Fixed Income asset class overview

July 2024 (Data as at 30 of June 2024)

The second quarter saw four developed market central banks commence their interest rate-cutting journeys. This positions the Federal Reserve as one of the last to embark on the 'easing train', with the rate-cutting pace across the board expected to be gradual as inflation remains ahead of central banks' targets in most regions (except for Switzerland, which has seen two rate cuts so far).

Month in review

The European Central Bank, the Bank of Canada, the Swedish Riksbank and the Swiss National Bank cut interest rates in the quarter, with the Bank of England (BoE) expected to join in August as its headline consumer prices index (CPI) returned to its target of 2.0% year-on-year (YoY) in May.

US CPI in May showed the lowest monthly core reading since August 2021 at 3.4% YoY, with core personal consumption expenditure (PCE) (the Fed's preferred inflation gauge) increasing 0.08% month-on-month (MoM) in May to 2.6% YoY, the softest reading since November 2020. These figures helped cement expectations that rate cuts were still on the horizon from the Fed, but suggest that more evidence of disinflation will be needed to increase confidence that inflation is moving back to the 2% target.

Despite the lowering of policy rates in Europe, the fallout from the European parliamentary elections and subsequent announcement of snap French legislative elections saw European sovereign yields rise, with the Franco-German 10-year spread widening by 29 basis points (bps) to 80 bps in Q2 – the biggest quarterly widening since the fourth quarter of 2011, when the euro sovereign crisis was ongoing.

In the investment grade (IG) market, spreads finally widened in June after tightening for most of the year. The sell-off can be attributed to several factors, including the weaker economic data and political risks in France. Despite widening spreads, total returns have remained generally positive, driven by the duration component as yields fell. USD IG generated a total return of 0.6% over the month, with EUR and GBP returning 0.7% and 0.8% respectively. The Global IG index offered a spread of 102 bps in June, several bps wider versus the prior month.

June was a positive month for high yield (HY) markets, with carry and tighter rates driving returns. The Global HY index delivered 0.8% thanks to the rally in government bond yields that followed the news of softer US inflation and the first interest rate cut from the ECB. However, French election uncertainty weighed on spread performance and euro HY markets lagged (0.6%) their US (0.9%) and EM (1.1%) counterparts. HY floating rate notes (FRNs) returned 0.5% during the month, outperforming HY credit default swap (CDS) indices thanks to their lower beta / sensitivity to wider spreads.

June was a mixed month for emerging market (EM) debt, although the year-to-date trend of hard currency (HC) outperforming local currency (LC) continued with EM FX coming under more pressure, particularly in the Latin America region. Spreads were broadly wider in the month, with most of the widening seen in the high yield portion of the market. IG outperformed HY in June, with LC and HC EMD sovereigns returning -1.1% and +0.6% in June respectively, and HC EMD corporates returning +0.9%.

Inflation

US CPI inflation came in below expectations in May, at 3.3% compared to the expected 3.4%. Core CPI inflation was also lower than expected, at 3.4% versus 3.5%.

Overall, this was a good and encouraging report. A couple of things, in particular, stood out:

1) The deceleration in inflation was broad-based. The lower inflation figure was not due to a few outliers, but rather reflected a widespread trend. Most categories experienced a decrease in inflationary pressures in May, which is especially evident when considering median inflation (which focuses on the core of the distribution and excludes outliers).
2) Supercore inflation -- which also excludes shelter and rent costs -- fell significantly. This is the Fed's preferred inflation indicator as it is closely linked to wage growth and, consequently, the potential wage-price spiral. Supercore inflation entered negative territory in May, reinforcing the message that a wage-price spiral is unlikely at this stage.

The narrative has shifted once again, from ‘inflation is reaccelerating’ to ‘inflation is falling off a cliff’. The truth is likely to lie somewhere in between. Inflation is decelerating and will continue to do so, driven by a normalisation in service inflation. However, this process will be slow as these categories typically exhibit stickiness.

Meanwhile, it is important to monitor core goods inflation. It has been in deflation over the past few months, partly due to a strong dollar and weaker Chinese growth. However, this category is fairly volatile and could quickly surprise to the upside if circumstances were to change.

In conclusion, inflation is moving in the right direction, with encouraging signals now emerging from the Fed's preferred category. This was a positive report, and investors are justified in celebrating, but they should also exercise caution and avoid getting ahead of themselves. Returning to the target will take time, and patience is still required.

