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M&G Investments

# Fixed Income asset class overview

## September 2023

September proved to be the worst-performing month of 2023 so far – it was also the 7th successive year when the Bloomberg Global Aggregate Index has posted losses in September. As the third-quarter bond sell-off continued, the 10-year US Treasury yield reached 4.685%, the highest level since 2007. There were yield increases across the curve, but also a definite steepening.

## Month in review

The big story in September was central bank rhetoric, with 'higher for longer' the flavour of the month. On both sides of the Atlantic, key central bank figures were keen to convey the message that rate cuts will not be coming soon. At its September meeting, the Federal Reserve's (Fed) quarterly 'dot plot', which projects where policymakers see interest rates in future, reflected a 50-basis point (bp) increase in the 'median dot' for the fed funds rate in 2024.

The European Central Bank (ECB) hiked its deposit rate to 4% for the first time in its history. ECB President Christine Lagarde stressed in her press conference that 'The key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target'.

The Bank of England (BOE) and the Fed both kept rates unchanged at 5.25% and 5.25-5.50%, respectively. A key risk that fixed income investors are looking out for is the possibility that central bankers might have 'overtightened' in their battle against inflation.

In Investment Grade (IG), yields remain historically high, with the Euro IG market offering a yield of 4.5%, a yield of 6.3% in GBP IG and 6.1% in the US. The spread on the Global IG Index remains almost unchanged on the August figure at 134bps.

High Yield (HY) spreads were fairly resilient despite bond market volatility. The Global HY Index finished the month down 0.7%, at a spread level of 438bps. However, the asset class remains up around 5% year-to-date. Floating rate notes (FRNs) benefited from the asset class's extremely low duration and continued to outperform most fixed income asset classes. They have returned more than 10% this year.

In Emerging Market (EM) hard currency bonds, the high yield portion (-1.74%) of the benchmark outperformed investment grade (-3.44%). This was largely due to the lower duration of the HY segment, with much of the price movement over the month coming from core rates selling off. Local currency sovereigns underperformed the rest of the EM debt market as US dollar strength weighed negatively on currencies. Despite spreads widening in much of the EM universe, there was some spread recovery in Africa after they widened in August following the coups in Niger (July) and Gabon (August).

## Developed market sovereigns

"Higher rates for longer" was central banks' motto of the month and investors moved to push out the likely timing of any rate cuts. In September, the timing of a first 25bps rate cut by the Fed was pushed out from Q2 2024 to Q3 2024.

We also saw rate hikes in the Nordics (Sweden, Denmark and Norway). All other main developed market central banks paused their hiking cycles.

In the US, we saw a meaningful increase in the unemployment rate for August to 3.8% (vs. 3.5% expected), while average hourly earnings growth fell from the prior month (0.2% vs. 0.4%). Both data points provided an indication of labour market softening.

Monthly CPI for August came in at 0.6% due to an uptick in gasoline prices (up 10.6% on the previous month). That 0.6% reading was the strongest monthly inflation print since June 2022. In turn, that sent the year-on-year (YoY) CPI up to 3.7%, which was a bit higher than the 3.6% expected by the consensus.

Core CPI came in stronger than consensus at 0.3% month-on-month (MoM), so investors are still pricing in a near-evens chance of another Fed rate hike this year.

In Europe, latest revisions to Q2 GDP growth for the euro area showed a two-tenths downgrade, with the latest estimate at 0.1%. This means we've now had a -0.1% contraction in Q4 22, followed by 0.1% growth in both Q1 and Q2 23, indicating that there's been stagnation since last autumn.

Annual CPI came at 5.2%, which was better than expected (5.3%).

In the UK, we saw weaker-than-expected employment data, with payrolls falling 1k in August from the previous month. The unemployment rate over the three months to July rose from 4.2% to 4.3%.

There was a strong downside surprise from the August CPI print, where headline inflation unexpectedly fell to 6.7%, below the expected figure of 7.0%. Consequently, the Bank of England kept its policy rate on hold at 5.25%, which ended a run of 14 successive hikes.

Past performance is not a guide to future performance.

