For Investment Professionals only.

Fixed Income asset class overview

October 2023

October was marked with concerns over geopolitical risk following conflict breaking out in the Middle East and fears that this may spread into the wider region, which prompted a shift to "risk off" sentiment in the markets. Economic data continued to come in relatively strong, particularly from the US, adding to fears of higher rates for longer.

Month in review

US Treasury yields rose for the sixth successive month in October off the back of strong economic data, alongside indications of inflationary pressures persisting. Core CPI (excluding food and energy) for September came in at a five-month high of 0.3%. The market is pricing in a 41.5% chance of a hike by the January Federal Reserve (Fed) meeting.

Higher longer-term borrowing costs are visible in the real economy, with the average 30-year mortgage rate in the US hitting its highest point since 2000, at 7.9%.

European data were not as strong, with a preliminary Q3 GDP reading for the euro area showing a contraction of 0.1% quarter-on-quarter (QoQ). However, European sovereign bond yields did recover somewhat.

In investment grade (IG), spreads generally moved higher as a result of macro headwinds, including rates volatility and a mixed earnings season. The Global IG Index is trading at a spread of 140 basis points (bps), up almost 10 bps from September. Financials underperformed corporates, and lower quality names fared worse than higher quality names. Overall, yields remain historically high, with euro IG at 4.5%, sterling at 6.4% and the US also at 6.4%.

High yield (HY) suffered from the geopolitical risk and US economic resilience (which led to fears of higher rates for longer), with spreads widening 30-40 bps. European HY held up better (-0.2%) than US HY (-1.2%) and EM HY (-1.3%). Floating rate notes (FRNs) benefitted from the asset class's near-zero duration and returned an almost flat -0.1%. Within the asset class, higher quality names performed better.

In emerging markets (EM), the HY (-0.6%) part of the benchmark continued to outperform IG (-2.1%), suggesting the core rates move is yet to translate into a broad widening of spreads. In a divergence to September, local currency sovereigns (-0.5%) outperformed the rest of the EM debt market (except for the frontier-centric NEXGEM Index). Hard currency (HC) sovereigns gave back 1.4%, with HC corporates doing slightly better, declining 1.2%.

Developed market sovereigns

Despite another strong round of US economic data, there has been some market focus over the month on whether the attack by Hamas on Israel on 7 October could lead to a much wider escalation. The result has been a volatile month with an unclear path of returns, a rise in gold prices, a flat US dollar (USD) and sovereign yields rising to then lose some ground.

The JOLTS report of job openings for August showed the US labour market more resilient than expected with job openings unexpectedly rising to 9.610m (versus 8.815m expected). However, ADP's report of private payrolls showed just 89k jobs were added in September (versus 150k expected), the weakest number since January 2021.

Looking at US inflation, there was more proof that it had been ticking up in recent months; in September, the Consumer Prices Index rose 0.4%, whereas the annualised rate of CPI was 3.7%, slightly higher than expected.

US housing starts recovered to an annualised rate of 1.358m in September, moving up from their three-year low in August. However, building permits fell back. There was an upside surprise to US new home sales, which rose 12.3% month-on-month. This coincided with US 30-year mortgage rates hitting 7.90%, a fresh 23-year high.

Third-quarter GDP came in at an annualised rate of 4.9%,, surprising positively from the 4.5% expected; this is the fastest pace of growth in nearly two years.

In Europe, the European Central Bank (ECB) kept rates unchanged at 4.0%. It retained its "data-dependent" approach and issued guidance that "rates will be set at sufficiently restrictive levels for as long as necessary". There were some dovish tilts, with ECB President Lagarde noting that "inflation dropped markedly in September" while yields "had risen".

UK GDP grew by 0.2% in August, in line with expectations. Although it was not a positive month for UK Gilts, 10-year yields were only up 3 bps after employment data released was slightly weaker than expected.

In Japan, core inflation dropped below 3% for the first time in more than a year on the back of easing gas and electricity prices.

