SPECIAL EDITION: U.S. ELECTION

Allspring

Income Generator

Politics & Bonds: 2024

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KEY TAKEAWAYS:

- Reacting to political change appears to be a better strategy than trying to predict it.
- Political "gridlock" tends to be good for bondholders.
- Fundamentals still matter: Allspring suggests considering U.S. duration and global credit.
- Our Fixed Income Road Map remains valid: 1) diversify duration, 2) prioritize flexibility, and 3) be intentional with risk.

Politics matter in financial markets as the political structure of a country, region, or district serves as the underpinning of any financial system. However, the intersection of politics and finance is complex because political decisions can have both direct and indirect effects on financial markets and economic conditions.

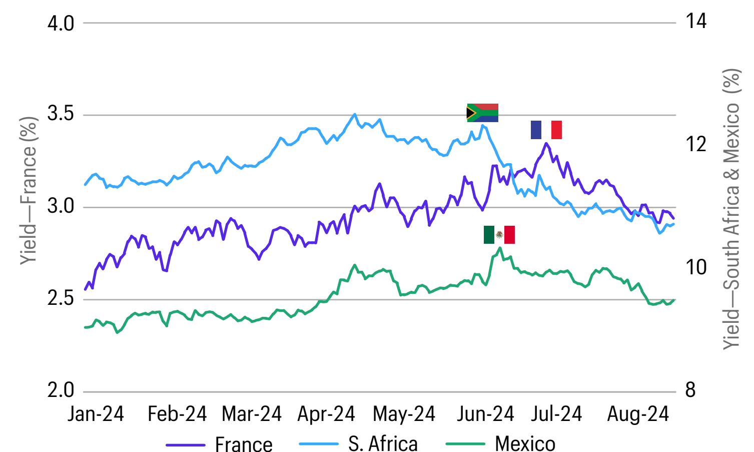
Fundamental economic principles such as ownership, claims on assets, taxation, earnings, and the use of debt all stem from the politics employed to organize a society. Furthermore, many policies—for example, monetary, economic, trade, government spending, and stability (or lack of it)—are defined by a country's political structure.

A historic year for politics

2024 is historic for politics in that more than 50% of the world's population has been heading to the polls this year to vote for their countries' leadership. India, Indonesia, the U.K., France, Mexico, South Africa, Venezuela, and South Korea have already elected new leaders in 2024. It's fair to say that, so far, the world's bond markets took most of these elections in stride, with limited bouts of volatility and a gentle downward trend in yields in each country following its election.

That said, a few opportunities emerged to capitalize on the changing political landscape in several countries, including France, South Africa, and Mexico (Figure 1). In each situation, astute analysis and nimbleness were required to capture the opportunity.

FIGURE 1. BOND YIELDS BEFORE & AFTER RECENT ELECTIONS (10-YEAR GOVERNMENT BONDS OF EACH COUNTRY)



Sources: Allspring and Bloomberg Finance L.P.

With two months to go until the U.S. presidential election, it remains to be seen if the same pre-election pattern will hold true.

