Fixed income at a turning point: strategies and outlook for 2024

A strong start to the year has been fuelled by hope that the global economy is heading for a soft landing, but can the momentum be maintained?

LSEG DATA & ANALYTICS

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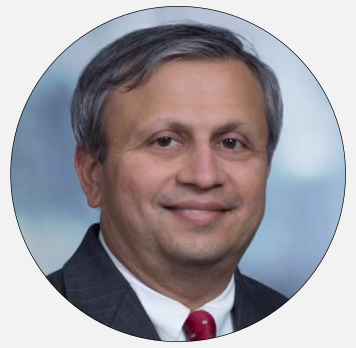
Foreword

Could 2024 be the year of the bond? It's a real possibility, despite such challenges as the uncertain outlook for inflation and ongoing regional conflicts

The fixed income landscape dramatically improved for traders and investors in the last months of 2023, bringing some much-needed relief to a market weighed down by another year of rising interest rates, geopolitical crises, bank failures and volatility. Central banks continued to talk tough at the beginning of the year despite signs that high interest rates were tempering inflationary pressures. Mid-way through 2023, as central banks stopped hiking rates and the yield on the 10-year US Treasury pushed 5% for the first time since the financial crisis of 2007, talk turned to the potential of easing in 2024 and the likelihood of a soft or hard landing for the economy. Positive economic figures at the end of the year suggested resilience in the corporate sector and rates and equities rallied.

The consensus is for a much better year for fixed income assets in 2024; the market remains hopeful that rate cuts are coming and this gives investors confidence to move out of cash into longer-dated securities. There will be challenges. In many major economies, inflation is proving hard to eradicate, which reduces the likelihood of rate cuts. There is a wave of refinancing on the horizon. Additionally, as central banks move from quantitative easing (QE) to quantitative tightening (QT), a major bond buyer will exit the market. The threat to the global economy and inflation from further geopolitical crises will also be closely monitored. Nevertheless, despite the challenges, 2024 may still turn out to be year of the bond.

Authors



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> "We're in a very unique space at LSEG, as we sit at the heart of an ecosystem supplying data for multi-use cases – on the analytics side and especially on the fixed income side – in this new AI world."
>
> **Andres Gomez,**
> Head of Analytics Business Development, LSEG

A look back to fixed income in 2023

Bank failures and the ongoing impact of conflict in Ukraine provided a problematic backdrop for last year. However, these challenges were overshadowed by signs that inflation is moderating. Optimism on rate cuts fuelled an end-of-year bond rally to remember

The three trends that defined 2023

Economy 01

Geopolitical instability and the lasting effects of the Covid-19 pandemic raised concerns for the health of the global economy. The war in Ukraine continued to impact global supply chains, and the conflict in the Middle East exacerbated the situation, with Red Sea shipping re-routed around the Cape of Good Hope following Houthi rebel attacks. High inflation was met with tight monetary policy, and trade disruptions undermined the growth potential of major economies.

Bank failures 02

In March 2023, three regional US banks failed along with Silicon Valley Bank (SVB), triggering a crisis of confidence in the resilience of banks and the stability of financial markets around the world. Risk management processes were severely tested by the sudden end to what had been a period of historically low interest rates. As the outlook for the economy deteriorated, uninsured deposits were rapidly withdrawn at the likes of SVB – a banker to high-tech and life sciences start-ups – at the same time as its unrealised losses on longer-term investments increased.

In Europe, Credit Suisse, which had struggled with a series of scandals and negative rumours about its financial health, also experienced significant deposit outflows while potential trading counterparts became increasingly unwilling to take the other side of deals. In March, UBS agreed to a forced acquisition of Credit Suisse. As part of the deal, Credit Suisse Alternative Tier 1 bonds were written down to zero, creating further turmoil in the bond market.

Interest rates and inflation 03

US inflation peaked at 9.1% in June 2022, but the Federal Reserve and other central banks continued to tighten monetary policy to prevent inflationary pressures from establishing within domestic economies. Fed funds continued to rise through the first half of 2023, before stabilising at 5.50% in June.