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	4.9	-1.3	-3.0
Bunds	2.8	0.3	-0.9
Gilts	4.5	-0.3	-4.4

Source: Bloomberg, 31 October 2023

Inflation

Once again this month US inflation came in slightly above expectations. Headline inflation rose 0.4% during the month, keeping year-on-year inflation at 3.7%. Core inflation (which excludes energy and foods) was up 0.3% in the month, registering at 4.1% year-on-year.

The key theme this month was rents, which came in above expectations. Everything else was pretty much in line with expectations. Excluding rents, inflation remains close to the 2% target. Rents surprised to the upside, but we are not too worried about them; we believe they are still going in the right direction, although not as quickly as expected.

Going forward, we think it is likely some additional upward pressure will come from items such as healthcare insurance, airfares and energy. Rents will continue to deflate, in our view, although probably not as quickly as people thought. As a result, inflation will likely find resistance around this level, before it can continue its downward trend. How low inflation will go will be the key question to answer.

The sharp decline in money supply would suggest that deflation is a real possibility; however, velocity (how quickly money flows through the economy) continues to rise, and that will likely put a floor to how far inflation can fall.

In a recent blog, we explain why we think inflation is likely to keep surprising to the upside and how some of this reasoning has started to play out. We also highlight six scary charts in our annual Halloween blog.

Investment grade credit

There were more 'tricks' than 'treats' for the credit market this month. Halloween hasn't been kind to corporate bonds as spreads generally rose in October. Spreads have been buffeted by macroeconomic headwinds -- in particular higher volatility in government bond markets -- and a mixed earnings season.

Despite this, the move wider in credit spreads appears to have been mostly orderly. The Global Investment Grade Index was trading with a spread of 140 bps at the end of October, almost 10 bps higher compared to the previous month.

Across sectors, some of the higher-beta and more cyclical sectors generally underperformed. Financials, particularly in the US, underperformed non-financials, while across ratings, lower quality names underperformed higher quality issuers.

Overall, yields remain historically high. Currently the Euro IG Index offers a yield of 4.5%, whereas the GBP and US IG Indices have a yield of 6.4%.

Going forward

The continued volatility in government bonds is finally starting to impact the credit market, pushing spreads wider. The move so far has been mostly orderly, with spreads generally remaining historically tight and far from signalling any sort of stress in the financial market.

Companies' balance sheets within IG remain generally healthy, while refinancing risk is low, in our view, as they managed to take advantage of the previously low-yield environment to lock in attractive rates on their debt.

However, the macroeconomic picture is slowly changing. Eurozone growth has turned negative. In the US, while consumers generally remain in a decent financial position, their situation is gradually deteriorating and the conditions that allowed for the recent positive growth numbers are now reverting. Real rates are firmly into positive territory, while government spending, which until recently was partially offsetting the sharp reduction in liquidity, is now reversing its course.

Monetary policy and fiscal policy have now started to move in the same (tight) direction. The combination of higher rates, lower liquidity and diminishing fiscal support will likely put pressure on consumer spending, and this in turn will result in lower growth.

Credit investors should be more selective in this environment, in our view, and avoid taking excessive risk. Investment grade investors, however, could take comfort from the fact that rates are higher today and could potentially offset the rise in spreads in case the situation were to deteriorate.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	132	-1.8	-1.4
Euro IG	159	0.4	2.8
UK IG	166	-0.2	1.0

Source: Bloomberg, 31 October 2023

High yield credit

October was a weak month for riskier assets driven by geopolitical risk (leading to investors' cautious positioning) and the continued resilience of the US economy (adding to fears of higher rates for longer). Global high yield (HY) markets produced returns of -1.0% in October as rates continued to rise and HY spreads widened by c.30-40 bps during the month. In fixed markets, European HY fared better (-0.2%) thanks to a more supportive rate backdrop, while US HY fell 1.2% and EM HY declined 1.3%.

Floating rate HY benefited from its near-zero duration and was once again unaffected by the government bond sell-off. The Global HY FRN Index returned -0.1% over the month, with carry offsetting most of the downward drag from wider spreads (40 bps).

Higher quality bonds outperformed in October in both the US and Europe. Most HY sectors were weak last month, with the worst performing being healthcare, technology and cable, and packaging (-3.0%). Among the best performers were utilities and services.