Be nimble, be quick

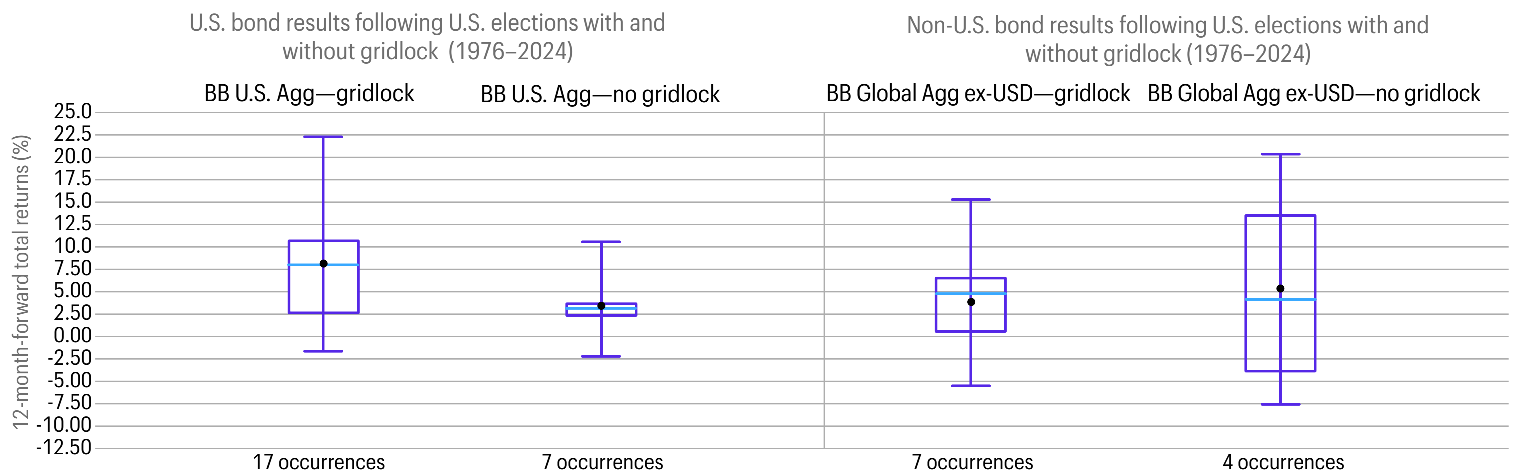
History suggests it's a fool's game to try to pre-position a bond portfolio for a U.S. election. However, repositioning a bond portfolio *after* an election—based on the mix of power across Congress and the president—appears to benefit a portfolio.

In short, bond markets seem to prefer a divided government with some degree of gridlock between Congress and the president. Conversely, a united government—with one party controlling both houses of Congress and the presidency and no gridlock—tends to weigh on bond markets. It's interesting to note that non-U.S. dollar bonds have served as a nice counterpoint to these two trends.

Based on analysis from Allspring's Quantitative Insights & Data Science team, U.S. bonds have tended to generate healthy positive total returns over the 12 months following an election in which control of the U.S. House, Senate, and presidency is divided between the political parties, resulting in some degree of gridlock.

Looking back over the past 48 years and 24 election cycles, the *left* side of Figure 2 shows that the Bloomberg U.S. Aggregate Bond Index delivered an average total return of about 8% over the 12 months following the 17 instances during the tracked period when power was shared across different parts of government—and in sharp contrast, returned only about 3.4%, on average, over the 12 months following the 7 instances of united government.

FIGURE 2. U.S. BONDS OUTPERFORMED WITH U.S. POLITICAL GRIDLOCK AND UNDERPERFORMED WHEN THERE WAS NONE. NON-U.S. BONDS DID THE OPPOSITE.



Source: Allspring Quantitative Insights & Data Science team. BB U.S. Agg = Bloomberg U.S. Aggregate Bond Index; BB Global Agg ex-USD = Bloomberg Global Aggregate ex-USD Index.

For the left and right charts in Figure 2:

- The black dot = the mean
- The blue stripe = the median
- Q1 (25th percentile) & Q3 (75th percentile) = the bottom & top of each box, respectively
- The bottom whisker = the minimum and the top whisker = the maximum

At a high level, this makes sense as political gridlock tends to slow the pace of change and limit the amount of debt-fueled fiscal impulse. Conversely, when one party gains control of government, the likelihood of a surge in debt-fueled stimulus increases and bond markets tend to underperform.

To be fair, not all gridlocks are created equal—different parts of the bond market have tended to perform differently depending on a gridlock's strength. Historically, "strong" gridlock (Congress is united under one party and the president is a member of the other) has tended to be the best environment for bond market returns. However, during periods of "weak" gridlock—when Congress is divided—municipal and short-maturity corporate bonds have tended to meaningfully outperform periods of both strong gridlock and no gridlock.