Interest rates at the long end of the curve also increased during the first part of the year before the yield on the 10-year US Treasury peaked at just over 5.00% in October – a level not seen since 2007. Increasing confidence that inflation was being tamed and optimism that central banks would start easing in 2024 created the conditions for investors to return to the bond markets. Bond prices rallied hard in November and December, registering the strongest two-month performance for the market for over 30 years, and saving it from a third year of declines.

Navigating 2023's fixed income volatility

A rollercoaster year ended with investors moving out of cash to lock in higher yields

> "At the beginning of 2023, the fixed income market was concerned about the possible economic impact of high interest rates and bank failures. Recessionary fears receded in the second half and fixed income, credit and equity markets all rallied hard."
>
> **Unmesh Bhide,**
> Director, Securitized Products Valuation, LSEG

The final two months of 2023 were a saviour for fixed incomes asset managers. As late as October, the fixed income market was on course to set a record third straight year of losses as fears over the impact of central bank interest rate policy on the economy persisted. But growing optimism that inflation was back under control and expectations that short-term interest rates would likely be lower in 2024 gave confidence to investors to lock in absolute yield levels in government bonds.

Welcome economic indicators, meanwhile, pointed to a world heading for a soft landing rather than recession, which fuelled buying interest in equity markets and in corporate credit. Confidence in the prospects for corporate earnings resulted in credit spreads tightening, with buyers attracted by headline returns and in the pick-up in government bonds. Credit-sensitive corners of the bond market performed strongly as the economy avoided recession. High-yield bonds gained 13.5%, making for their best year since 2019[1].

Fixed income funds, which had suffered from massive withdrawals in 2022, experienced positive flows during much of 2023 as inflation fell; mutual bond funds and fixed income ETFs drew $375 billion of inflows in 2023, according to Lipper[2], with flows particularly strong in the first half of the year. This trend is set to continue in 2024 as the fall in money-market rates is expected to encourage investors out of cash and into the longer end of the curve to pick up higher rates of interest.

The enthusiasm for fixed income ETFs continued to gain momentum during 2023 with BlackRock's iShares division reporting a record-breaking year for fixed income inflows. Some $331.9 billion was added.

1 www.morningstar.co.uk/uk/news/244495/what-caused-2023s-everything-rally.aspx

2 www.lseg.com/en/data-analytics/asset-management-solutions/lipper-fund-performance

The impact of 2023 on fixed income trading

All of these changes in the fixed income ecosystem created significant challenges for asset managers and investors. They need:

Precise data

In times of high volatility, asset managers and investors need data that they trust, whether evaluated pricing data for less liquid fixed income instruments or comprehensive reference data for trading and compliance needs. Data accuracy is always vitally important, but in volatile markets it is even more essential.

Data transparency

The trading environment of 2023 reinforced the importance of transparency in fixed income pricing data and index data. Asset managers and investors need to see the methodologies and data behind every evaluated price.

Greater demand for ETFs and portfolio and index trading also requires accurate real-time data for traders to accurately hedge positions. They need to be able to understand with precision what is happening in the underlying markets of the indices they use.

Data consistency across front, middle and back office

Challenging markets make it even more important to be able to work with connected data across the enterprise and through the entire trade lifecycle.

Pricing and index data is needed in the front office for back testing and best execution and daily portfolio valuation. This data needs to be applied across the middle office for risk management and compliance and in the back office for clearing and settlement processes. Both indices and securities data, including pricing, need to be consistent for robust portfolio management and risk management.

Obtaining pricing and index data from a trusted, recognised provider is very important. Portfolio managers and the teams that support them need to have confidence in the data they use to deliver value to both customers and shareholders.

Looking at fixed income trends in the future

Rate cuts are on the agenda in 2024, and the global economy is set for a soft landing. But challenges remain

The fixed income outlook is increasingly positive for investors in 2024. The inflation cycle has turned and short-term interest rates are set to trend lower. Thoughts now focus on prospects for the global economy. Can central banks engineer a soft landing, or will the period of high interest rates of the last couple of years tip economies into recession as a result of the battle to ward off inflation?

4.9%

third quarter real GDP increase in US in 2023

0.6%

forecast rise in growth in Europe in 2024

The debate on whether rates will remain higher for longer continues. Although rate cuts are expected in many economies this year, the pace is highly uncertain. Switzerland was the first major central bank to announce a cut (in March), but the timetable for reductions in the US is receding.

