Fixed Income asset class overview

April 2023

M&G Investments

Compared to March, April was a pretty quiet month for markets. Most asset classes traded within a fairly narrow band and ended the month not too far off from where they started.

Month in review

Markets cautiously renewed their expectations of a rate hike at the May Fed meeting, after the tightening in financial conditions brought on in March by the banking volatility somewhat reversed throughout April.

There were also increasing signs of concern around the US debt ceiling deadline at the short end of the Treasury market. It is unclear whether issues here would cause a safe-haven Treasury rally, or a sell-off of Treasuries on the back of worsened US credit risk.

Developed Market Sovereigns

April turned out to be quite uneventful compared to what we experienced in the first quarter of this year. Indeed, it was the least volatile month since the pandemic according to some market observers.

Over the month in the US, we saw the signs of initial market concern about the US debt ceiling deadline, and investors moving into one-month Treasury bills that don't face any debt ceiling default risk.

The absence of market turmoil in the month led investors to put growing weight on the chances that the Fed would deliver another interest rate hike in May, thus taking the fed funds rate above 5% for the first time since 2007. At the same time, the latest data continued to show that inflation remained resilient, with core PCE still running at +0.3% in March, while unemployment ticked down back to 3.5%.

In Europe, resilient inflation (CPI at 6.9% and core at 5.7%, unchanged from the previous month) and expectations of further rate hikes left European sovereign bonds flat in April. The ECB has some catch-up to do in terms of rate hikes compared to the US considering the strength of the underlying economy (unemployment still at an historic low).

In the UK, gilts underperformed, after the latest CPI data for March showed an above-expected print of +10.1%.

Elsewhere, the Bank of Japan maintained the yield curve control policy at Governor Ueda's first meeting.

Past performance is not a guide to future performance.

Government bond total returns

	10-year yield %	Total return % (1m)	Total return % (ytd)
Treasuries	3.4	0.5	3.6
Bunds	2.3	0.1	1.6
Gilts	3.7	-1.7	0.4

Source: Bloomberg, 30 April 2023

Inflation

Consumer price inflation remains high in the UK - CPI fell slightly to 10.1% (it has trended generally downwards over the past few months), but is remaining stubbornly elevated.

Eurozone CPI continues to show some signs of moving downwards, although it rose a touch on the month and remains at around 7%.

March's US inflation print was more encouraging. Headline inflation surprised to the downside, falling to 5% YoY from the 6% recorded in February. Core inflation remains sticky, as expected.

The big news from the report was that we finally saw some deceleration in rents growth. Rents is the biggest category in the inflation basket and up until now it has been increasing very rapidly, keeping overall inflation elevated. Inflation excluding rents would have actually been negative in March.

Clearly one data print doesn't make a trend and we need to see more evidence that rents inflation is in fact decelerating. From one side, falling house prices would suggest a further deceleration in rents, however we need to keep in mind that wage growth is still elevated and this can potentially sustain higher rents.

So let's keep an eye on rents and let's hope that trend continues. If it does, inflation will likely decline faster than expected and this should be very bullish for bonds.

Where will the terminal rate be?

The "terminal rate" is the rate at which central banks will finally stop hiking rates.

The volatility in the banking sector last month led to the market sharply repricing its expectations of how much central banks would hike – market participants lowered their hike expectations, even pricing in rate cuts by the start of next year, as the financial sector issues led to a tightening in conditions.

As we start May, the markets have softened their expectations of cuts, although we think this looks a bit dovish. We continue to think central banks will remain under pressure to keep rates elevated for some time. The sticky part of the inflation basket (mainly services) remains extremely elevated and broad-based. There is still a lot more work to do before we can finally claim victory over inflation.

Investment grade credit

April could be described as the "calm after the storm". US regional banks and Credit Suisse caused some market turbulence, but the quick resolution of these issues, together with generally positive macroeconomic data, restored confidence amongst investors pushing volatility lower. This in turn supported credit markets as spreads tightened back to where they were at the beginning of the year.

The Global Investment Grade Index is currently trading with a spread of 147bp, down more than 20bp from the highs reached during the banking stress in March and down a touch from the previous month.

Overall yields remain historically high. Currently the EUR IG index offers an yield of 4.1%, the GBP IG index has a yield of 5.7%, while the US market is at 5.3%.

Going forward

Macroeconomic data continue to suggest a recession is not imminent and the latest GDP prints reaffirmed how resilient economies are. Consumption has generally increased as consumers are becoming more comfortable with falling inflation. The housing market is surprising to the upside as house prices have started to increase again while issues in the banking sector seem, so far, limited to regional banks.

This is generally good for credit, but risks clearly remain elevated and we are yet to see the full impact of last year's increase in rates. Moreover, if central banks keep rates elevated in an environment of falling inflation, real rates will move further up, increasing the chances of a recession.

In this environment of high uncertainty, a more balanced and diversified approach could be beneficial. We believe the investment grade market provides investors with natural diversification qualities and can be a source of resilience during uncertain market conditions thanks to its duration component.

