Allianz Global Investors

APRIL 2024

Fixed Income Forward

Rate cuts likely to come at more measured pace

The recession-defying strength of the US economy has continued to dominate global bond markets into the second quarter. March data for US nonfarm payrolls, consumer prices and retail sales[1] were robust enough to underscore a sharp reversal in rate cut expectations versus the start of the year. Markets are now pricing in only one or two 25bp cuts by the Fed in 2024, down from six or seven back in January.[2] That repricing has pushed US Treasury yields to new year-to-date (YTD) highs.[3]

Rate cut uncertainty growing

German government bond yields have risen to a lesser extent, widening the 10-year yield differential between the US and Germany to around 210bp.[3] The ECB is now widely expected to cut rates in June and to deliver a total of three 25bp cuts in 2024,[4] emboldened by a downward trend in euro area core inflation and weaker growth prospects; the IMF's latest forecasts[5] show the German economy growing a meagre 0.2% in 2024 compared to 2.7% for the US.

Still, a June rate cut by the ECB is not guaranteed. The current disinflationary trend could be upended by a possible shock to energy prices from escalating conflict in the Middle East. And in the US, Fed Chair Jerome Powell this week highlighted that it may take longer than expected for US inflation to get to target.[6] Against this rather open-ended backdrop, we prefer to add rates exposure through yield-spread (targeting the difference between two countries' bond yields in the same maturity) and yield-curve (targeting the difference between the same country's bond yields in different maturities) strategies, instead of taking more outright duration risk.

Credit spreads may not cheapen

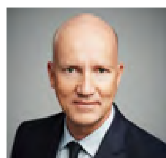
Credit risk meanwhile continues to benefit from excess demand, much of which comes from institutional investors who need to add corporate bonds to their asset mix to match liabilities. Spreads look expensive versus long-term ranges, and while they can't stay rangebound forever, history shows they may not cheapen for some time in the absence of a credit crunch. Solid corporate balance sheets and no big negative catalysts in the short term support the case to stay invested for the carry.

In investment grade we continue to favour financial issuers, including floating rate notes mostly issued by

Fixed income market performance

Indicative market indices Data as of 12 April 2024	Total return YTD 2024 (%)	Total return March 2024 (%)	Yield-to-worst (%)	Effective duration (years)
Asian high yield	6.54	1.81	13.3	2.6
Global convertible bonds	2.09	1.77	0.5	1.9
US floating-rate notes	2.04	0.57	5.9	0.0
Euro high yield	1.70	0.41	6.5	2.8
Global emerging-market sovereign bonds	0.74	2.09	8.0	6.5
Euro investment grade	0.42	1.19	3.7	4.5
US high yield	0.37	1.16	8.1	3.3
Euro government bonds 1-3 years	-0.07	0.36	3.0	1.9
US Treasury bonds 1-3 years	-0.11	0.35	4.9	1.6
Asian investment grade	-0.43	0.94	5.5	4.6
Euro aggregate	-0.51	1.09	3.1	6.6
Global aggregate	-0.97	0.90	3.9	6.7
Global government bonds AAA-AA	-1.48	1.09	3.3	7.7
US investment grade	-2.24	1.29	5.6	7.2
US aggregate	-2.52	0.92	5.1	6.2

Source: Bloomberg, ICE BofA and JP Morgan indices; AllianzGI, data as at 12 April 2024. Index returns in USD-hedged except for Euro indices (in EUR). Asian and emerging-market indices represent USD denominated bonds. Yield-to-worst adjusts down the yield-to-maturity for corporate bonds which can be "called away" (redeemed optionally at predetermined times before their maturity date). Effective duration also takes into account the effect of these "call options". The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or as investment advice. Past performance, or any prediction, projection or forecast, is not indicative of future performance.



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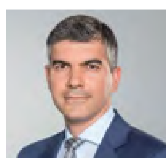

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banks, which can offer more value relative to some industrial issuers. In high yield (HY), security selection is paramount, as is avoiding credits that are overly levered with imminent refinancing needs. This time round spreads on bonds rated CCC or lower have not rallied as much as in 2021, suggesting that credit differentiation is back and should drive credit allocations much more from here on.

Opportunities in EM, Asia

In other spread assets, hard currency emerging market sovereign bonds are hanging onto their YTD positive returns, with supportive carry and spread compression more than offsetting higher US Treasury yields. Sovereign spreads tightened across the rating spectrum, with B and CCC credits outperforming. Among the lower rated countries, those that have made progress in securing IMF financing packages, such as Ecuador, Egypt, Pakistan and Sri Lanka, have delivered outsized bond returns. We are also constructive on Asian local rates, such as in Thailand (relatively steep long end on yield curve), Korea (likely global bond index inclusion, negative net supply) and Indonesia (high real rates and room for rate cuts).

