BNY

iFlow

MACRO MORNING BRIEFING

October 18, 2024

Credit, Growth and iFlow Short

- US lack of credit fears may be changing and wrapped around the noise of FOMC policy against the US election and the real economy.
- The spread of IG vs. MBS has shifted in 2024 but that may be under threat in 2025 our iFlow Short data (reflecting our security lending) reveal unstable correlations.
- The ongoing rate path from the Fed to a terminal rate of 3% may not be as calming on rate volatility as in previous easing cycles with the risks of credit not fully reflected in markets.

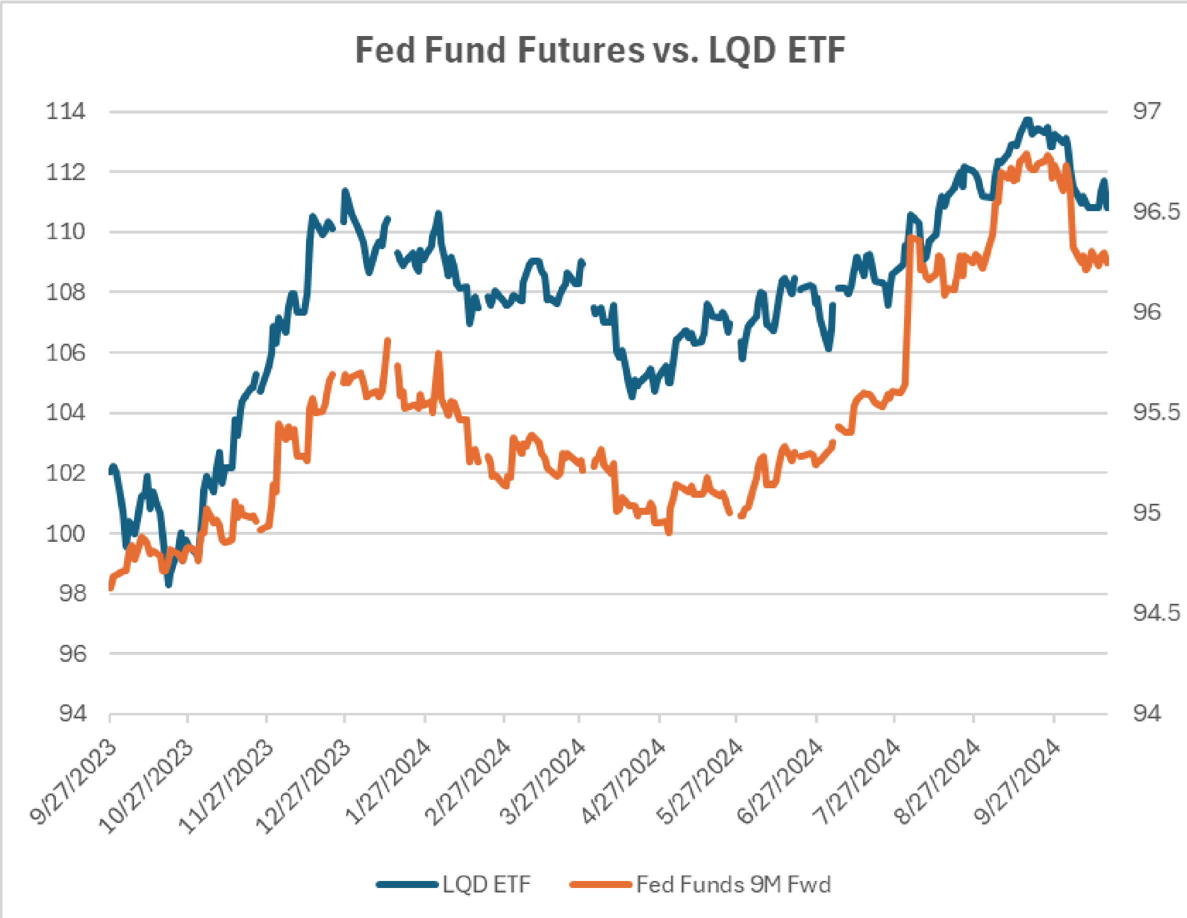
Neither investment grade (IG) bonds nor mortgage back securities (MBS) are going to be immune to the volatility in fixed income markets over the weeks ahead – with the focus on US uncertainty, the Fed rate cutting path and the US election.