The issue in the US is that inflation remains stubbornly high. Despite the extended discipline of higher rates, in the first months of 2024, the economy is running medium-hot, with the Federal Reserve expecting real GDP to rise 2.1% in 2024[1]. In Europe, meanwhile, growth is stagnating and is likely to remain subdued throughout 2024 – the ECB forecasts eurozone growth of just 0.6% in 2024, 1.5% in 2025 and 1.6% in 2026[2].

While central banks have room to cut rates, they are still intent on squeezing out inflation from domestic economies. At the same time, they are mindful that the tight interest rate policy of the last two years could precipitate a recession.

That said, economists expect that central banks will have room to start reducing interest rates in the second half of the year. Although expectations are reduced, markets are are still pricing two or perhaps three US Federal Reserve cuts in 2024.

With short-term interest rates tipped to fall and optimistic about a soft-landing, investors have the confidence to move out of cash and into long-dated securities. That process already started at the end of 2023, inverting the US Treasury yield curve, but it is likely to continue during 2024 as returns in the front end of the curve start to fall.

The hunt for additional fixed income yield also resulted in a rally of credit spreads during the last two months of 2023 and there is likely to be limited room for further spread tightening. Corporate spreads, which tightened in correlation with rising equity markets, may have little room to extend that performance. That correlation is likely to be less pronounced in 2024, with refinancing a concern in high-yield. Servicing high levels of interest rates on new debt taken out to finance maturing bonds could prove a test for borrowers.

There is also a greater supply of public sector debt refinancing for the private sector to absorb as central banks look to reduce the size of their balance sheets by replacing quantitative easing with quantitative tightening.

While the outlook for fixed income in 2024 is broadly positive, there are plenty of opportunities for volatility to return. Potential triggers include a hard landing for the global economy, a surge in inflation, and default rates increasing in commercial real estate.

There is also potential for new volatility from further deterioration of the geopolitical crises in Ukraine and the Middle East. And then there's the small matter of almost half the world's population going to the ballot box this year.

To negotiate the challenges of 2024, firms will need access to an ever-widening array of high quality independent data, including indices and analytics across the fixed income universe. This will need augmenting with data covering other asset classes and non-financial data points that can feed into algorithms and generative AI models.

1 www.federalreserve.gov/monetarypolicy/fomcprojtabl20240320.htm

2 www.ecb.europa.eu/press/projections/html/index.en.html

> “We'll see greater need for independent, robust pricing data from the middle and front office as instruments become more complex and harder to value, whether that be for price discovery or risk assessment.”
>
> **Jayme Fagas,**
> Global Head, Valuations and Transparency Services, LSEG

2024

Managing regulatory change in challenging times

Authorities in the US and Europe are continuing to refine market rules to reduce risk and accelerate the drive to ESG

Regulators continue to pursue policies that improve the structure and transparency of financial markets, including fixed income, in order to enhance market integrity, encourage competition and protect investors.

In the US, the Securities and Exchange Commission (SEC) said it would exempt broker-dealers from applying disclosure rule (Rule 15c2-11) to 144A bonds. The disclosure rule required dealers to ascertain that an issuer's financial statements are publicly available and that they had reasonable faith that the information was accurate and reliable before quoting its securities. There had been fears that the rule would impact liquidity in the market for bonds sold to sophisticated investors.

It also amended Rule 15c6-1 to shorten the settlement cycle for securities transactions from two business days after the transaction to one business day (T+1). The change, which will come into effect in May 2024, reduces market risk and enables investors to gain earlier access to proceeds from transactions.

In Europe, the European Securities and Markets Authority (ESMA) launched a call for evidence to assess the costs and benefits of a move to a reduction in the settlement cycle to T+1 in other jurisdictions. It is tasked to produce a report by January 2025.

The UK's taskforce on T+1 settlement reported in March 2024 and recommended a switch no later than December 2027, although it said the UK should consider whether its timetable should be co-ordinated with that of continental Europe.

The process of moving away from the LIBOR benchmark continues. Although SONIA (for sterling) and SOFR (for US dollars) are now the market reference points, some synthetic US dollar LIBOR rates will continue to be published until the end of September for legacy contracts.

