M&G Investments

Fixed Income asset class overview

February 2024 (Data as at 31 January 2024)

The timing of the Federal Reserve's (Fed) first interest rate cut has been investors' hottest topic in recent months. However, Fed Chair Jerome Powell's remarks following the Federal Open Market Committee's (FOMC) January meeting poured cold water on the idea of a cut at the March meeting and the odds dropped to one to three. So, while rate cuts are expected soon, confidence they will be as early as the first quarter has been dialled back.

Month in review

After the strong finish to 2023, bond markets were more subdued in January as investors scaled back their expectations of rate cuts as early as March. Geopolitical concerns persisted, particularly as strikes by Houthi rebels on commercial shipping in the Red Sea led to significant supply-chain disruption. This saw oil prices rising again in January following three monthly declines, with Brent crude up 6.1% to $81.7 a barrel.

In the US, December's inflation data showed a marginal reacceleration, with both headline and core inflation hotter than expected. As inflation is proving to be stickier than anticipated, Fed Chair Powell may struggle to implement all the rate cuts that are currently factored into the market, in our opinion.

Investment grade (IG) supply continued to beat expectations (and records) in January, as borrowers took advantage of rallying yields to refinance at lower rates. Strong demand continued as investors were eager to buy bonds with elevated yields before the Fed starts cutting, leading spreads to continue to perform well in the month. Bond yields have been volatile as investors focused on higher-than-anticipated growth and a solid labour market, potentially leading to smaller rate cuts than anticipated. The Global IG index saw a small spread compression of a few basis points (bps), with a broadly flat total return due to the underlying yield volatility.

In a mixed month for high yield (HY), global spreads trended sideways, ending the month 10 bps wider from the start of the year, delivering a 0.4% return. Duration didn't help either, as yields rose following delayed rate-cut prospects. However, floating rate notes (FRNs) saw strong returns for the month (1.7%), thanks to rate insulation and further spread compression (c.-30 bps).

Emerging markets debt (EM) retreated in January after the end-of-year rally that was spurred on by investors' expectations of near-term Fed rate cuts. The reversal was across the board, although spreads were left broadly unchanged, with the hard currency index only slightly wider over the month. Much of the underperformance in EM was found in the sovereign space, particularly within local currency government bonds (-1.5%). The hard currency corporate bond market bucked the trend and provided a positive return (0.6%).

Inflation

The latest data showed that US inflation reaccelerated in December. Both headline and core inflation came in higher than expected. Headline CPI ended 2023 at 3.4% year-on year (YoY), compared to the market's expected 3.2%. Core inflation was 3.9% over 12 months, exceeding the expected 3.8%. A couple of noteworthy points stood out:

1) **Core goods**: Most of the effort to bring down inflation in recent months was driven by core goods. This category was heavily affected by supply chain issues during the pandemic. However, as economies reopened, the situation started to improve and core goods began to adjust, experiencing a period of disinflation. This trend appears to have ended, contributing to the higher overall inflation number.

2) **Rents**: We know that rents are decreasing, but the market over-anticipated the speed of their fall. Rents are the stickiest category of the CPI basket, and while they will decrease, this will take time. Patience is required.

Looking ahead, inflation is expected to moderate further, although perhaps not as quickly as some had anticipated. Rents will continue to decrease slowly; other service categories are likely to remain sticky as their main input cost, wages, remains elevated. Additionally, it will be interesting to monitor core goods, especially given the recent increase in shipping costs due to geopolitical tensions.

In conclusion, the expectation of a pivot by the Fed was based on the belief that inflation was rapidly approaching the target. Instead, inflation has also made a pivot, but in the wrong direction. Inflation is proving to be stickier than expected, and Powell may face challenges in implementing all the projected rate cuts that are currently factored into the market.

Developed market sovereigns

After the incredibly strong rally that we saw in November and December, January was a weaker month for sovereigns as investors pushed out their expectations for rate cuts beyond Q1. Fed Chair Powell suggested that a cut in March is unlikely. The market now seems more set on May as the date of the first cut. Most developed market (DM) government bonds ended January in negative territory, with the Bloomberg Global Aggregate Treasury Index down 1.9% on the month.