The outperformance of IG debt relative to MBS since the pandemic has been part of the mystery of US fixed income trading. From 2021 to now, IG has outperformed MBS by 87%, but over the last six months this has flipped and MBS since August have led, increasing by 7%. So, what’s different now?

Over the past two years, markets have gone from thinking there will be a recession to believing in the likelihood of a soft landing to a belief in a no-landing scenario. The pricing of fed funds futures nine months forward has been one of the best ways to understand the lack of credit fears in US fixed income markets. The clear link between IG and fed fund futures is shown in Exhibit #1 – where generic nine-month fed funds futures are compared to the LQD ETF. The broader composite of ETFs in

IG shows a similar story: The credit market believes in the power of the Fed to protect asset prices.

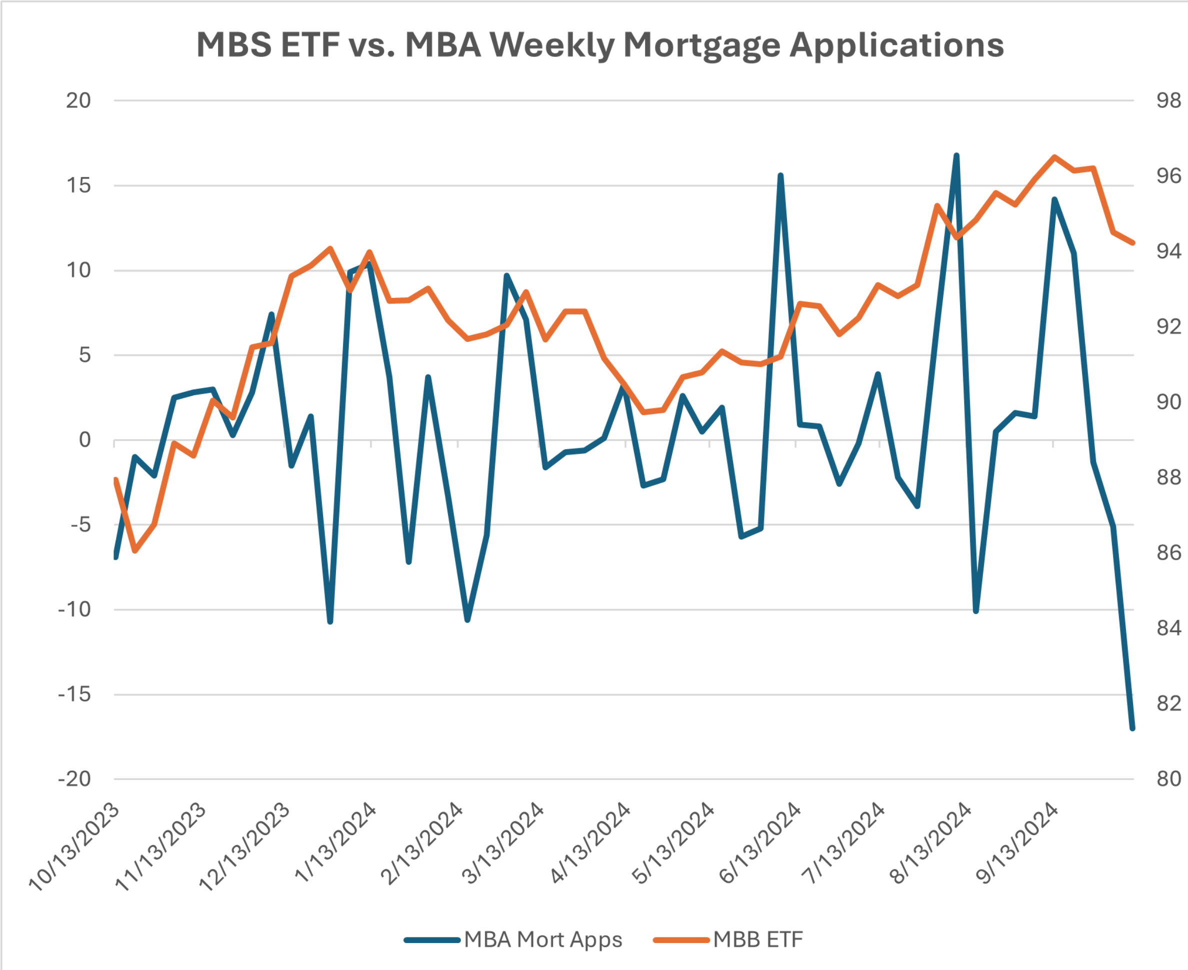
Exhibit #1: IG and FOMC Policy Expectations Are Correlated