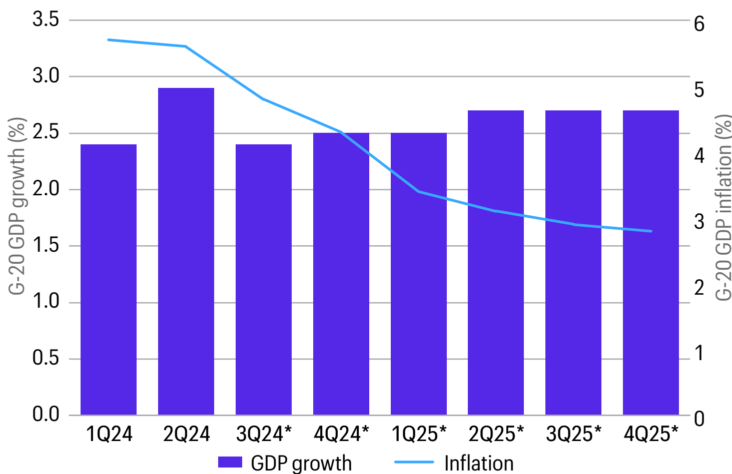
It's also important to note the comparatively opposite results non-U.S. bonds have delivered in the aftermath of previous U.S. elections. During periods of gridlock, non-U.S. bonds have, on average, lagged U.S. bonds—whereas they've outperformed them during periods of no gridlock.

Fundamentals matter

As much as politics matter, economic fundamentals tend to matter more. Despite all the rhetoric leading up to an election, it's hard to ignore a country's economic cycle. Unless leadership attempts a radical policy redirection, economic fundamentals are likely to reassert themselves shortly after the election.

Broadly speaking, over the remainder of 2024 and into 2025, global growth is expected to decelerate while prices moderate. Furthermore, central banks have started adjusting to a slower growth/lower inflation world with easier monetary policy and lower base rates. This should be a favorable macroeconomic environment for bond investors as yields continue to fall and yield curves normalize.

FIGURE 3. FAVORABLE BACKDROP: G-20 GROWTH & INFLATION



Sources: Allspring and Bloomberg Finance L.P.

*Consensus forecasts from Bloomberg's ECFC function. (Bloomberg Key Functions provide analysis and information on securities, sectors, and regions. The ECFC function is used to view economic forecasts and compare regional forecasts.)

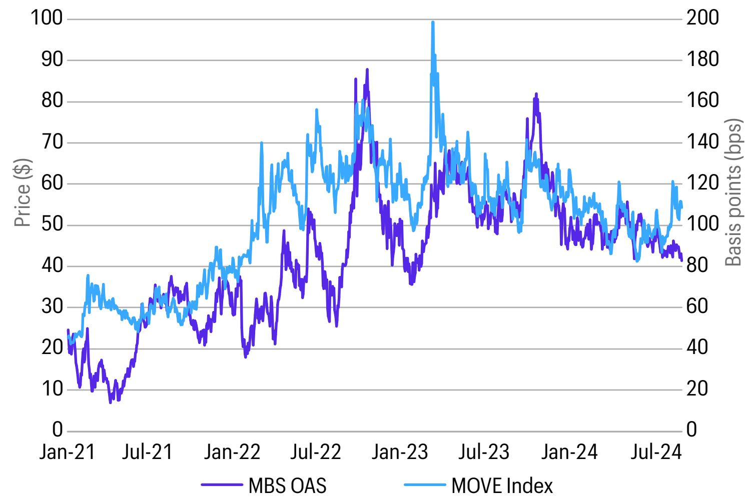
GDP = gross domestic product

The G-20 is a forum of the 20 largest world economies that meets regularly to discuss pressing issues facing the global economy.