In the US, although Powell dampened expectations of a March cut, the FOMC did adjust its statement to drop its tightening bias in exchange for ‘any adjustments to the target range for the federal funds rate’. The market is pricing in five cuts by the December meeting, so although the expectations for the first cut have been pushed out, the market is still very much expecting a relief from the monetary tightening we have experienced. The market is confident that inflation is still headed in the right direction and the Fed will continue on its anticipated, more dovish trajectory.

US government bonds (Treasuries) ended the month down 0.2%, a familiar tale for most of 2023 before the extraordinary rally we witnessed into the end of the year.

In the eurozone, Q4 GDP figures showed zero growth rather than the expected -0.1% contraction, avoiding a technical recession. Similarly to the US, investors dialled back their expectations of rate cuts by the European Central Bank (ECB), with the implied probability of a cut in April chopped from being fully priced to under 60%. Euro sovereign bonds were down 0.6% over the course of January.

In the UK, there are mixed views on whether the Bank of England (BoE) will be an early mover and the first major central bank to cut rates or whether it will wait for the Fed to move first. Currently, the first cut is expected for the June meeting, with four cuts priced in by December. Inflation remains sticky in the UK, and headline CPI rose slightly to 4.0% YoY in December, which, combined with flat labour market data, did not help UK government bonds (gilts). In spite of this, the attention is on the timing of cuts, rather than talk of further hikes. Gilts suffered more than euro sovereigns and US Treasuries in January, falling 2.2%.

In Japan, the story continues to be around when its Negative Interest Rate Policy (NIRP) will be ended. The ‘shunto’ wage negotiations in April mark a key point in the calendar and could give an indication as to a shift in the Bank of Japan’s (BOJ) policy. Given the rally in Japanese government bonds (JGBs) over November/December, post the shunto negotiations may be a favourable time for the BOJ to take action. The market sees December as being the most likely time for a rate hike this year, but we think it may be closer to May.

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	3.9	-0.2	-0.2
Bunds	2.2	-0.7	-0.7
Gilts	3.8	-2.2	-2.2

Source: Bloomberg, 31 January 2024

Investment grade credit

After the big rally seen towards the end of last year, most investors were expecting to see some weakness re-emerging in credit markets, driven mainly by supply pressures. Supply has been historically large as companies took advantage of the rally in bond yields to refinance at lower rates. However, despite this heavy issuance, IG spreads continued to perform well in January, driven primarily by a strong demand, coming particularly from the retail space.

On the other hand, rates have been volatile as investors’ attention moved back to higher-than-expected growth and a solid labour market, which in turn might push central banks to cut less than expected.

The Global IG index saw its spread compressing by under five bps, bringing the overall spread to 111 bps. Total return was broadly flat and affected by the volatility seen around rates.

The asset class continues to provide a historically elevated level of yield. Currently, the EUR IG index offers a yield of 3.7%, the GBP IG index has a yield of 5.4%, while the US market stands at 5.2%.

Going forward

The macroeconomic environment remains supportive for the asset class, in our opinion. Inflationary pressures are easing while economies are growing, albeit at a slower pace. Yields are still historically high, and rate cuts are now expected in 2024, which should be supportive for fixed income investments, in general. The IG market could further benefit from its natural diversification, in our view, as it combines duration and credit risk. If economies were to enter into a recession, the duration component of this asset class would help performance, as interest rates would likely decline. On the other hand, if economies were to continue to grow, spreads would likely tighten, supporting the returns for IG bonds. Moreover, IG companies' balance sheets remain generally healthy, and refinancing risk is low as they took advantage of the previously low yield environment to secure attractive rates on their debt.

However, spreads are now historically tight, leaving investors with little room for error. In this environment, it is advisable to remain selective and focus on generating alpha rather than relying solely on beta.