Government bond total returns (in local currency)

| | 10-year yield % | Total return % (1m) | Total return % (ytd) |
|---|---|---|---|
| **Treasuries** | 4.6 | -2.4 | -1.7 |
| **Bunds** | 2.8 | -2.4 | -1.2 |
| **Gilts** | 4.4 | -1.0 | -4.1 |

Source: Bloomberg, 30 September 2023

## Inflation

In the middle of the month, the US Bureau of Labor Statistics (BLS) released the inflation numbers for August. Headline CPI rose 0.6% MoM (3.7% YoY), while core CPI increased 0.3% MoM (4.4% YoY).

Energy was the key driver behind the increase as gasoline prices have risen in recent weeks. Transportation also contributed significantly as airfares have rebounded, while motor vehicle insurance costs have continued to rise, reaching almost 20% YoY.

Overall, this wasn't a terrible report. Inflationary pressures continue to ease; however, signs are emerging that inflation has likely found a floor for now. If the past two months are any indication of future inflation, core CPI will likely end the year somewhere in between 4% and 4.5%, well above the Fed's target.

Going forward, we expect rents inflation to keep trending lower, while other core items will likely rebound, offsetting the impact from rents. Energy will mainly be a distraction, in our view, adding volatility to the overall inflation number.

The Fed will likely stay away from the usual distractions and will continue to focus on "super core inflation" (core services excluding housing). Unfortunately, that indicator is rebounding, keeping the door open for another rate hike this year.

In a recent blog, we explain why we think inflation is likely to stay surprising to the upside and how some of this reasoning has started to play out.

## Investment grade credit

It was a month dominated by moves in government bonds. US Treasuries in particular came under enormous pressure in September and yield curves started to steepen again. However, the credit market has remained remarkably well behaved, with credit spreads little moved or even tighter over the month.

The Global Investment Grade Index is currently trading with a spread of 134bps, almost unchanged compared to the previous month.

The physical IG market generally outperformed the derivative market (CDS indices), where spreads have been more reactive to rising rates. Across sectors, commodities and some cyclical businesses outperformed, while financials and autos (currently impacted by a workers' strike in the US) generally underperformed.

### Going forward

The renewed volatility in government bonds has so far had little impact on the credit market. Spreads remain generally tight, as investors appear more comfortable about the overall economy and the potential for a soft landing (bringing inflation down with causing an economic slowdown).

However, the macroeconomic picture seems to be deteriorating, particularly as central banks remain willing to keep monetary policy in restrictive territory, despite falling inflation and weakening labour market dynamics.

The risk of a policy mistake (central banks overtightening) is arguably the key risk investors should consider today. So far, investors don't seem particularly concerned as spreads remain tight. However, rising rates and rising macro risks could at some point put pressure on spreads.

Credit investors should arguably be more selective in this environment and avoid taking excessive risk as valuations are back to fair value, in our view, leaving little room for errors.

However, investors in investment grade bonds could take comfort from the fact that rates are higher today and can potentially offset rises in spreads, in case the macro environment were to deteriorate.

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Investment grade total returns

| | Credit spread (bps) | Total return % (1m) | Total return % (ytd) |
|---|---|---|---|
| **US IG** | 125 | -2.4 | 0.5 |
| **Euro IG** | 151 | -0.9 | 2.3 |
| **UK IG** | 161 | 0.0 | 1.2 |

Source: Bloomberg, 30 September 2023

## High yield credit

High yield (HY) spreads held up well in September, despite rate volatility. The interest rate sell-off was a large drag on monthly returns offsetting positive carry and spread performance in some parts of the market.

The Global HY Index returned -0.7% in September, with US HY the main underperformer. YTD returns for Global HY tally to 5.5% going into the final quarter of 2023, where most of that return can be attributed to spread return.

Floating rate HY benefited from its near-zero duration and was largely unaffected by the govt bond sell-off in September. The Global HY FRN Index returned 1.3% in the month supported by both carry and spread compression (-65bps). YTD HY floaters have outperformed most fixed income asset classes with returns of more than 10%.

Rating performance continued to be led by lower quality bonds (CCC and B) supported by technicals such as low issuance and relatively thin liquidity. All HY sectors were weak last month.

In terms of valuations, financials and energy trade close to the tightest level in 12 months, while telecommunications and cable have lagged the most YTD. More generally, low supply and resilient fundamentals could continue to support spread levels. Having said that, traditional HY markets remain priced for a perfect soft-landing scenario.