Investor interest in sustainability continues to drive the growth of ESG bonds and ESG bond funds. The European Parliament adopted a new voluntary standard for the use of a European Green Bond label (EuGB), the first of its kind in the world. The regulation lays down uniform standards, aligned with the EU's taxonomy for issuers wishing to use the EuGB label for marketing bonds. This will enable investors to better direct their money towards sustainable businesses. It is expected to increase interest in these products – and drive demand for more data.

Issuers will be able to utilise the EuGB Standard from December 2024.

AI, data and the cloud: the technology opportunities

Artificial intelligence (AI) is emerging as an essential tool that helps asset managers and investors identify opportunities and manage risk

This year looks set to see the wider implementation of AI in the fixed income market. As well as negotiating an always unpredictable and volatile environment for fixed income, firms will need to efficiently manage the risk of holding multiple portfolios of securities with increasingly complex structures across a variety of asset classes where correlation may change rapidly. They will need to increase their agility to minimise the impact of potential negative events, dynamically hedge fixed income and cross-asset class portfolio exposure and run scenarios using financial, economic and political data in order to benefit from emerging opportunities. They must also enhance operational efficiency internally to satisfy compliance teams as the regulatory environment evolves. Key strategic themes for fixed income operations include:

> “As more and more AI, machine learning and large language models are deployed this year, there will be a huge need for good, clean historical data as well as real-time data on which they will be trained and kept up to date.”
>
> **Andres Gomez,**
> Head of Analytics Business Development, LSEG

More data

In order to meet their business and regulatory requirements, trading desks and the middle office are finding they need access to additional data types, including intraday pricing or historical data for back-testing. Some firms want to monitor a price for price discovery, others need additional reference data. All of this data needs to be connected with the evaluated pricing data that they already receive, supplied in a one-stop shop data ecosystem.

The advent of more accessible AI programming among a wider number of market participants will require an even greater array of reliable, transparent and robust real-time and historical data sets.

Data is not enough

Developing sophistication in the market and the need to manage market volatility is a growing demand for fixed income analytics. Firms need to augment their analytics – in the front, middle and back office – to improve portfolio management, identify trading opportunities and manage risk in a more efficient way. Some are using “out-of-the-box” analytics while others are using services that provide building blocks that can be developed into their own custom analytics.

More data and analytics in the cloud

The wider trend towards moving fixed income data, processes and analytics to the cloud is increasing although firms are adopting the approach at different speeds. Smaller, cloud-native firms may already have their fixed income data, analytics and order management systems in the cloud as they benefit from greater agility and a lighter regulatory touch than with larger firms. The increasing use of AI will increase demand for more data and more analytics based in the cloud as asset managers and investors adapt processes to identify opportunity, manage risk and remain compliant.

2024

Planning for the future: thinking strategically about fixed income data

The outlook is good, but volatility will remain. These five strategies can help investors seize the opportunities of 2024

The broad consensus is that the fixed income market is on track to generate positive returns in 2024. However, volatility and market fragmentation are still on track to present challenges – and opportunities – for asset managers and investors. Here are five things to focus on in the coming year.

Trading less liquid fixed income securities

Less liquid fixed income securities are becoming an increasingly important sector for asset managers and investors in the hunt for alpha returns, but they need robust, accurate and independent pricing to provide an evaluated or indicative level for these instruments, or to prove best execution. LSEG Pricing Service is an independent, global evaluated pricing source covering over 2.8 million of fixed income securities and OTC derivatives. The evaluations approach encompasses strict validation and governance processes and evaluations are delivered multiple times per day for some asset classes. It offers transparency for all evaluations and includes price recipes, corresponding market colour and other relevant data.