In summary, while spreads may not appear historically attractive, the positive macroeconomic environment, combined with the aforementioned features, makes this asset class particularly appealing for investors. Furthermore, active investors can continue to capitalise on market dislocations, mitigating the impact of tighter spreads and potentially achieving better performance.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (YTD)
US IG	102	0.2	0.2
Euro IG	130	0.1	0.1
UK IG	133	-1.1	-1.1

Source: Bloomberg, 31 January 2024

High yield credit

Global high yield (HY) delivered a 0.4% return in January. In a mixed month, Global HY spreads trended sideways ending the month 10 bps wider that the start of the year. Duration didn't help as yields rose following delayed rate cut prospects.

US HY underperformed (0.0%) versus EM HY (1.0%) and European HY (0.9%). A good portion of this underperformance is likely attributed to the sell-off in DISH Network, a cable provider, whose bonds fell materially on the back of management actions attempting to strip assets from some classes of creditors. DISH is the seventh largest issuer in the US HY index.

Lower-quality ratings (US CCC cohort) also saw a reversal of fortune from recent months, underperforming higher quality. The best performing sectors in January were energy and retail.

HY FRNs delivered strong monthly returns (1.7%) thanks to rate insulation and further spread compression.

Current views

- Following the late rally in 2023, HY spreads tightened and are now just under 400 bps. Overall, market valuations look less attractive, but we believe there are pockets of value remaining. The focus is on credit analysis and stock selection.
- An active and open new issue market is supportive for the asset class and may help spread containment.
- We believe fundamentals are largely healthy as many lower-quality credits managed to refinance either via the private credit or loan market. Potential future rate cuts will also help many sectors and issuers such as real estate.
- Geopolitical risks and central bank policy errors remain the biggest uncertainties for the HY market going forward.

Past performance is not a guide to future performance.

High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (YTD)
US HY	359	0.0	0.0
Euro HY	394	0.9	0.9

Source: Bloomberg, 31 January 2024

Emerging market bonds

January saw a retracement after the 2023 end-of-year rally, which had been spurred on by investors significantly bringing forward their expectations of Fed rate cuts. The slight reversal was felt across the board, including FX and core yields, although spreads were left broadly unchanged, with the hard currency government bond index only 18 bps wider over the month.

Much of the underperformance in EM was found in the sovereign space, particularly within local currency debt, but the hard currency corporate market bucked the trend and provided a positive return in January. The frontier-centric NEXGEM index declined 0.3% over the month.

For sovereigns, the recent two-month rally ran out of steam with a slight reversal in markets' expectations for rate cuts, although this was not a major retracement. In the local currency space, rates outperformed FX although there was not a great deal to separate them. In the hard currency space, HY outperformed IG, which reflects the driving forces of the market being focused on core rates rather than credit risk and spreads in January. Across regions, the Middle East was the was worst performing in the currency space and across hard currency bonds, reflecting the changing sentiment in the region. Asia performed positively in the local currency space and was the best performing hard currency region, posting a decline of 0.7% over the month.

Within the corporate market, HY outperformed IG with HY returning 1.3% versus -0.2% in the IG space. There were some standout sectors such as real estate and metals & mining, which returned 2.0% and 1.6%, respectively. Real estate rallied on the back of a China property rebound, although underlying data remains negative in this space with Evergrande now being ordered to liquidate. By region, HY Africa performed strongly, led by Zambia. EM Europe was also strong on the robust sentiment in Poland, strong returns from Ukrainian corporates and Georgia. The Middle East stood out as the underperforming region of the month due to its IG status, with Saudi Arabia posting poor returns (-1.5%).

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	-1.5	-1.5
Hard currency government	410	-1.0	-1.0
Hard currency corporate	312	0.6	0.6

Source: Bloomberg, 31 January 2024

Currencies

The US dollar strengthened in January, outperforming other G10 currencies.

Past performance is not a guide to future performance.

Key currency pairs

	Change % (1m)	Change % (YTD)
GBP/USD	-0.3	-0.3
GBP/EUR	1.7	1.7
EUR/USD	-2.0	-2.0

Source: Bloomberg, 31 January 2024

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.

M&G Investments