Fixed Income asset class overview

May 2024 (Data as at 30 of April 2024)

M&G Investments

April saw a succession of upside surprises in data releases, which at first, did not 'materially change the overall picture' according to Federal Reserve (Fed) Chair Jerome Powell, but over time became harder to dismiss. This saw expectations for mid-year rate reductions being pushed further into 2024, with investors now betting on two rate cuts at most by year-end.

Month in review

During the month, US data highlighted that core CPI (excluding food and energy) rose at a monthly pace of 0.4% in March for a third consecutive month. Meanwhile, core PCE rose at an annualised rate of 3.7% in the first quarter, ahead of the 2.0% increase in the fourth quarter of 2024.

As it became increasingly difficult to argue that the stronger inflation prints in January and February were a temporary blip, the US 10-year treasury yield rose to 4.68%, hitting 2024 highs. This saw US Treasuries trend down -2.3% for the month, versus gilts (-2.9%) and bunds (-1.8%).

April also saw growing geopolitical tensions in the Middle East, sending Brent crude oil prices to their highs for the year, above $92/bbl. However, tensions eased towards the end of the month, resulting in oil prices falling back, with Brent closing up 0.4% for the month at $87.86/bbl.

Despite the repricing of government bond yields, investment grade (IG) spreads continued to tighten in April, driven by a supportive macroeconomic backdrop and strong company balance sheets. In April, EUR IG (-0.8%) outperformed US IG (-2.3%) thanks to a more dovish European Central Bank (ECB) and hot US inflation data. The Global IG index offered a spread of 98 bps in April, marginally lower versus March. HY continues to provide historically elevated levels of yield, with the EUR IG index yielding 4.0%, while the GBP and USD IG indices both yielded 5.8%.

Global high yield (HY) markets returned -0.7% during the month, as a combination of renewed rates, geopolitical tensions and earnings-driven volatility pushed HY spreads wider – although they did manage to snap back, finishing the month roughly unchanged. Similar to IG, over the month European HY (0.0%) outperformed US (-1.0%) and emerging markets (EM) (-0.9%) thanks to better behaved rates and spreads. As refinancing activity continues to gather pace, primary issuance was strong in the month.

In EM, all portions of the market delivered negative returns over the course of April, weighed down by the strength of US data and geopolitical events. As a result of the US dollar strengthening, hard currency (HC) outperformed local currency (LC), as has been the case year-to-date; HC corporate bonds returned -0.9% and both HC and LC sovereign bonds returned -2.1%. However, despite the negative performance, spreads continued to tighten across most portions of the market, with IG corporates in particular looking tight on valuations.

Inflation

The two key sources of sticky US inflation are moving in the right direction

US inflation can be relatively ‘sticky’, especially compared to inflation rates in other countries. This is partly due to the fact that a majority of items in the US inflation basket are related to services rather than goods. Goods tend to be more volatile, while services are generally more stable. To provide some figures, service-related categories account for approximately 60% of the overall inflation basket in the US. On the other hand, EM countries, and even other developed markets like Europe and the UK, have a greater emphasis on goods in their inflation indices. Europe, for example, has 40% in services and 60% in goods.

Initially, when it became evident that inflation was trending lower, investors expected a smooth path towards the 2% target, overlooking the stickiness of US inflation. The higher-than-expected US inflation probably drove economists to expect stickier inflation outside the US as well. However, the prevalence of price rises for goods likely contributed to lower-than-expected inflation readings in those markets. As a result, currently only the US is experiencing higher-than-expected inflation, while most other countries are reporting inflation below expectations.

Even for US inflation, it is worth noting that the stickiest components appear to be moving in the right direction. The key components to consider are rents, which account for approximately 35% of the inflation basket, and core services excluding rents (referred to as ‘supercore’), which make up around 25% of the inflation basket.

Let's examine them closely:

1) Rents: They are highly sticky due to the calculation methodology employed by the Bureau of Labor Statistics (BLS) and the nature of the rental market. Historically, housing market trends have been a leading indicator for rent inflation, with house prices typically leading rent inflation by about 18 months. House prices have stabilized following a recent surge, suggesting that rent inflation is likely to continue moderating throughout 2024.