Current views

- We are generally cautious on valuations at current spread levels – in our view, they do not offer compensation.
- We believe the 'higher for longer' narrative has merit and, coupled with persistent inflation, suggests earnings deterioration and wider spreads going forward.
- We are not adding risk at these levels in the US, Europe or EM and we are especially cautious on EM given volatility and USD strength etc. We are staying close to neutral/slightly underweight.
- Technical elements such as supply/demand imbalance and attractive 'all-in' yields need to be respected; we do not want to get too underweight as a result.
- We believe fundamentals are still reasonably supportive for now, but macroeconomic deterioration is anticipated. This could probably be worse in Europe than the US.
- Corporate balance sheets are generally in good shape, in our view, and pre-emptive re-financings have pushed out maturities at attractive rates.
- We expect default rates to increase modestly, but it will likely be issuer-specific events, not a wholesale spike in defaults. Our base case scenario 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.)

Past performance is not a guide to future performance.

High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	442	-1.2	4.7
Euro HY	495	-0.2	6.1

Source: Bloomberg, 31 October 2023

Emerging market bonds

The story in October was similar to September insofar as core rates, and US Treasuries (UST) continued to sell off. The market movements have been relatively orderly. It's noteworthy that the high yield portion of the benchmark continues to outperform investment grade, despite spreads widening more, which suggests that the core rates move is still not translating into a broad widening of spreads. The IG and HY portions of the index returned -2.1% and -0.6% respectively.

In a reversal of September's trend, local currency sovereigns outperformed the rest of the emerging market debt (EMD) market, except for the frontier-centric NEXGEM Index which returned -0.05% over the month, bringing year-to-date performance down to 9.75%.

FX at a broad level was flat, but across countries and regions performance varied considerably, with emerging European currencies, such as the Polish zloty and Hungarian forint, being among the highest performing. Conversely, the Mexican peso continued to give back some of the returns achieved year-to-date, with the Indonesian rupiah also underperforming.

Corporate emerging market debt saw negative returns driven by widening spreads but also through the US Treasuries sell-off. There was not much divergence in performance between investment grade and high yield, although there was a greater spread move in the high yield space, which widened 26 bps over the month compared to investment grade, which widened 13 bps. Corporates marginally outperformed the hard currency space owing to the lower duration. Similar to last month, sectors with greater duration such as oil & gas and pulp & paper were the worst performing off the back of the rate sell-off.

Elsewhere, China property continues to drag down real estate, but financial returns were positive. Spreads widened across the Middle East by 16 bps in October; Israel and Jordan were the worst performing, widening by 71 bps and 47 bps, respectively. Asia outperformed other regions, with China ex-real estate holding up well.

Past performance is not a guide to future performance.

Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	-0.5	3.7
Hard currency government	441	-1.4	0.4
Hard currency corporate	338	-1.2	2.1

Source: Bloomberg, 31 October 2023

Currencies

In October, the US dollar strength continued. This likely reflected both the 'higher rates for longer' sentiment in the US and some of the weakness in Chinese economic growth that we have seen. In our view, the dollar seems quite overvalued from a long-term perspective, but it could continue with some momentum in the near/medium term.

The yen had a weak month despite some expectations that the yield curve control (YCC) policy would be eased. In fact, the Bank of Japan made a fairly small tweak to policy, which was not enough to support the yen. We discuss this further in a recent blog.

It was a weak month for most EM currencies.

Past performance is not a guide to future performance.

Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-0.4	0.6
GBP/EUR	-0.4	1.7
EUR/USD	0.0	-1.2

Source: Bloomberg, 31 October 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.

For Investment Professionals only and Institutional Investors. Not for onward distribution. No other persons should rely on any information contained within. The views expressed represent the opinions of M&G Investments which are subject to change and are not intended as investment advice or a forecast or guarantee of future results. Stated information is provided for informational purposes only. It is derived from proprietary and non-proprietary sources which have not been independently verified for accuracy or completeness. While M&G Investments believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions which may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. This financial promotion is issued by M&G Luxembourg S.A. The registered office is 16, boulevard Royal, L-2449, Luxembourg. NOV 23 / 1098401