Index-based fixed income strategies

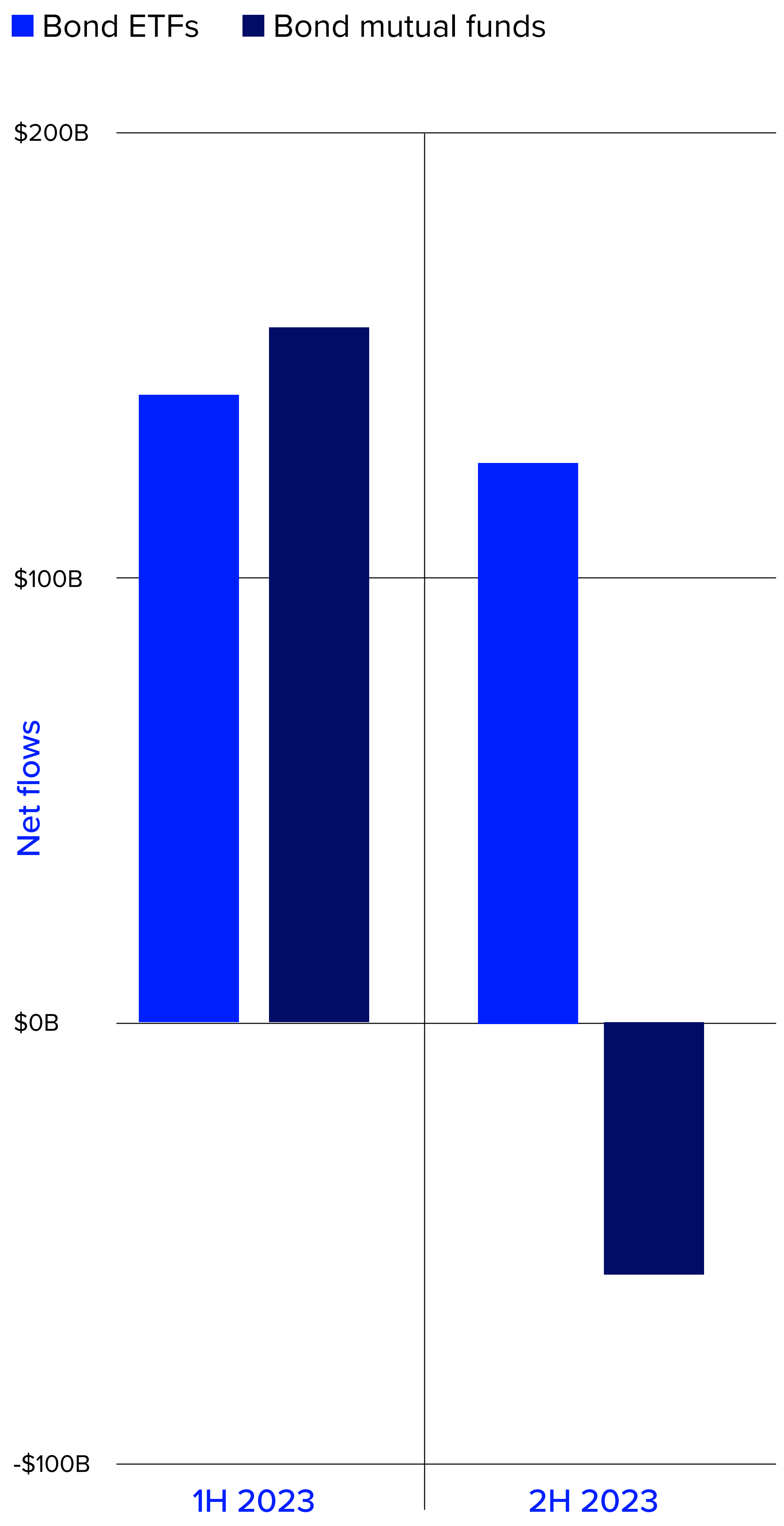
Some asset managers and investors may wish to engage with index-based fixed income products to simplify their strategy and avoid liquidity issues. FTSE Russell's fixed income indices are a comprehensive and flexible range of benchmarks designed to measure and analyse the performance of global, regional, and local debt markets. Investors can implement their investment view with a modular selection of sub-indices available in any combination of asset class, maturity and rating. LSEG Pricing Service is the largest pricing provider to the FTSE Russell fixed income indices, which means that users have the perfect tool for pricing and hedging the underlying constituents.

Performing fixed income analytics to develop new trading strategies

To find opportunities ahead of the crowd, asset managers and investors need to increase their use of fixed income analytics. Capable of handling the most complex fixed income products, Yield Book is a trusted source for in-depth risk analytics and complex portfolio analysis across global markets.