Moreover, the yield available from the investment grade market remains historically elevated, providing investors with a good overall cushion to further absorb future volatility.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	140	0.8	4.3
Euro IG	160	0.7	2.3
UK IG	172	0.2	2.7

Source: Bloomberg, 30 April 2023

High yield credit

High yield markets benefited from a calm and carry-friendly environment in April, delivering a second straight month of positive returns. The global HY index was up 0.60% in a low volatility backdrop, with YTD returns hitting +3.8%.

Regionally, US HY (+0.9%) outperformed, supported by continued strong technicals as HY ETFs saw their largest monthly flows since November.

Lower quality bonds benefitted from the strong risk environment. CCCs outperformed BBs and Bs in April.

Sector performance was mixed and telcos continue to lag other spaces this year. Much of the sector weakness is driven by recent downgrade activity on key players (eg Altice, Dish and Lumen)

Primary activity picked up in April, although it remains below the historical average for the month. This year's issuance pace is now up +7.5% from this time in 2022 but remains at the low end of the historical range. FRN primary also picked up significantly with lots of refinancing activity.

Current market view

- We remain generally neutral on valuations, with a preference for adding USD over EUR credit, and some risk aversion to CCC and stressed situations.
- We believe technical elements (supply/demand imbalance, attractive all-in yields) remain supportive and are helping to contain spreads.
- Fundamentals are also generally supportive for now, in our opinion, although we need to work closely with analysts to avoid issuer-specific blow-ups.
- We expect a more shallow default cycle versus what is currently being priced in by markets.
- We are generally concentrating on higher-quality issuers and non-cyclical sectors, such as healthcare and technology, media and telecom (TMT).

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	450	0.9	4.7
Euro HY	487	0.4	3.2

Source: Bloomberg, 30 April 2023

Emerging market bonds

Emerging market bonds were volatile in April, pulled in various directions by economic headlines mostly emanating from developed markets. April started off in a decent manner for risk assets with the March banking crisis slowly ebbing away, but then the US and UK inflation reports dampened the mood. US Treasury yields rose and EM spreads widened towards the middle of the month. In the closing stages of April, overall better-than-expected corporate earnings provided some renewed positive sentiment for risk assets.

EM hard currency government bonds returned +0.5% over the course of the month, EM hard currency corporate bonds returned +0.9% and local currency government bonds also returned +0.9% in April. These movements are far from telling the whole story however, as the theme in the hard currency space was once again of spread decompression (similar to March), with high yield spreads significantly underperforming IG spreads.

Overall, the hard currency IG sovereign index returned +1.4% in April, while the hard currency HY sovereign index returned -0.4%. The EM hard currency IG corporate index returned +1.1%, versus +0.5% for HY hard currency corporate bonds.

EM FX total returns were on average stronger versus the US Dollar in April. Since the beginning of the year, local currency EM Bonds have returned +6.1% vs +3.1% for EM hard currency corporate bonds and +2.4% for EM hard currency sovereigns.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	0.9	6.1
Hard currency government	496	0.5	2.4
Hard currency corporate	372	0.9	3.1

Source: Bloomberg, 30 April 2023

Currencies

April (as compared to March) was quiet, and markets traded sideways in a narrower band. The USD weakened slightly further, whilst GBP, CHF and EUR strengthened as a result. GBP and EUR both benefited from a reduction in the cost of hedging and relative economic surprises over the month. We do not expect GBP strength to continue and see the recent rally more as a recovery from its very weak position of six months ago. Nevertheless, GBP is the strongest G10 currency YTD.

JPY in contrast lost the small gains it delivered over Q1 as the new Governor of the BOJ commented that yield curve control would continue until it would be appropriate to remove it. He also said that rates would remain accommodative as inflation was transitory rather than persistent (even though Japan has more inflation than it has ever had at circa 4%, it remains low versus other G10 economies). Over the month JPY was down vs the USD by more than 2.5%, most of which happened on the Friday of the BOJ meeting.

Given that we experienced some risk-on this month, it was quite surprising to see the NOK down with the underperformers. Traditionally the NOK had been a commodity-driven currency and the interest rate differential vs the ECB made the currency attractive for foreign investors. Over time this commodity correlation has weakened, as has its correlation with the EUR, and this has made the NOK less correlated with global risk assets than in the recent past.

There have also been macro headaches for the USD from an interest rate differential basis as the ECB continues to be hawkish, while the debate over the US debt ceiling has widened the usually 15bps 6m CDS spread to well over 200 bps. All of this seeks to undermine the relative value and safe haven status of the USD and US bonds and securities.

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Key currency pairs

	Level	Change % (1m)	Change % (ytd)
GBP/USD	1.26	1.9	4.0
GBP/EUR	1.14	0.3	1.0
EUR/USD	1.10	1.7	2.9

Source: Bloomberg, 30 April 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.

The views expressed in this document should not be taken as a recommendation, advice or forecast.