Source: Bloomberg, BNY

Many market observers believe fixed income volatility will drop as soft-landing risks rise, and that then mortgages will outperform the corporate credit market. The negative convexity of lower rates in MBS pools is countered by the cyclical views that demand for new purchases will continue apace. The chart to consider in MBS is how applications for new mortgages or refinances shift with rates. This is about volume of the total product and its convexity to rate shifts. Clearly the volatility of the last two weeks should give some pause to the view that MBS outperform IG. There is a clear requirement in spread trading that volatility remains tame and that the forward guidance of policy matches market expectations. The US election uncertainty adds to concerns about rates and adds to the risks of MBS in the short term.

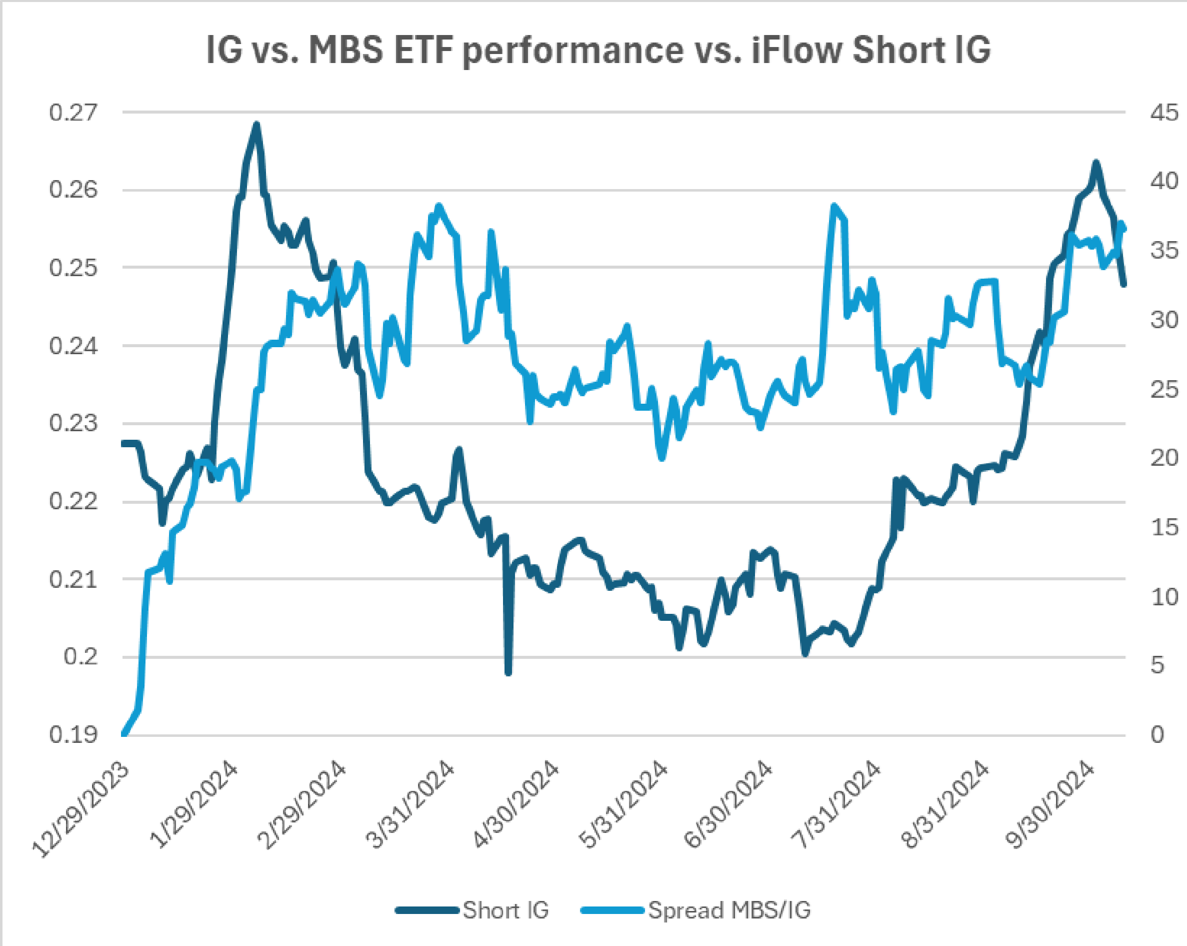
Exhibit #2: Mortgage Demand Drives Price