> "There are numerous correlations to keep track of so it's important to use a cross-sector approach and have a good analytical framework to manage risk and conduct 'what if' scenarios. That's where LSEG's data and analytics really add value."
>
> **Unmesh Bhide**
> Director, Securitized Products Valuation, LSEG

Bond fund flows started strong in 2023 but weakened after rate cuts seemed less likely



Source: Lipper

Yield Book has a particular specialism in modelling complex security types with an extensive security-level price and analytical history for research, back-testing, and development of investment strategies. In addition, Instrument Pricing Analytics is an API that provides on-demand analytic computation across asset classes, and pricing data, such as zero curves and volatility surfaces. Users also have control over the calculations they want to perform. Instrument Pricing Analytics combines quantitative analytics with native integration to market and reference data, which enables users to compute custom-tailored analytics.

Meeting fixed income regulatory requirements

Regulatory change often means making changes to the data and processes firms use to meet their compliance obligations. LSEG Reference Data provides comprehensive coverage of legal entity, corporate and compliance data that keeps pace with fixed income teams' risk management and compliance needs. With more than 80 million active and retired securities updated every week, LSEG Reference Data helps firms around the globe meet their regulatory requirements, such as MiFID II, Solvency II, FRTB, SFTR, CSD-R, LIBOR transition, SFDR, SEC Rule 2a-5 and more. In addition, as a long-trusted partner to clients, Yield Book supports independent risk assessment as part of clients' regulatory risk submissions, including model validation. While Yield Book offers out-of-the-box analytics with market-aligned standard assumptions, clients can also refine their analytics sets and include custom data, curve assumptions and scenarios

Managing risks associated with fixed income investing

Both the front and middle office need to be able to manage the risks inherent with investing in fixed income. Having a connected approach to fixed income data and analytics across the front, middle and back office has never been more important during time of market volatility. LSEG understands this and ensures that its data is connected so that fixed income asset managers and investors can work seamlessly across the whole span of their enterprise. Yield Book, for example, is driven by Pricing and Reference Data from LSEG, which also underpins the construction of FTSE Russell fixed income indices. This enables clients to access a fully integrated content set across prices, data, indices and analytics. Working with the right partner for fixed income data, indices and analytics can help asset managers and investors optimise their ability to seize opportunities, while also managing risk and ensuring compliance with regulatory obligations in a connected and transparent way.

> "Everyone needs to feel comfortable with respect to closing prices in fixed income, and not just the more liquid, commoditised instruments. Customers trust in our expertise, our quality assurance and exposure to market colour, to provide accurate pricing on 2.8 million fixed income instruments every day."
>
> **Jayme Fagas,**
> Global Head, Valuations and Transparency Services, LSEG

