M&G Investments

Is it time to consider debt market opportunities?

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Key points

- Investors have become increasingly concerned about the risk of a global economic recession, with economic activity in Europe likely to be affected by uncertainty over gas supplies.
- There are signs that US inflation may have peaked, although we believe many of the forces such as globalisation that kept inflation low for so many years could start to unwind.
- After significant declines this year, we believe there are long-term opportunities in the fixed income space for flexible and diversified investors.

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Rising temperatures and prices

In Europe, at least, it has been a relentlessly dry, hot, disruptive and unpredictable summer. Inflation, already on the very high side, continues to be a major worry. The 'cost of living' crisis is troubling workers (labour disputes have risen), consumers, and businesses alike.

Governments are attempting to address the situation through a combination of fiscal policy, price caps, pleas for rationing, and energy trade deals with neighbouring countries (eg, France may supply Germany with gas, while Germany could offer electricity to France). In the UK, a freeze on energy bill price rises has been mooted, coupled with a reversal of some tax rises; energy bills are set to climb from an average of £1,971 to a capped level of around £2,500 in October. Capping energy prices to a level that is considered relatively affordable was the first measure that new Prime Minister Liz Truss announced, but there have been warnings that even so many families will be in dire hardship. Meanwhile Germany has announced a €65bn package of tax breaks and support for the most vulnerable.

As we look ahead to Autumn, there are plenty of known events that could prompt market volatility. The European Central Bank (ECB) has just increased interest rates by 75 basis points and said more rises would follow in the coming months, while the Federal Reserve (Fed) is expected to hike again later in the month. There will be snap elections in Italy towards month end – with forecasts saying the far-right Brothers of Italy party could win. Meanwhile, worries about the provision of Russian gas will likely persist and the war in Ukraine continues with no obvious sign of a short-term resolution.

In the US an intensification of the quantitative tightening programme is well telegraphed so, in theory, should already be reflected in prices. Elsewhere, tensions in Taiwan are ongoing and close attention will be paid to China's strict COVID-19 policies and the property market, where buyers have been refusing to pay mortgages on unfinished homes and prices have fallen.

A shift from inflation to recession

This has undoubtedly been a brutal year for fixed income markets against a backdrop of persistently high inflation and increasingly hawkish rhetoric from the world's central banks. And this summer has seen an intensification of market worries and uncertainties. This has triggered steep sell-offs across the asset class, with 10-year Treasury yields reaching as high as 3.5% earlier in the year, which compares with around 1.5% at the start of 2022.

These moves have been broadly mirrored across other developed market government bond markets, with both the ECB and the Bank of England embarking on their own rate hiking cycles to combat soaring inflation. In early September, the yield on a 10-year UK gilt touched 3% – its highest level since 2014.

The past couple of months, however, has seen a shift in the inflation narrative, with markets now becoming more focused on the risk of a global recession. The Treasury curve has become deeply inverted, indicating that bond markets are starting to look through the current rate hiking cycle, and pricing in the likelihood that the Fed may need to start cutting rates in 2023 to offset slowing growth.

Europe probably faces the greatest risk of an economic slowdown, given the uncertainties over gas supply, which could have a significant impact on German growth in

particular. However, given the near double-digit levels of inflation in Europe, we think the ECB will for the time being need to keep hiking in order to maintain its credibility – it has to be seen to be acting. What's not clear at this stage, is what level inflation will need to fall to before the central bank is prepared to start to loosen policy again. In the meantime, we may see other actions to boost European growth, such as renewed fiscal stimulus.

In the UK, we are seeing very elevated inflation, combined with sharply cooling growth. The Bank of England also appears somewhat more dovish than its peers, including even than the ECB. Furthermore, sterling continues to tumble with the currency recently experiencing its steepest monthly decline versus the US dollar since the Brexit referendum in 2016. This will create further cost pressures given that imports make up such a large part of the UK economy. For these reasons, it feels like inflation in the UK could remain higher for longer compared to other regions. We remain cautious on the outlook for sterling and UK assets generally.

Where next for inflation?