2) Core services excluding rents: This category includes items such as childcare, food away from home, and recreation activities. With labour as the primary input cost, wages play a crucial role in this category. It is the category most closely monitored by the Federal Reserve, as any wage-price spiral would likely manifest here. Wage growth is still historically elevated but it is normalizing in line with the labour market. Leading indicators for wages, such as quit rates suggest that the trend continues to decline. There is currently no evidence of a wage-price spiral occurring in this category, in our view.

While US inflation remains sticky, it appears that the stickiest categories, which represent a significant portion of the inflation basket, are trending in the right direction and are likely to continue doing so in the coming months. There may be some volatility in commodity prices, particularly if geopolitical risks increase, but such fluctuations are expected to be temporary and should not significantly impact the overall direction of inflation. Currently, inflation is not a concern, and it is premature to discuss its reacceleration.

Developed market sovereigns

Following a more positive month for the asset class in March, DM sovereigns were not immune to what was a trickier month across the board, as most asset classes lost ground in April. US exceptionalism – referring to the greater strength of the US economy versus peers, namely Europe and the UK – means that the market is now pricing more interest rate cuts in Europe and the UK and pricing two at most in the US by year end.

US data continued to come in strong in April, coupled with a third consecutive month of hot CPI, at +3.5% (versus 3.2% in February). This combination led to cuts being pushed further out yet again. Since the beginning of the year, we have moved from seven cuts being priced in by the market, to two at most by the end of the year. This was reiterated by Fed Chair Powell when he said that recent data indicated that it “is likely to take longer than expected to achieve confidence” about inflation. This was unsupportive for US Treasuries.

The eurozone is not experiencing the same sense of economic strength, although expectations of cuts were dialled back from 89 bps by the end of the year at the start of the month, to 66 bps by the end of the month. However, markets do expect that the ECB will cut interest rates before the Fed and are still expecting to see a cut at the June meeting, pricing it in at 87%. The decrease in total cuts by December was negative for European DM sovereigns.

In the UK, inflation continued to trend towards target, with the March numbers coming in at 3.2% for headline (from 3.4% for February) and core coming down from 4.5% in February to 4.2% in March. Yields moved higher in April as bond investors started to doubt that the Bank of England (BoE) can deliver a full rate-cutting cycle without the US cutting as well. The number of cuts priced in was reduced from three cuts by December to one and a half. The anticipated first cut was also pushed back to September. This led to gilts losing 2.9% over the month.

In Japan, the Bank of Japan (BOJ) kept interest rates around zero, but projected inflation to stay near its 2% target over the years to come. It stood by its previous guidance around the pace of its Japanese Government Bond (JGB) buying. Following the end of its negative interest rate policy (NIRP) last month, 2-year JGB yields hit another new high, finishing the month at 0.28%. The JGB index lost -1.20% over April.

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	4.7	-2.3	-3.3
Bunds	2.6	-1.8	-3.1
Gilts	4.3	-2.9	-4.6

Source: Bloomberg, 30 April 2024

Investment grade credit

Despite the repricing of government bond yields, IG bond spreads generally continued to tighten in April, driven by a supportive macroeconomic environment and strong balance sheets. Spreads on the Global IG index moved back below 100, but the total return was negative due to the duration component. In terms of total return, EUR IG generally outperformed (-0.8%) as the sell-off in rates was less pronounced, thanks to a more dovish ECB. Conversely, USD IG indices underperformed (-2.3%) as higher-than-expected inflation led to a significant repricing of US Treasuries. GBP IG also posted negative returns of -2.0%. The Global Investment Grade index currently offers a spread of 98 bps, which is marginally lower 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 4.0%, while the GBP and USD IG indices both yield of 5.8%.

Going forward

The macroeconomic environment remains supportive for the asset class. 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 Covid period. 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 companies' balance sheets remain healthy. Credit metrics are generally normalising, but they remain historically decent. Moreover, cash balances and profit margins remain historically high.