Developed market sovereigns

Core PCE, the Fed's preferred inflation gauge, increased 0.1% month-on-month in May to 2.6% YoY, which, combined with CPI, has helped cement expectations that rate cuts remain on the horizon from the Fed. The June Federal Open Market Committee (FOMC) median dot plot points to one cut by the end of the year (down from three expected in March). This saw the US Treasury index up 1.0% on the month.

In the eurozone, June saw the ECB delivering its widely-anticipated 25 bps cut, taking deposit rates down to 3.75%. The decision reflects progress on inflation over the past year, but was made despite the stickier-than-expected services inflation. This led the ECB to maintain its stance on data-dependency, affirming that future policy decisions will be evaluated meeting-by-meeting and that it will not pre-commit to a particular path.

Despite the lowering of policy rates, the fallout from the European parliamentary elections and subsequent announcement of snap French elections saw European sovereign yields rise, with the Franco-German 10-year spread widening by +29 bps to 80 bps in Q2 – the biggest quarterly widening since Q4 2011, when the eurozone debt crisis was ongoing.

In the UK, headline CPI fell to 2.0% YoY in May, returning to the Bank of England's inflation target for the first time since July 2021, down from its post-pandemic peak of 11.1% in October 2022. However, core inflation remained elevated at 3.5% YoY, underpinned by sticky services prices, contributing to the BoE's decision to maintain interest rates at 5.25%. Despite the robust core services inflation, market participants expect that the Bank is on course to cut rates in August, absent any significant upside data surprises. Overall, the UK Gilts index rose 1.3% in June. In Japan, 10-year Japanese Government Bond (JGB) yields rose to 1.05% over the month on growing expectations of further monetary policy tightening by the Bank of Japan (BoJ), with the central bank due to detail plans to taper its bond buying at its July meeting. Some market participants are also factoring in a possible interest rate hike, whilst others question whether the BoJ would announce two major initiatives at the same meeting.

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	4.4	1.0	-0.8
Bunds	2.5	1.4	-2.1
Gilts	4.2	1.3	-2.6

Source: Bloomberg, 30 June 2024

Investment grade credit

After tightening for most of the year, spreads finally widened in June. The sell-off can be attributed to several factors, including weaker economic data and political risks in France.

When looking at specific sectors, the spread repricing was broad-based, with financials generally leading the way. In terms of regions, Europe underperformed, mainly due to the volatility caused by the French elections. In terms of credit ratings, lower-rated names, such as BBBs, generally underperformed, indicating a risk-off sentiment in the market.

Despite the widening spreads, total returns have remained generally positive, driven by the duration component as interest rates fell. The USD IG market generated a total return of 0.6%, while the EUR market returned 0.7% and the GBP market was up 0.8%.

Currently, the Global IG index offers a spread of 102 bps, which is slightly wider compared to the previous month. The asset class continues to provide historically elevated levels of yield. Presently, the EUR IG index offers a yield of 3.9%, while the GBP and USD IG indices both have yields of 5.6%

Going forward:

The macroeconomic environment remains supportive for the asset class, in our view. Inflationary pressures are slowly easing, while growth remains supported by a healthy labour market. Many IG companies remain in a solid position, having taken proactive measures to hedge against rising inflation during the pandemic. By locking in low financing costs for an extended period, these companies have insulated themselves from potential interest rate increases. Furthermore, their large cash balances are now earning attractive interest rates, allowing them to benefit from rising rates. As a result, despite higher rates, most IG corporates' balance sheets remain healthy.

Credit metrics are generally normalising, but they remain historically decent. Moreover, cash balances and profit margins remain historically high.

However, most of the good news is priced into the market, as spreads, the extra compensation investors receive to own corporates, are trading near historically tight levels. Yet, this doesn't mean investors should ignore the asset class. Spreads can remain tight for a prolonged period of time, as was the case between 2004 and 2006. The currently supportive macroeconomic environment, together with healthy balance sheets, suggests that spreads might remain tight or even tighter for longer.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	96	0.6	0.0
Euro IG	117	0.7	0.5
UK IG	121	0.8	-0.1

Source: Bloomberg, 30 June 2024

High yield credit

June was a positive month for high yield markets, with carry and tighter rates driving returns. The Global HY index delivered 0.8% (in USD terms) thanks to the rally in government bond yields that followed news of softer US inflation and first rate cut from the ECB.