Conclusion

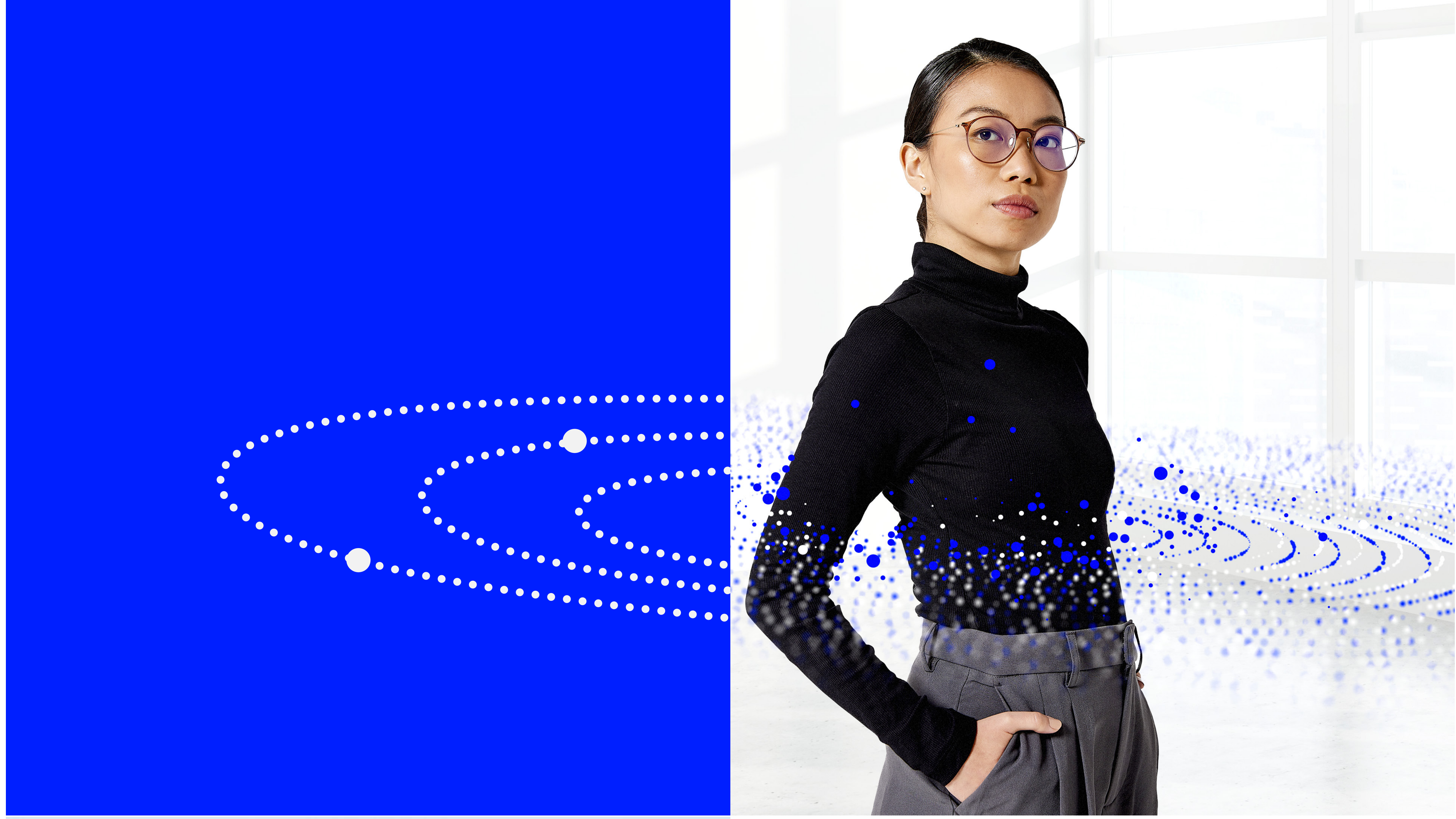
Amid rapid change, asset managers and investors must expect the unexpected. Data and analytics need to be agile

To thrive in a changing fixed income environment, asset managers and investors must be strategically proactive about the data and analytics they need. Being able to identify opportunity, manage risk and remain compliant means engaging with data and technology in new ways.

LSEG is uniquely able to meet the evolving needs of fixed income traders and investors. Operating with the same fixed income data across products, these solutions deliver a connected approach across the front, middle and back office. LSEG provides firms with the confidence of receiving complete and consistent coverage of fixed income markets and instruments across reference data, pricing, indices and analytics from one single provider.

This enables firms, for example, to optimise their fixed income strategy with pricing and reference data that is integrated into their indices. And when fixed income pricing and indices are calculated using the same data, portfolio valuations are not susceptible to basis risk. They are more accurate. With the same data being used in the middle office, firms are also assured that risk management and compliance processes are more transparent.

The outlook for the fixed income markets may be positive in 2024, but perhaps the biggest lesson learned from 2023 is that fixed income asset managers and investors should expect the unexpected. Optimising opportunity, managing risk and embracing regulatory change in a volatile environment requires data and analytics that are as agile as the firm itself wants to be.



Delivering strategic value

In challenging markets, confidence is vital. LSEG's robust data and analytics provide the insights investors need

LSEG is a leading global financial markets infrastructure and data provider that is a trusted source for powerful, in-depth fixed income pricing, reference data, indices and analytics.

This creates new opportunities for fixed income portfolio managers and investors. For example, they can now access the data and analytics they need in a "one-stop shop". And they can engage with the same data sets through the front, middle and back offices – and across different use cases.

It also means that asset managers and investors can operate with greater confidence in challenging markets, knowing they are working with high-quality, transparent fixed income pricing and reference data, indices and analytics throughout the enterprise.

We hope you find this e-book informative. If you are interested in discussing the content further, please visit our website.

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