve control and the potential for rate cuts in the United States, our specialists think the large gap between rates in the two countries—around 4% for 10-year government bonds currently—is unlikely to close anytime soon.

Hedging into US dollars from the yen and other developed markets currencies has remained attractive. Transactions in sterling, the euro, and the Canadian dollar have all offered investors extra yield potential when hedged into US dollars, the team noted.

In perhaps the most significant move in the currency markets recently, the Israeli shekel plunged after the country announced it was at war, prompting the Bank of Israel to intervene and support the currency. But the US dollar, often viewed as a safe haven in a crisis, did not strengthen as much as expected in response, according to our currency experts.

Emerging Markets Currencies and Rates: Resilient

Despite the dollar's recent strength, emerging markets currencies have held up well, and local yields were averaging 7%–8% by our team's estimate.

Latin America has been leading the charge so far in 2023 thanks to high real yields relative to other regions. Mexico and Brazil have been the stars in that respect, and Colombia has also outperformed, our analysts noted. While Chile has been underperforming this year for several idiosyncratic reasons, the country's current account deficit has been improving. Real yields in the region should start declining as the monetary policy easing cycle extends, with Brazil and Chile having already begun cutting policy rates.

Currencies and rates in emerging Asia have been struggling under the weight of China's growth slowdown, which has driven down the yuan, as well as the weak Japanese yen and higher oil prices. But in the view of our analysts, China's economy may be bottoming out, with the large exception of the property market, and they expected growth to hold at 4%–5% over the next year.

Fundamentals in Asia overall were strong as usual, including external balances, and deficits—where they existed—were under control, the team noted.

Nevertheless, the team was closely watching some serious risks.

- **Potential policy mistakes.** Some emerging markets central banks have started to cut rates lately, after reaching the end of their rate-hike cycles last year. But the Fed has committed to higher-for-longer interest rates at the same time, raising the chances of policy mistakes in emerging markets.
- **China's ailing property market.** Once China's largest developer, Country Garden finally defaulted on a loan and recently announced it could not pay all of its international debt. Overall, the distress in the property market has kept investor sentiment and Chinese consumer confidence very low.
- **The possibility of a hard landing.** Pricing in emerging markets currencies and rates has reflected the expectation that the US economy is heading toward a soft landing, which means a different outcome would likely trigger selloffs, in our analysts' view. They were looking to the Fed's meeting in November for more clarity on that issue.

The Big Question

It seems that all roads still lead back to that issue: Will the US economy achieve a soft landing and help sustain global growth?

In mid-October, the International Monetary Fund said the chances have increased in its view.⁴ Yet, the recent rise in long-term US bond yields has tightened financial conditions further and added some weight to the argument for a hard landing, or recession. As fixed income investors closely watched developments in the Middle East, parsed the economic data rolling in, and looked to the Fed for clarity, finding select opportunities for high-quality yield was the order of the day.

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, curve spreads, and deficit figures in Viewpoints were sourced from: [Resource Center | U.S. Department of the Treasury](#)

² Bankruptcies: Marketwatch, 14 October 2023. Credit card data: St. Louis Federal Reserve (FRED), accessed 16 October 2023. Mortgage rates: Bankrate, 11 October 2023.

³ 4 October 2023: [Zambia's Creditor Group Sees \\$6.3 Billion Debt Deal in Days - Bloomberg](#); 9 October 2023: [Exclusive: Ukraine sounds out bondholders on debt restructuring, new financing -sources | Reuters](#)

⁴ October 2023: [World Economic Outlook, October 2023: Navigating Global Divergences \(imf.org\)](#)

Important Information

Originally published on 17 October 2023. Revised and republished on 20 October 2023.

An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Emerging markets securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in these countries. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

The indices referenced in this document are included merely to show general trends in the market during the periods indicated and are not intended to imply that investments made pursuant to the strategy are or will be comparable to any index in either composition or element of risk. The strategy is not restricted to securities comprising any index. The strategy may use various investment techniques not reflected in an index. The indices referenced herein are unmanaged and have no fees. One cannot invest directly in an index. There is no guarantee that the strategy's performance will meet or exceed any index.

Certain information contained herein constitutes "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "intent," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events may differ materially from those reflected or contemplated in such forward-looking statements.

This document reflects the views of Lazard Asset Management LLC or its affiliates ("Lazard") based upon information believed to be reliable as of the publication date. There is no guarantee that any forecast or opinion will be realized. This document is provided by Lazard Asset Management LLC or its affiliates ("Lazard") for informational purposes only. Nothing herein constitutes investment advice or a recommendation relating to any security, commodity, derivative, investment management service, or investment product. Investments in securities, derivatives, and commodities involve risk, will fluctuate in price, and may result in losses. Certain assets held in Lazard's investment portfolios, in particular alternative investment portfolios, can involve high degrees of risk and volatility when compared to other assets. Similarly, certain assets held in Lazard's investment portfolios may trade in less liquid or efficient markets, which can affect investment performance. Past performance does not guarantee future results. The views expressed herein are subject to change and may differ from the views of other Lazard investment professionals.

This document is intended only for persons residing in jurisdictions where its distribution or availability is consistent with local laws and Lazard's local regulatory authorizations. Please visit www.lazardassetmanagement.com/globaldisclosure for the specific Lazard entities that have issued this document and the scope of their authorized activities.