Asian HY credit recorded its fifth consecutive month of positive returns in March. Macau gaming Q4 earnings were decent from a credit perspective, though below equity market expectations. In China's property sector, credit investors continue to rotate to higher quality issuers as nationwide sales remain weak. Unlike the real estate market, industrial production growth looks strong, providing Chinese exporters with domestic overcapacity that helps price goods competitively.

WHAT TO WATCH

1 US tariffs on China

President Biden is expected to announce an increase in tariffs on certain aluminium and steel products from China, in response to a rise in low-cost imports and concerns about routing Chinese exports to the US via Mexico. While such a trade standoff may stop short of a trade war, it may hurt market sentiment if trade protectionism becomes a hotly contested issue between the US presidential candidates.

2 European bank lending

The April 2024 euro area bank lending survey run by the ECB revealed a continued turn for the better in bank credit.[7] While there was still a fall in demand for corporate loans, the overall outlook is improving. Banks expect to see further normalisation in the second quarter, though that seems to hinge on the accuracy of expectations for an upcoming ECB rate cut, and several more to follow after that.

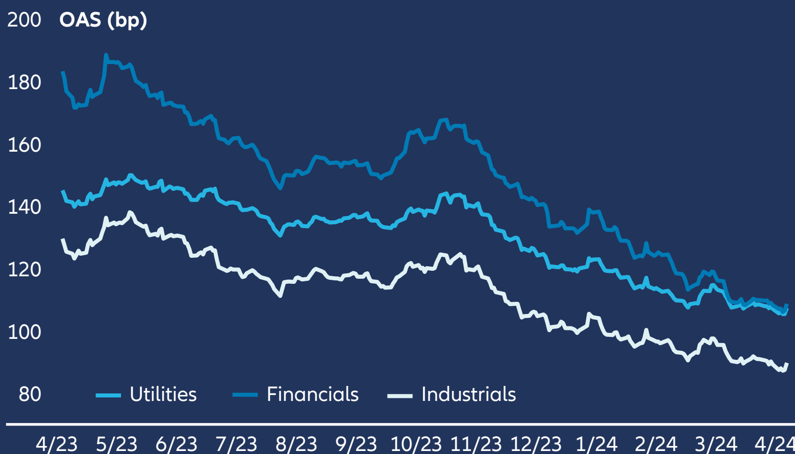
3 Middle East conflict

Iran's attack on Israel further complicates the outlook for energy prices and, by implication, the ECB's efforts to bring down inflation to target as the risk of higher oil prices creeping into the euro area's core inflation is not negligible. Another climb in oil prices could harm a European economy that had just began to recover, and while natural gas prices have risen too following Russia's attacks on Ukrainian facilities.

CHART OF THE MONTH

Financials still our top pick in investment grade

Global investment grade option-adjusted spreads (OAS) by sector



Investment grade bonds from financial issuers outperformed other sectors in Q1, delivering 139bp of excess returns and continuing their rally from Q4 2023. Utilities and industrials returned 113bp and 86bp, respectively. Energy was the top-performing sub-sector for the quarter, with WTI crude around 20% higher over the period benefiting an industry that has seen multiple takeovers as companies deploy excess profits. Capital goods issuers fared the worst, returning 33bp driven by a strong underperformance in USD credits with sticky input costs weighing on spreads.

We continue to favour financials given the benefits associated with elevated rates and attractive valuations relative to industrial issuers. Within industrials we like energy, especially US firms issuing in the euro market, while the defensive attributes of US-regulated utilities are also compelling.

Source: Bloomberg Global Aggregate Corporate Index (Unhedged), data as at 12 April 2024.

1. US Bureau of Labor Statistics, 5 April 2024; US Bureau of Labor Statistics, 10 April 2024; US Census Bureau, 15 April 2024
2. CME FedWatch Tool, 16 April 2024
3. Bloomberg benchmark government bond indices, 17 April 2024
4. Bloomberg World Interest Rate Probability (WIRP), 16 April 2024
5. IMF, World Economic Outlook, April 2024
6. Wilson Center, The Washington Forum on the Canadian Economy, 16 April 2024; **www.wilsoncenter.org/event/launch-washington-forum-canadian-economy**
7. ECB, April 2024 euro area bank lending survey, 9 April 2024

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