**Current views**

- We are generally cautious on valuations at current spread levels – in our view, the market is priced for a perfect soft landing scenario.
- It may be difficult for spreads to tighten further in the near-term.
- Europe has underperformed the US over the summer but now caught up. We are not adding risk at these levels in either market; we are staying close to neutral/slightly underweight.
- Technical elements such as supply/demand imbalance and attractive 'all-in' yields continue to support spread containment.
- We believe fundamentals are still reasonably supportive, but macro deterioration is anticipated. This could probably be worse in Europe than the US.
- Corporate balance sheets are generally in good shape.
- We expect default rates to increase modestly but it will likely be issuer-specific events, not a wholesale spike in defaults. Our base case for the next 12 months is a 3-4% global default rate.
- We are generally concentrating on defensive trades (eg, non-cyclicals v cyclicals, up-in-quality, actively underweight real estate, etc.)

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High yield total returns

| | Credit spread (bps) | Total return % (1m) | Total return % (ytd) |
|---|---|---|---|
| **US HY** | 403 | -1.2 | 6.0 |
| **Euro HY** | 459 | 0.4 | 6.4 |

Source: Bloomberg, 30 September 2023

## Emerging market bonds

The story in September was similar to August insofar as the summer beta rally continued to stall with core rates and US Treasuries continuing to sell off. Similarly, data from China continued to weigh on investor sentiment.

The market movements were relatively orderly, and it's noteworthy to highlight that the high yield portion of the benchmark actually outperformed investment grade, despite spreads widening more. This suggests the core rates move is not translating into a broad widening of spreads or contributing to a general 'risk-off' environment. The IG and HY portions of the index returned -3.44% and -1.74%, respectively.

Local currency sovereign bonds once again underperformed the rest of the emerging market debt (EMD) market including the frontier-centric NEXGEM index, which declined 1.1% in September, bringing year-to-date performance down to 9.81%.

Currencies were mixed but broadly negative as the USD strengthened over the month. The Colombian peso was one of the strongest performers, reversing some of the weaking seen in August, which came as a result of the central bank now being one of the last in the region to cut rates owing to stickier inflation.

In the hard currency space, spreads widened across both the investment grade and high yield segments, although high yield outperformed on a total return basis as the sell-off in core rates dominated much of the story.

Spreads in Africa tightened after the marked widening in August following the events in Gabon and Niger.

EMD corporates saw negative returns driven by widening spreads, although high yield slightly outperformed investment grade once again, due to its lower duration component. Hard currency corporates outperformed sovereigns, which was driven primarily by the greater duration of the hard currency's index.

There was little in the way of sectoral divergence, with much of the sell-off driven by duration resulting in the likes of oil & gas, paper & pulp, and technology, media and telecoms (TMT) experiencing the worst effects of the move in Treasuries.

By region, Asia outperformed, with India and Macau posting flat returns. China was in line with the index. Central & Eastern Europe, Middle East and Africa (CEEMEA) was also an outlier with Ukraine posting very strong returns (+8%) on the back of a tender offer on distressed MHP bonds. This unexpected event has repriced most of the other Ukrainian corporate bonds. Turkish corporates, which were very active in the new issue market, posted small positive returns.

On the other hand, Latin America (-1.6%) underperformed significantly the rest of EM. Argentina was one of the few countries in September that experienced spread widening, together with Guatemala. Mexican corporate bonds were down almost 2% over the month with Colombia, Brazil, Peru and Chile also underperforming the index.

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Emerging market bonds total returns

| | Credit spread (bps) | Total return % (1m) | Total return % (ytd) |
|---|---|---|---|
| **Local currency government** | n/a | -3.4 | 4.3 |
| **Hard currency government** | 440 | -2.6 | 1.8 |
| **Hard currency corporate** | 329 | -0.8 | 3.4 |

Source: Bloomberg, 30 September 2023

## Currencies

In September, the US dollar continued to strengthen against most other currencies. This likely reflected both the 'higher rates for longer' sentiment in the US, as well as some of the weakness in Chinese economic growth that we have seen.

The pound sterling, the euro and the yen were notable underperformers against the dollar in the month. It was another weak month for most EM currencies.

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Key currency pairs

| | Change % (1m) | Change % (ytd) |
|---|---|---|
| **GBP/USD** | -3.7 | 1.0 |
| **GBP/EUR** | -1.3 | 0.3 |
| **EUR/USD** | -2.5 | 0.8 |

Source: Bloomberg, 30 September 2023

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

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OCT 2023/1073905_Global