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Fixed Income newsletter

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Editorial

Interest rates are caught between economic optimism and geopolitical incertitude

Macroeconomic indicators continue to beat expectations, foreshadowing a stronger global cyclical recovery, despite the increase in political and geopolitical incertitude on many fronts.

Encouragingly, the general recovery appears to be broader-based than last year, amid signs of an economic improvement among emerging economies including Brazil and Russia. The US and China of course remain the main drivers underlying global growth, followed by the eurozone. US business and consumer confidence remain strong, even before the implementation of the so-called reflationary reforms promised by Donald Trump. The prospect of a more expansionary budgetary policy over the next few quarters should be taken into consideration. However, the composition and timing of a potential tax reform remain uncertain as the Trump administration is not entirely free of constraints, as demonstrated by the failure to secure approval for the law proposing the repeal of Obamacare. In any case, the effects of further stimulus measures will not kick-in until 2018. Against this more buoyant backdrop, headline inflation gauged by the household expenditure deflator is already at 2.1%, with core inflation reaching 1.8%. The Fed can pursue its monetary normalisation strategy, through two further rate hikes by the end of the year, and even begin to reduce the size of its balance sheet by halting reinvestments. Technically, this move should drive yields higher, by increasing the supply of available securities for investors. However, long-term treasuries yields are easing as the markets believe that a reduction in the Fed's balance sheet may slow the pace of base rate hikes. The US yield curve term premium is contracting, amid increasing geopolitical tensions involving the US.

In the eurozone, economic outlook remains promising despite political incertitude stemming from the Brexit and the forthcoming elections. The eurozone is facing the challenge of maintaining its current growth rate over the next few quarters. Given the absence of core inflationary pressures, the ECB should contribute, as it is unlikely to taper its securities purchase programme until early 2018. The ECB could adjust its forward guidance in September of this year. In anticipation, interest rates, which are currently exceptionally low across the entire German yield curve, would trend towards a higher equilibrium level. This scenario could nonetheless be jeopardised by significant downside risks due to political incertitude threatening to destabilise the eurozone. The rise in the anti-European vote in France has made the markets wary of French OAT bonds, with the spread over Germany widening, and heightened nervousness also spilling over to Italy and Spain in particular. Even if the winning candidate in France is pro-Europe, risk premiums will not ease significantly, as the forthcoming elections in the UK and Germany will provide further sources of volatility.

The rise in interest rates, which usually accompanies an improvement in the economic situation, is therefore temporarily undermined by mounting political issues. If these issues prove to be only temporary, fundamental factors will remain firm and take centre-stage once again, reconstituting the term premium through higher interest rates.

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Key macro trends & investment strategy

Europe

Eurozone government bonds sold off during the first quarter of 2017. The yield on the 10-year German Bund reached a peak of just under 0.5%, before declining by the end of Q1 to just above 0.3%. Heightened political concerns caused peripheral Eurozone sovereign bonds to underperform German Bunds, and French spreads over Germany touched a three-year high.

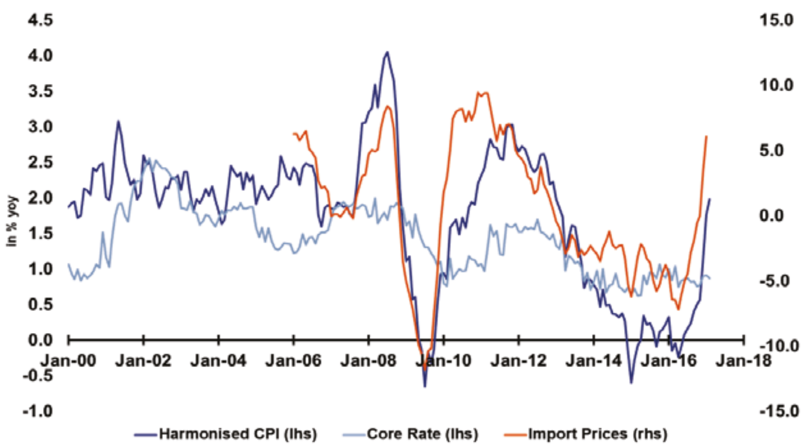
Economic news indicated that growth in the Eurozone was picking up, with the flash estimate of the composite purchasing managers' index (PMI) rising to a six-year high in March, following on from strong readings in both January and February, driven by strong activity in both Germany and France. Eurozone inflation rose to a four-year high of 2.0% in February, above the official target of "just under 2.0%", but declined to 1.5% in March. While Eurozone headline inflation has finally started to accelerate, core inflation slid to 0.7%. First inflation data on March have shown slowdown in Germany and Spain. However, the transmission mechanism between headline and core inflation could re-start working in the coming months.