Source: Bloomberg, BNY

On the other side of the spread IG has its own set of idiosyncratic problems. The troubles in one company – Boeing – have infected many IG indices as this may eventually become a historic fallen angel. One reason for the credit outperformance during the Covid-19 pandemic was the Fed action to buy such companies. Credit has remained tight on spreads. Tracking credit worries since the Great Recession has shifted from CDS to spread to ETF watching. Exhibit #3 highlights the role of IG shorts using iFlow short data (measuring the security lending of this product). The fear of a recession or a bumpy landing of the US economy vs. FOMC policy being a lifebuoy for asset prices clearly shows up in our investor flows.

Exhibit #3: IG Shorts Not the Full Story of Risk

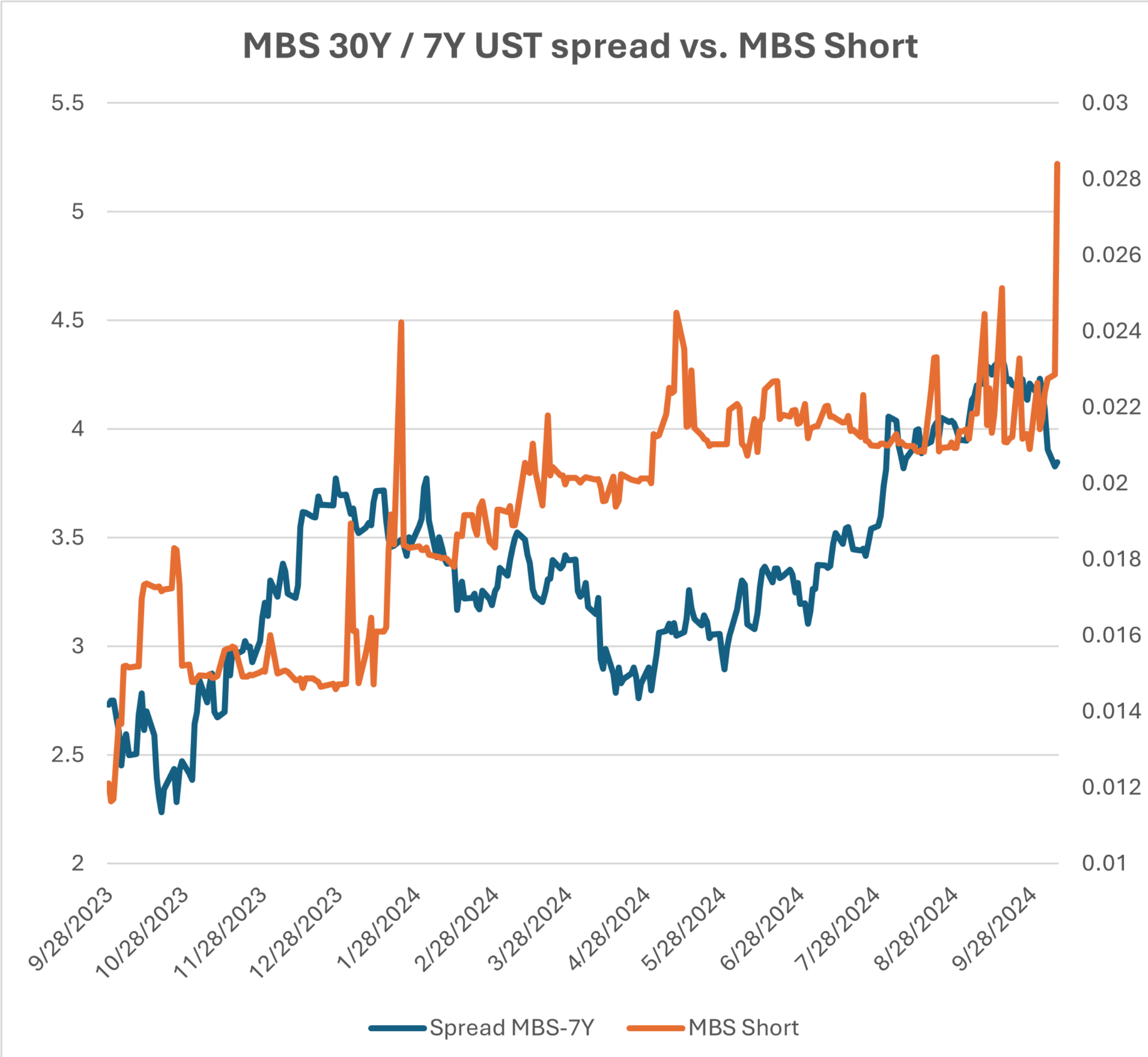


Source iFlow Short, BNY

In 2024, the shift in Fed policy outlooks mattered more and led to a sharp increase in MBS interest – as shown in the ETF markets. The outperformance of MBS also was part of the August BOJ-related washout in risk – when the weaker US jobs report coupled with a hike in Bank of Japan rates and stock market correction led to a drop in IG but a rally in MBS. This normalized