While there remains a lot of uncertainty, there are signs that US inflation may have peaked and could start to ease throughout the remainder of the year. Supply chains are gradually returning to normal, while we have also seen an easing in a number of commodity prices, such as copper and oil. On the demand side, higher interest rates and fiscal tightening should start to cool economic growth, which in turn should put downward pressure on inflation. With powerful base effects to also consider, we think US inflation could well fall below 4% by next year, although there are clearly a lot of moving parts which could change this trajectory quite rapidly.

However, looking beyond 2023, we think the Fed may have a more difficult job keeping inflation below 2% than has previously been the case. This is due to the fact that many of the forces that kept inflation so low for so many years could start to unwind. In particular, globalisation is likely to be a less powerful force going forward, reflected by issues such as the onshoring of supply chains and increased use of tariffs and other restrictive trade measures.

An environment of gradually falling inflation and slowing growth could provide a supportive environment for global bond markets. Having started the year with a meaningful underweight duration stance, we have therefore been gradually adding duration into our portfolios throughout 2022 and currently favour more of a neutral duration position.

Opportunities in credit and elsewhere

Credit markets have also come under pressure in 2022, with the Fed's hawkish stance again being a key driver behind the deterioration in sentiment. US investment grade corporate bond yields are now at higher levels than during the height of the COVID crisis. The key difference this time is that the spike in yields has been mainly driven by a higher risk-free rate, while credit spreads themselves have been relatively well-behaved.

At the moment, credit markets appear to be pricing in a downturn, but not an outright recession. We think, therefore, now is a good time to be adding some credit risk, although we remain highly selective with a focus on higher quality, more defensive names, which should hold up better if we do see a more recessionary scenario.

The other positive aspect is that we expect defaults to remain low in most parts of the market, with many companies having taken the opportunity to re-finance their debt for several years. Overall, we think investors are being well-compensated for taking credit risk in the high yield segment. However, there are some areas where we remain wary, such as CCC-rated high yield names where we think defaults could rise quite significantly. There are also a number of sectors which we think could face stress, notably retailers and European property companies.

Another area that is looking historically attractive, in our view, is emerging market debt. This asset class has seen significant drawdowns this year, with yields now at very elevated yields. Despite the ongoing strength of the US dollar and global economic headwinds, we think there are now some very attractively priced areas of the market on offer. Performance in regions such as Latin America, for instance, has remained relatively well insulated from the effects of the war in Ukraine, and many countries there continue to benefit from elevated commodity prices.

Can the US dollar rally continue?

The US dollar has been the standout performer of 2022, appreciating strongly against nearly all major currencies. This outperformance has been driven both by its 'safe haven' attributes and its attractive interest rate differentials versus other countries, such as the eurozone and Japan. However, if the Fed is able to engineer a soft landing (ie, raise interest rates without causing a major economic downturn), then we think the US dollar could weaken from this point. On the other hand, if we see a hard landing and a sharper economic slowdown, then we will probably see further dollar strengthening. At the other end of the scale, the Japanese yen has been a very poor performer over the past couple of years. Again, a key driver has been interest rate differential, with the Bank of Japan keeping interest rates pinned to zero.

Fixed income in the new environment

With inflation remaining very elevated for now, it can feel like investors are suffering from a shrinking list of areas to park their cash. However, with significant year-to-date market falls already behind us, we would argue that there are now plenty of long-term opportunities for investors to consider in the fixed income space.

While many bond investors who avoided being overly exposed to duration have been rewarded on a relative basis during the sell-off so far this year, we think now might be the time to start reversing some of these positions. Base effects should mean that we see well-publicised annual inflation figures come down over the course of 2023, which should be positive news for bond markets, particularly as a US-led hiking cycle now appears to us to be close to becoming fully priced in.

However, inflation is likely to remain the dominant theme driving markets for the remainder of the year, and we will be closely assessing a range of metrics to gauge its likely direction in 2023. Over the next few months, markets will also have to contend with several key political events, including mid-term elections in the US, while the situation in Ukraine and its implications for European gas supply will remain a key focus.

In an uncertain environment it is important to keep a flexible and diversified approach. From a fixed income perspective, this means having the ability to adjust duration, credit risk and currency exposure in response to a rapidly changing macro situation. We would highlight the importance of being able to invest across a diverse range of fixed income assets. Alongside more traditional government and corporate bonds, we are also keeping an allocation to instruments that should be better placed to withstand a more inflationary environment, such as inflation-linked bonds and floating rate notes.

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