Stronger growth and rising inflation data prompted speculation that the European Central Bank (ECB) would begin to wind down its monetary stimulus measures. The ECB kept its policy unchanged in March (note, that the size of its monthly bond purchases has been reduced from EUR 80bn to EUR 60bn per month since 1 April, as already announced in its December 2016 meeting), although ECB President Mario Draghi did note that there was no longer "a sense of urgency" for further stimulus measures given that deflation no longer presented a risk to the Eurozone.

The drop of oil prices in March led to a repricing of inflation expectations towards the end of Q1. The Joint OPEC and non-OPEC monitoring committee reaffirmed their strong commitment to achieve the reduction of 1.8mb/d and hinted that there seems to be a high probability for an extension of the agreement after June, but without any meaningful impact on the market. Break-even inflation rates were also influenced by the renewed uncertainty of US President Trump's ability to pass reforms and fiscal cuts.

The busy agenda of political events in 2017 started in mid-March with the elections in the Netherlands. The Dutch electorate assigned the Eurosceptic party PVV less seats than what polls had indicated in the run-up to the elections. However, market sentiment is dominated by headlines around the presidential elections in France of which the first round will take place in April. At the end of March, the UK Prime Minister triggered Article 50, the start of the two-year process to leave the EU, and fended off calls for a second referendum on Scottish independence.

Eurozone rates of inflation



Source: Bloomberg, Datastream – april 2017

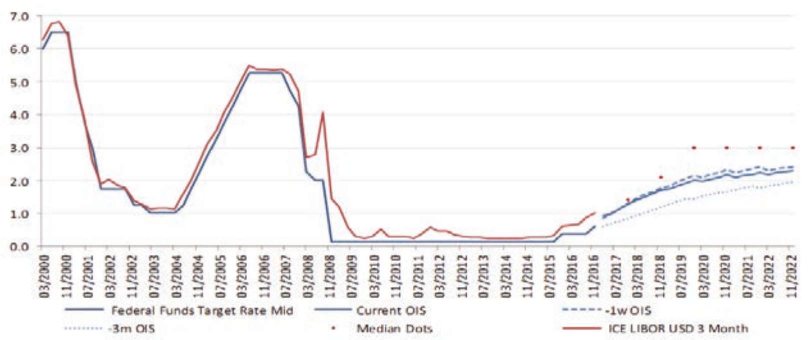
USA

It was a volatile quarter for US bonds, with yields oscillating as investors analyzed economic data, the fiscal agenda as well as Federal Reserve (Fed) statements for indications about the timing and extent of rate rises in 2017. The yield on the 10-year US Treasury bond reached a peak of 2.62% in mid-March amid fears that strengthening growth would mean the Federal Reserve will be more aggressive in raising rates. However, the fading of the Trump rally (after legislation to replace Obamacare failed to gather sufficient support in Congress) and the Fed's relatively dovish tone regarding future rate rises helped yields to fall once more, closing the quarter slightly lower than their level at the end of December. Rising inflation helped Treasury Inflation Protected Securities (TIPS) to outperform nominal Treasuries.

Economic fundamentals remain healthy in the US. The ISM manufacturing PMI rose to a two-year high, and the equivalent survey for the non-manufacturing sector also signaled that activity was increasing. A robust jobs market – more than 235,000 jobs were added in both January and February – helped consumer confidence. Inflation, as measured by headline consumer prices, increased to 2.7% in February, the highest level since March 2012, while the Federal Reserve's preferred measure of inflation, the core Personal Consumption Expenditure Index, rose to 1.8% on a year-on-year basis.

In March, the Federal Reserve raised the Fed Funds rate by 25 basis points to a range of 0.75% to 1.0%. However, the US central bank did not change its "dot plot" projections of interest rates in 2017 and 2018, calming down concerns of a steeper rate hike path compared to its earlier forecast of two further hikes this year.