quickly but highlights the link of government guarantees in the mortgage markets. The risk for 2025 could lie in that linkage coming under doubt should policy toward the agencies' role in underwriting shift. The MBS performance against the US 7y government note is noteworthy in thinking about the risks ahead with the rise in shorts over the last few days reflecting both rate moves and the uncertainty of events ahead. There is a correlation between rates and MBS that has been increasingly unreliable.

Bottom Line: The credit cycle has not worked since the pandemic in part because of the FOMC's actions and the government role in that crisis. The rise in rates has not had the usual effects on the business cycle. The aftermath has left investors rethinking the role of fixed income in portfolios and the attraction of carry or relative value spread positioning. The problems of 2024 have been the noise of market pricing of Fed policy against guidance and the real economy.

Exhibit #4: US Rates and MBS Correlation Less Stable?



Source: iFlow Short, BNY

Disclaimer & Disclosures

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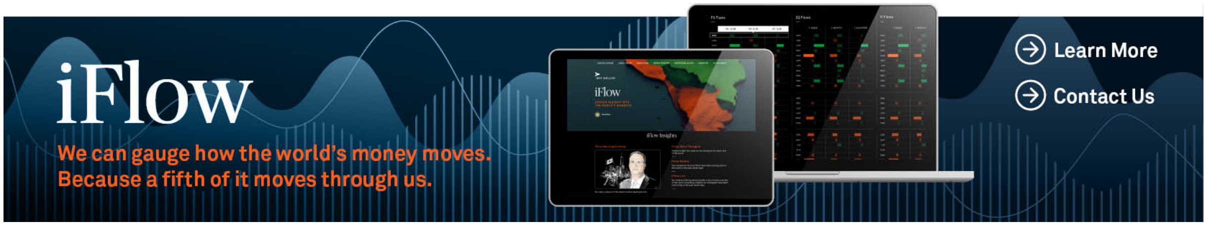

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