However, French election uncertainty weighed on spread performance and euro HY markets lagged (0.6%) their US (0.9%) and EM (1.1%) counterparts. HY FRNs returned 0.5% during the month, outperforming HY CDS indices thanks to their lower beta/sensitivity to wider spreads.

By rating quality, CCC rated bonds outperformed in Europe but this was largely driven by a number of security-specific stories. The CCC index is filled with distressed names trading at low cash prices, so small price movements can make a big difference. In the US, however, we saw a stronger performance from the higher-rated bands.

Primary markets in both the US and Europe remain active. Most supply remains for refinancing purposes. Net issuance has been very light so far this year, and we expect that to remain the case given a lack of expected M&A/LBO activity.

Current views

- For the first time in a long while, the European macroeconomic environment looks more supportive than that in the US, with rate cuts on the table. US data has meant it has become more complicated to predict rate cuts by the Fed. We are currently overweight Europe. For us, stock selection remains the key to avoiding distress and capturing improving stories. With our strong analyst coverage, we believe we can find opportunities across a truly global opportunity set: Europe, UK, US and EM names.
- In our view, technicals remain very strong with issuance levels lagging the pace of inflows and reinvestment. We remain fully invested in the market, but also don’t want to be overweight risk as we believe HY spreads are not fully pricing many risks, such as geopolitical conflicts.
- HY spreads are rich versus history and versus higher-rated credit, with spreads outside of distressed tails tracking at post-Global Financial Crisis (GFC) tights. But in our view, current levels still compensate investors for an ‘average’ default cycle. Currently the European HY market is pricing in a five-year implied default rate of 24%, assuming a 40% recovery rate. By contrast, the actual five-year default rate in the index was on average ~13%, with the worst five-year default rate of 38%.
- BB and B spreads have compressed, limiting attractive relative value opportunities. The only part of the market that offers any kind of spread premium today is CCCs, but elevated spread levels here are mostly a function of some very distressed names trading wide. There may be some opportunities in CCC, but it is necessary to be very selective.

Our base case is for the status quo to persist: a gradual unwind of tight monetary policy along with improving growth – providing a decent backdrop for HY. From today’s entry point, we believe there is scope for the asset class to generate reasonable returns in 2024, possibly mid-to-high single digits, given the power of carry, expected low defaults, reasonably strong corporate balance sheets and lower rate volatility.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	318	0.9	2.6
Euro HY	358	0.6	3.3

Source: Bloomberg, 30 June 2024

Emerging market bonds

June was a mixed month for emerging market debt, although the year-to-date trend of hard currency (HC) outperforming local currency (LC) continued with EM FX coming under more pressure, particularly in the Latin America region. Spreads were broadly wider over the month although most of the widening was seen in the HY portion of the market.

The performance of the LC index unwound the strengthening seen in May, which remains the only month YTD that saw LC markets perform positively. Much of the YTD LC performance has stemmed from a very strong dollar, supported by markets pushing back expectations for the Fed to cut. This continued in June with the majority of EM currencies depreciating versus the dollar. On a spot basis, only a handful of currencies strengthened, most notably the South African rand following their election, which removed an element of uncertainty. On a total return basis there was, however, better performance considering the level of interest available.

IG outperformed HY in the hard currency sovereign and corporate markets.

Within the EM bond index, MTD returns between the two were 1.1% and 0.1%, respectively. However, YTD returns still strongly favour the HY portion, which is up 5.2% versus -0.5%. In the hard currency space, the NEXGEM was the worst performer delivering a flat return. However, YTD the NEXGEM is the strongest performer at 5.1%.

The corporate index was up over the month, with returns across all regions and sectors being positive. However, the gap between HY and IG was a bit tighter at 2.0% versus 1.0%, respectively. From a sector perspective, real estate was once again a strong performer, as well as technology, media & telecom (TMT) and pulp & paper. The spread return was broadly negative during the month, but was offset by a strong interest return.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	-1.1	-3.7
Hard currency government	400	0.6	2.3
Hard currency corporate	267	0.9	3.8

Source: Bloomberg, 30 June 2024

Currencies

The Japanese yen saw sharp declines, sparking speculation as to whether the authorities would intervene.

The euro fell over the month as investors weighed up French election uncertainty.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-0.8	-0.7
GBP/EUR	0.5	2.3
EUR/USD	-1.2	-3.0

Source: Bloomberg, 30 June 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