Fed Funds Rate, FOMC Guidance & Market Pricing

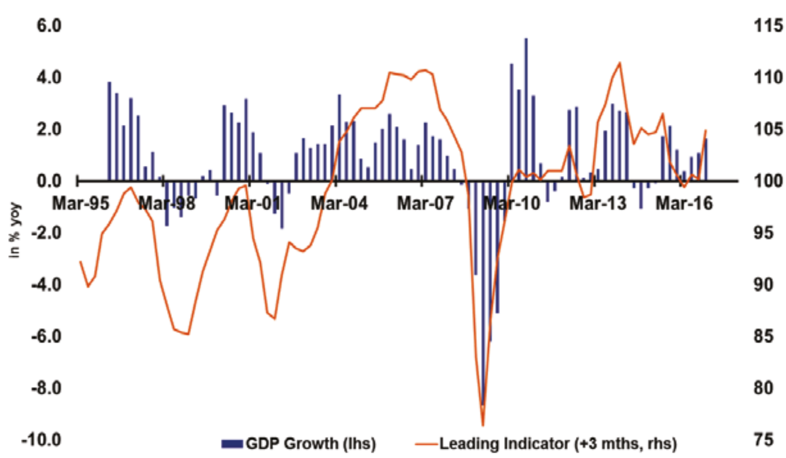


Source: Bloomberg, AllianzGI – April 2017

Japan

Japanese equities ended the quarter with marginal losses, lagging other regions as exporters were hurt by the firmer tone to the Japanese yen. Economic data was mixed: Japan's fourth-quarter GDP growth was revised up to 1.2% on an annualized basis, from an initial estimate of 1.0%, due to higher capital expenditure and business investment. However, the preliminary reading of the Nikkei-Markit manufacturing PMI fell to a three-month low in February. Despite a rather lacklustre economic picture, the Japanese rate of unemployment is trending down which could result in higher wage pressure at some stage. Core consumer prices excluding fresh food rose by 0.2% on a year-on-year basis in February, the second consecutive increase in 13 months.

Japanese GDP



Source: AllianzGI Economics & Strategy – April 2017

Emerging markets

Emerging markets put in a strong showing in the first quarter of 2017, with the JP Morgan sovereign EMBIG-D index returning +3.86%, as spreads tightened by -29bp. Emerging market corporates likewise saw positive performance, with the JP Morgan CEMBI-BD index returning 2.97%, as spreads tightened by -30bp, to close the quarter at a spread to worst of +261bp vs. UST. Buoyed by inflows, the JP Morgan GBI-EM GD index put in a strong, +6.50% return, in dollar terms, during the quarter.

Gains were driven by spread tightening in the EM asset class, given that the treasury component had little impact during the quarter. The UST 5yr tightened a mere -1bp and the 10yr UST tightened by -6bp. Corporate spreads closed the period at +261bp (STW), near five year tights, and sovereigns ended at a spread of +310 vs UST. Currently sovereign spreads appear to be at fair value versus the 10yr mean.

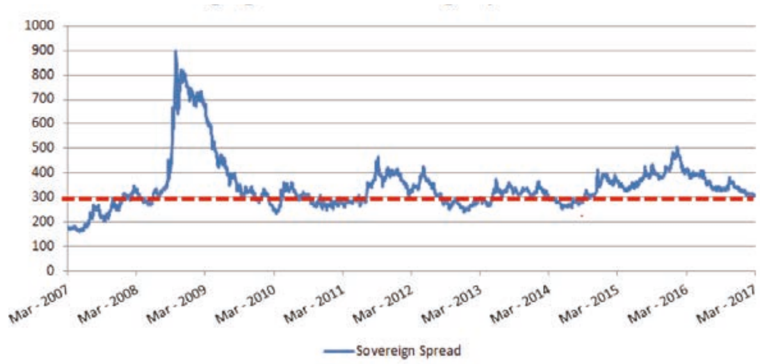
The emerging market asset class continued to be supported by macro factors, with Brent oil pricing maintain a price north of US$ 50/bbl throughout the quarter. Middle Eastern assets were an obvious beneficiary. Anticipations of stimulus programs in the US and China contributed to improved investor sentiment yielding healthy inflows to both EM hard currency and local currency markets. Year to date hard currency inflows totalled US$15.2bn, whilst local currency inflows totalled US$ 7.7bn as of 29 March (source: JP Morgan)

In the corporate market, new issue supply hit an all-time record, totalling US$120bn in the quarter. Asia accounted for US$76bn of this. Supply was easily absorbed by investors who experienced cash flows totalling nearly US$89bn from maturities, coupons amortizations, buy-backs/tenders and calls of existing holdings.

