Fixed Income asset class overview

July 2023

Fixed income assets broadly sold off in both the US and Europe as yields rose, with central banks continuing their hiking cycles, and with the continued resilience shown in economic data. While the market seems to expect that we are approaching, or have reached, the end of the hiking cycle, there are clearly still risks of further hikes from here, particularly in Europe. Gilts were the exception to the general sell-off in sovereigns, moderately outperforming.

Month in review

There was positive inflation news from the US, with its lowest core CPI result since February 2021, supported elsewhere by the UK CPI figure, which offered the biggest downside surprise in two years. UK CPI now stands at 7.9%. Despite the data continuing in the right direction, it looks like the market is still wary of the risk of some more interest rate hikes from here.

The Fed did not rest further following its June 'hawkish pause', hiking by 25bps to lift the upper bound of its interest rate range to its highest level for 22 years. The European Central Bank (ECB) also hiked 25bps to bring the deposit rate to 3.75%. ECB President Christine Lagarde sent some dovish signals in her post-decision press conference, potentially signalling the end of what some market observers called the rate-hiking "autopilot", and a shift into manual – meaning, slower interest rate rises.

A surprise move at the end of the month was the Bank of Japan's (BOJ) decision to loosen its yield curve control (YCC) policy. Japan's central bank kept its target for 10yr JGB yields at 0%, but widened the upper limit they would be allowed to reach to 1% from the previous 0.5% cap. It still looks like the road will be bumpy from here though, as the BOJ then came back in to buy some more bonds.

From a credit perspective, the generally positive macroeconomic news has prompted investors to take on more credit risk, with the spread of the Global IG index tightening from 140bps to 129bps over the month. The HY market is up 6.1% YTD, with the US market outperforming.

EM continued to perform well, with the HY segment of the market outperforming IG as it has done over 2023, supported by the risk-on sentiment during the month. Local currency (LC) sovereigns and FX also continue to outperform, with EM corporates also performing positively.

Developed market sovereigns

Central banks continued their hiking cycle in July. Although the market expects that this is likely the last hike for the Fed and ECB, risks remain to the upside, particularly for the latter, as the euro area continues to face inflation far above its target level.

In the US, payroll numbers for June came in at the softest print since December 2020, although the overall report remained relatively firm and there is still heat in the labour market (the unemployment rate came down to 3.6%).

However, there was positive inflation news, with the US economy recording its weakest core CPI print since February 2021, for the month of June. The PPI for June came in at just +0.1% MoM, taking the YoY number to 0.1%, down from 1.1% in May, the lowest level since August 2020. US GDP surprised on the upside, coming in at +2.4% in the second quarter, vs. expectations of +1.8%.

In the euro area, ECB commentary was slightly dovish although a further hike in September is still on the table. HICP data showed euro area inflation remains firmly above the ECB's target, with the headline for July at 5.3% and core inflation rising to 5.5%, above expectations. At the same time, euro area growth expanded in the second quarter, with GDP rising +0.3%.

In Japan, the BoJ tweaked its yield curve control policy last week. The central bank kept the target for 10yr JGB yields at 0% but widened the upper limit of the band to +1%. The change could finally be an initial step towards policy normalisation, in our view. The main trigger for the change was Tokyo CPI rising to 3.0% in July YoY. This means that CPI has been ahead of the BoJ's target for 14 consecutive months.

Past performance is not a guide to future performance.

Government bond total returns

	10-year yield %	Total return % (1m)	Total return % (ytd)
Treasuries	4.0	-0.4	1.2
Bunds	2.5	-0.4	0.8
Gilts	4.3	0.8	-2.7

Source: Bloomberg, 31 July 2023

Inflation

US inflation continues to cool down. The annual rate of inflation slowed to 3% in June, hitting the lowest point since 2021. The best news however comes from the core component of the inflation report. Excluding energy and food, inflation only grew 0.158% MoM. This is a level consistent with sub 2% YoY inflation.

While one report doesn't necessarily make a trend, it is reassuring to see that median CPI was also down significantly, suggesting the low print was not due to a few outliers, but rather a more broad-based reduction.

Going forward, inflationary pressures will likely continue to ease, reflecting the sharp decline in money supply. Also, rents inflation, which represents the largest component of the CPI report, is likely to continue its downward trajectory in our view, reflecting the slowdown in the housing market.

While the Fed will welcome this report, it wasn't enough to prevent the central bank from hiking in July. Policymakers will want to see more evidence going forward, particularly coming from the labour market. However, the report is a big step in the right direction and suggests that the end of the hiking cycle is fast approaching.

UK inflation also slowed by more than expected in June, falling to its lowest level in over a year. The Consumer Price index was 7.9% YoY, down from the previous 8.7% recorded in May. Crucially, the fall in the rate of inflation was not only driven by goods (which are currently in deflation on a MoM basis), but also by services. As a result, core inflation was also lower.

UK inflation is clearly still too high, but June's print was a step in the right direction. UK inflation will likely continue to fall, as we think it is simply lagging the trend in other countries. We expect to see more good news on UK inflation this year, which in turn should be supportive for gilts.

Investment grade credit

A better-than-expected macroeconomic environment is pushing investors to take more credit risk, driving spreads lower. The Global IG index saw spreads tightening by 11bp in July to 129bp. On the other hand, rates remain generally range-bound, as stronger growth means central banks will likely keep interest rates higher for longer.

The increased willingness to take on more credit risk is evident both across sectors and ratings. Cyclical sectors continue to outperform, driven by the areas that have been under the spotlight in recent months (such as financials and real estate). Across credit ratings, investors are moving down in the credit spectrum, as BBBs continue to outperform within the IG space.

