Monthly commentary

Allianz Global Opportunistic Bond

Summary

- US activity continued to surprise to the upside in February, pushing yield curves flatter, and bond yields higher.
- The market activity caused a negative return for the strategy in the month, as rising yields and flatter curves weighed on our interest rate exposure.
- Looking ahead, divergent economic trajectories going into a global rate cutting cycle present increased opportunities for cross-market relative value strategies while insufficiently priced term premia favour long-end curve steepeners – an environment in which the strategy is positioned to deliver attractive total returns.

Performance analysis

In February, government bond yields rose as US activity, especially in the labour market, continued to surprise to the upside. A host of US Federal Reserve policymakers also highlighted the risks of moving too quickly on easing policy, citing the need for further evidence of a sustained disinflation trend. Market pricing for Fed rate cuts in 2024 reversed from the 150bp of cuts priced at the beginning of the year towards the Fed's dot plot projections which are closer to three cuts this year. Both 2-year and 10-year US Treasury yields rose sharply, ending the month at 4.62% (up 41bp) and 4.25% (up 34bp), respectively.

In the Euro area, Q4 GDP data suggested that economic activity in the region remained stagnant, especially in Germany, although survey data did suggest that the peripheral economies continued to outperform the core. ECB President Lagarde cautioned against making a hasty decision on rate cuts and pointed to wage growth as an increasingly important inflation driver. 10-year Bund yields ended the month at 2.41%, up 25bp; the 10-year Italian BTP spread to Bunds tightened to 143bp, around 2-year lows. In the UK, despite an economy sliding into a technical recession at the end of 2023 and lower than expected CPI inflation at 4% y/y, 10-year Gilt yields still ended the month at 4.12%, 33bp higher. Japanese real activity at the end of 2023 also surprised to the downside, but with core CPI inflation still coming in higher than expected, Bank of Japan policymakers continued to hint that the era of negative interest rates and the yield curve control policy are close to coming to an end. 2-year JGB yields rose to 17bp, their highest levels since 2011, although the JPY still ended the month 2.4% lower versus the USD. Meanwhile, in China, authorities continued to ease monetary policy in response to anaemic economic activity and deflationary pressures; CPI inflation declined by 0.8% y/y – the weakest reading since the global financial crisis. 5-year CGB yields fell to 2.22%, their lowest levels since the start of the COVID pandemic.

Investment strategy and activity

The continuing reset higher in global yields was a challenge for our long duration basket. Prior to the release of the US labour market data in the first week of the month, we decided to trim back our global duration footprint following the move lower in yields ahead of the US payrolls print. The team decided to reduce in half our long Australian duration position, taking profit on a 38bp compression in 10-year yields since building the position in September. We maintain a long duration bias via US treasuries, Australia, New Zealand, Norway, and Brazil.

Our global curve steepener theme detracted from performance. The 10s30s curve steepener in Germany and 7s30s steepener in the US detracted as better than expected data on both sides of the Atlantic caused markets to delay rate cut expectations to the beginning of the summer, causing a re-flattening of both yield curves. Meanwhile, our relative value trade to be long 30y UK Gilts vs. German Bunds added value over the month.

In FX markets, the strong US data lifted the US dollar, especially during the first half of the month. We decided to use this opportunity to take profits on our long USD vs. EUR position. Elsewhere, our long Norwegian Krone vs British Pound, traded broadly sideways in the month, with a marginal drag to performance.

Meanwhile, the Japanese yen, weakened over the month as global rates were priced higher. This challenged our long JPY position, structured versus both EUR and USD, which also detracted at the margin.

Over the month, the team added a new relative value FX trade to the strategy. Strong labour market data in New Zealand led markets to price in another rate hike by the RBNZ, while the RBA was priced to begin a rate cutting cycle by mid-year. With the AUDNZD FX cross moving towards the lower end of its one-year range, we used this opportunity to open a long position in AUD against NZD on the expectation of policy convergence between the two markets. At the end of the month, the RBNZ held constant its policy rate and was less hawkish than expected; the trade contributed to performance over the month.

We also added to our long INR against EUR position as we expect the Reserve Bank of India to keep tight management on currency volatility through 2024 which makes for a good environment to earn carry. Indian real GDP growth is projected to be 6.3% in 2024 and is showing some of the strongest cyclical momentum globally. Given India's strong GDP growth, the RBI is less concerned about the effects of tighter monetary conditions on growth, while it is committed to managing liquidity and financial stability, including supporting the INR.

Credit spreads continued to tighten, with average global corporate spreads tightening 4bp. The strategy retains a modest long exposure to Corporates, with selection focused on Financials, non-cyclical Industrials and US regulated Utilities, which added value in February. The team also increased exposure to a long position to US mortgage spreads to profit from the increased carry versus Treasuries.

Looking ahead, firm US economic data appears to confirm hopes of a US soft landing in 2024, but growth prospects in the rest of the world are far more subdued. Central banks are still signalling a bias to cut interest rates this year, even though the timing of the cuts have been pushed back given that central banks still need convincing that inflation is moving sustainably towards their inflation targets. We believe that the macro and policy backdrop favours yield curve steepeners and presents a constructive backdrop for sovereign relative value strategies in the months ahead.

Opportunities

- + Interest income on bonds, capital gains opportunities on declining interest rates.
- + Addition of high-yield and emerging-market bonds increases return potential.
- + Currency gains against investor currency possible.
- + Broad diversification across numerous securities.
- + Prospect of extra returns through single security analysis and active management.

Risks

- – Interest rates vary, bonds suffer price declines on rising interest rates. The volatility of the fund unit price may be increased.
- – Addition of high-yield and emerging-market bonds increases risk of volatility and losses, considerably.
- – Currency losses against investor currency possible
- – Limited participation in the return potential of single securities.
- – Success of single security analysis and active management not guaranteed.

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