On a macro basis, early missteps by the Trump administration and infighting within the Republican Party led to a failed attempt to repeal and replace Obamacare. This proved supportive to the EM asset class, as investors took comfort in the realization that it would prove difficult to find any agreement within congress that would lead to a meaningful overhaul the North American Free Trade Agreement, anytime soon. Latin America was an obvious beneficiary in the hard currency space, with strong performances in Brazilian and Mexican assets along with several of the smaller economies in the region.

As valuations have pushed ever tighter, we recognize that returns driven by spread improvement may give way to carry over the coming months. New issue supply should help temper further tightening in the corporate space. Within emerging markets we struggle to identify a specific catalyst that might lead to a material repricing of the asset class in the near term, thereby disrupting the positive dynamics observed year-to-date. Macro drivers stemming from developed markets may prove to be the larger contributors to volatility in the coming months.

Emerging Markets Sovereign Spread vs UST



Source: J.P. Morgan EMBIG index, Bloomberg. Levels as of market closing on 31 March 2017

Currencies

Despite the rate hike in March, the US dollar weakened over the first quarter as the Federal Reserve's forecasts for the future path of interest rates were more dovish than expected by the market. US President Trump's corporate tax plans could trigger an upward movement of the USD: a lower US company tax rate should support the currency via increased inflows chasing higher after-tax equity returns and via US multinationals repatriating profits into the US.

Nevertheless, current valuation as well as the huge European current account surplus caution against getting too bearish on EUR / USD, while European political risks could trigger an EUR undershoot. In the second half of the year, the market focus could shift towards tapering discussions of the ECB, making the EUR / USD divergence trade less attractive and suggesting a recovery of the undervalued EUR / JPY. The slightly hawkish tilt at the March ECB press conference indicated that the EUR is sensitive to a shift in monetary policy.

Trade-weighted G4 currencies

Source: Bloomberg – April 2017

Political risks suggest that Pound Sterling could remain weak. GBP/USD fell back towards the lower end, as the start of the "Brexit" process has been triggered. GBP could fall further versus USD due to three main reasons: First of all, a large UK current account deficit of 5.1% of GDP. Secondly, negative and widening 2yr UK-US interest rate spreads and, lastly, Brexit-related capital outflows.

Credit

Q1 credit markets performance was positive for both Euro Investment Grade (IG) performing 0,25% and Euro High Yield (HY) performing 1,6% mostly thanks to a good rally in February.

The evolution of 5-year and 10-year German interest rates was a rollercoaster and weighed on the Euro IG performance. The ECB is progressively preparing the market for lower amount of purchase and it may be a significant factor in working out the direction of credit spreads going forward. Total flows over Q1 2017 into the IG asset class were slightly negative (-€ 0.3 bn) after a strong reversal in March (+€ 1.35bn or +0.9% of AuM according to JP Morgan).

Total flows over Q1 2017 into the HY asset class were negative (-€ 0.8 bn or 1.1% of AuM according to JP Morgan) and were mixed all through the quarter. New issues on the Primary market however do easily meet the demand of investors, a larger slice of which is made of IG investors looking for the relatively compelling yield offered by HY issuers compared to their natural market. Given the current tight spread, new issues often struggle to outperform in secondary.

Overall we keep a neutral recommendation in our IG and HY flagship portfolios given the current valuation which could be seen as fair to slightly expensive. We haven't turned negative yet as fundamental and technical factors are still supportive look good, all the more so the geographical diversification of credit markets gives a good protection against the specific political risks in Europe. We keep monitoring French issuers, especially French banks, as they could be under pressure and show excess spread widening following the French election results of 1st round.