Critical to this benign macro backdrop will be the pace of change and the dispersion across regions. Interest rate volatility remains elevated in many jurisdictions and is likely to remain so given the considerable decline in central bank support in most major markets over the past three years. Also, while inflation trends are certainly pointing lower, inflation tends to come in waves. The battle against higher prices isn't quite over yet—another wave of inflation, regardless of size, could boost interest rate volatility.

With the U.S. Federal Reserve poised for a cycle of rate cuts, we favor extending duration and positioning for a steeper yield curve. Also, we believe that with elevated levels of interest rate volatility, traditional pass-through, mortgage-backed securities appear attractive (Figure 4). We believe, as well, that credit markets outside the U.S. offer better value than credit markets inside the U.S. (Figure 5).

FIGURE 4. U.S. INTEREST RATE VOLATILITY & MBS SPREADS



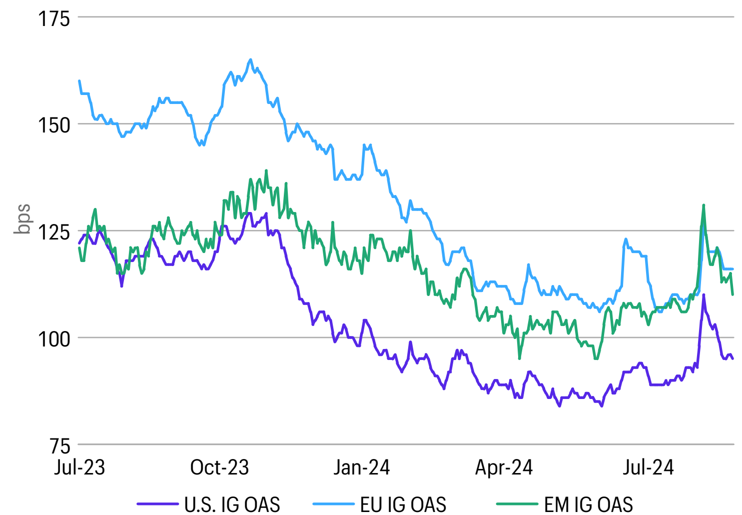
Sources: Allspring and Bloomberg Finance L.P.

MBS OAS = mortgage-backed securities option-adjusted spread

OAS = the measurement of the spread of a fixed income security rate and the risk-free rate of return

MOVE Index = Merrill Lynch Option Volatility Estimate (MOVE) Index

FIGURE 5. GLOBAL IG CREDIT SPREADS



Sources: Allspring and Bloomberg Finance L.P.

IG = investment grade

EU = European Union

EM = emerging markets

From our perspective, Europe and select parts of emerging markets represent opportunities to take advantage of more generous risk premiums and improving credit fundamentals.

Diversify, preserve flexibility, and control risk

Politics certainly matter for bond investors, but the granularity of an election matters as well. Being able to react to a shifting landscape can be just as important as pre-positioning for an expected outcome. At Allspring, we currently employ three basic principles to navigate these shifting markets.

01 **Diversify duration.** The "Goldilocks moment" is upon us. Add duration to portfolios to benefit from lower yields in 2024 and 2025.

02 **Prioritize flexibility.** Implementing small decisions across multiple sectors and maintaining investment flexibility are preferable to maintaining one big macro view.

03 **Be intentional with risk.** Use high nominal yields and generous real yields* to build durable, inflation-beating cash flow streams over the coming years.

*Real yields are the stated return minus the inflation rate.

For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains. Visit our website at www.allspringglobal.com.

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The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.

The Bloomberg Global Aggregate ex-USD Index (unhedged) is an unmanaged index that provides a broad-based measure of the global investment-grade fixed-income markets excluding the U.S.-dollar-denominated debt market. You cannot invest directly in an index.

The Merrill Lynch Option Volatility Estimate (MOVE) Index measures U.S. interest rate volatility. The measured volatility it based on 2-year, 5-year, 10-year, and 30-year U.S. Treasuries. You cannot invest directly in an index.

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