Overall yields remain historically high. The EUR IG index offers a yield of 4.3%, the GBP IG index has a yield of 6.2%, while the US market is at 5.6%.

Going forward

Growth continues to surprise to the upside, while inflation to the downside. Economies are generally moving in the right direction, led by a strong labour market, which in turn fuels consumption. Moreover, the most cyclical sectors of the economy are starting to rebound, and that will likely push a recession further away.

This is a good environment for credit, in our view. On the one hand, spreads can tighten further as investors become more comfortable with the overall economy, assigning a lower probability of defaults. On the other hand, falling inflation will likely push central banks to stop hiking, preventing further losses from the duration component of corporate bonds.

In this scenario, the performance of IG bonds will likely be driven by spreads. Rates, while range-bound, will continue to benefit investors thanks to the attractive level of carry they currently offer, in our opinion.

However, what if the above assumptions are wrong? What if we do actually get a recession or a severe slowdown this year? In that situation, we believe the IG market could still perform relatively well. Unlike a few years ago, rates today are much higher -- providing investors with a greater cushion. Moreover, if we do get a recession, central banks will be in a position to cut rates significantly and that in turn will benefit assets with longer duration profiles, such as IG bonds, in our view.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	119	0.4	3.7
Euro IG	147	1.0	3.1
UK IG	157	2.3	1.3

Source: Bloomberg, 31 July 2023

High yield credit

HY markets delivered another strong month with +1.5% total return (in USD terms). The US (+1.4%) continues to outperform Europe (+1.2%) and EM (1.3%). The Global HY index is now + 6.1% YTD – an impressive result given all the rate volatility, concerns about the late cycle and rising interest costs.

Performance was led by lower-quality bonds in the US, where bonds rated CCC and lower returned +2.4% in July supported by technical factors such as a lack of issuance and relatively thin liquidity. In Europe, weaker credits lagged, likely impacted by the Casino and Altice complexes.

Most sectors were up last month. In the US, retail, cables and energy were the standout performers.

Primary markets remain very quiet in both the US and Europe. The HY FRN primary market saw a couple of new deals, mainly relating re-financing activity.

Current views

- Positioning remains fairly close to neutral to slightly underweight credit risk
- Technical elements (e.g. supply/demand imbalance, attractive all-in yields) are contributing to spread containment.
- Fundamentals are generally supportive for now, although care is required to avoid issuer-specific blow-ups.
- We expect a more shallow default cycle versus what is priced in by the market.
- We continue to focus on defensive trades (eg non-cyclicals v cyclicals, up-in-quality, etc).

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	379	1.4	6.9
Euro HY	450	1.2	5.7

Source: Bloomberg, 31 July 2023

Emerging market bonds

During July, emerging market debt (EMD) continued to perform positively across all segments, continuing a marked strengthening during 2023. The high yield (HY) segment continues to outperform investment grade (IG), which was supported by the broad risk-on environment and positive sentiment during the month. LC sovereigns outperformed the rest of the EMD market, except for the frontier countries (the JPM NEXGEM index returned 3.30% over the month, bringing YTD performance to 13.31%).

After pausing in June, the Federal Reserve raised rates by 25bps in July to 5.5%, in line with market expectations. Whether this level becomes the terminal rate remains to be seen, with future hikes and the potential for monetary loosening in 2024 being highly dependent on the robustness of the economy. However, the current consensus is for the US to experience a soft landing, which would potentially be supportive of EM assets.

In currencies, the South African rand, Colombian peso, and Argentine peso were the standout performers on a total return basis during July. This is a continuing trend from June 2023, which saw several LATAM currencies performing particularly well. The Colombian peso and Mexican dollar are the standout performers YTD.

Conversely, several currencies continued to struggle; these included the Turkish Lira, Taiwanese dollar, and Russian rouble. Asia currencies broadly saw a rebound in performance following a poor period in June. Local rates also continue to be supportive and stand to benefit from a number of EM countries being ahead in their monetary policy cycle, with local inflation levels appearing contained and rates to fall as a result.

EM corporates continue to perform positively, but also continue to lag the sovereign space. Whilst HY also outperforms IG in the corporate space, the difference is muted relative to sovereign indices with continued, elevated rates and subsequent borrowing costs weighing on corporate issuers. The effect of higher-for-longer rates is likely to play out further over the following quarters, weighing on sentiment in the corporate universe.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	2.9	10.9
Hard currency government	413	1.9	6.1
Hard currency corporate	326	1.0	4.7

Source: Bloomberg, 31 July 2023

Currencies

USD was a bit weaker during the month as interest rate differentials have been squeezed further recently. With strength YTD in the EUR, and less convincing forward outlook with rate differentials, our bias is to rotate out of EUR and back into USD now.

Sterling strength continued to some degree, fuelled by inflationary pressures remaining (despite the slight reduction in CPI) and some hawkish narrative by the BOE. GBP/USD reached a high of 1.31, the strongest level since April 2022.

As rate hikes continue to pass through into the economy in the UK, and despite a robust labour market, UK consumers are likely to feel the pinch in the second half of the year.

The Japanese yen had a mixed month, with some softening in the BoJ's commitment to control the yield curve. It is likely to be a bumpy road for JPY given the BoJ then came back in to buy some bonds. JPY still remains something of a global outlier and still looks extremely cheap, in our view.

EM FX had a slightly weaker month than June.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	1.0	6.2
GBP/EUR	0.3	3.3
EUR/USD	0.8	2.7

Source: Bloomberg, 31 July 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.