The general strength of IG companies' balance sheets is also reflected in the improved credit quality the asset class has experienced over the last few years. There have been more upgrades than downgrades, and single A bonds are now close to becoming the largest component of the investment-grade indices for the first time in about 10 years.

However, most of the good news is priced into the market, as spreads, the extra compensation investors receive to own corporate debt, are trading near historically tight levels. Yet, this doesn't mean investors should ignore the asset class, in our view. 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 well remain tight or even tighter for longer.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	91	-2.3	-2.4
Euro IG	112	-0.8	-0.4
UK IG	120	-2.0	-1.9

Source: Bloomberg, 30 April 2024

High yield credit

The Global HY market returned -0.7% during the month. A combination of renewed rates, geopolitical tensions and earnings-driven volatility pushed HY spreads wider although they managed to snap back and finish the month roughly unchanged (US HY 318 bps and EU HY 358 bps).

HY synthetic markets (CDS) also saw some weakness, with CDX HY down by 1%. European HY outperformed US HY and EM HY thanks to better behaved rates and spreads.

Most rating qualities performed in line with the index, however the CCC cohort continued to underperform, exposed to greater volatility and deteriorating fundamentals.

Defaults appear to be slowing in both US and Europe. For US HY, the 12-month troubled debt restructuring (TDR) currently sits at 4% (steady since October), while in Europe HY defaults fell to 3.65%. CCCs remain the key source of defaults across both regions. Non-cyclical sectors (telcos, pharma, real estate) continue to have the largest share of distressed debt.

Primary was very busy as refinancing activity continues to gather pace. We saw deals from Iliad (leading telecom provider in Europe), Volvo Cars (green bond), 888 (online betting), Boels (equipment rental), Transocean (energy), Comstock Resources (energy), Dufry (airport retail) or Rakuten (retail). We would expect issuance pace to moderate going forward.

Current views

- HY spreads remain unexciting, but all-in yields are still attractive with scope for absolute returns and carry. With moderate rate cuts, contained spreads and a mild default environment, the asset class could still deliver high single digit returns over 12 months, in our opinion.
- HY markets continue to see inflows and issuance is light versus previous years. As such, to us the market technical remains positive and should help contain/support spreads, even at current tight levels.
- We believe fundamentals are still resilient, with refinancing activity gathering pace and interest coverage ratios continuing to moderate from previously elevated levels. Potential future rate cuts will also help many sectors and issuers, such as real estate.
- Active management is more important than ever as security and country-specific risks are rising, such as the Altice France (SFR Group) episode, whose owner is trying to engineer a restructure (including bond haircuts) threatening bondholders with taking proceeds from asset disposal outside of the group.

Past performance is not a guide to future performance.

High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	318	-1.0	0.5
Euro HY	358	0.0	1.7

Source: Bloomberg, 30 April 2024

Emerging market bonds

All portions of the market delivered negative returns over the course of April, with markets being weighed down by stronger-than-expected US data and geopolitical events shadowing over portions of the market. In the hard currency space corporate bonds outperformed sovereigns owing to the lower duration profile. Rates drove portions of the negative performance over the month, but spread widening also detracted and was felt by most areas of the market. The only portion of the market that saw spreads tightening was within corporate bonds although that now leaves IG corporates, in particular, looking very tight on valuations.

HC bonds continued to outperform LC in the year to end-April. We are also seeing HY continuing to outperform IG across the asset class, which has been the case in both up, and down, months this year highlighting the greater role of rates, versus spreads, driving performance in the asset class. MTD, the HY portion of the HC index returned -0.9% versus -2.5% for investment grade. YTD, this creates an even more pronounced difference with HY and IG returning 4.0% and -3.3%, respectively. Despite the broader underperformance, and reflecting the HY outperformance, the much higher yielding countries such as Venezuela, Argentina, Ecuador, and Pakistan, continued to rally over the month. Notwithstanding this, the NEXGEM index returned -1.9% over the month but still leads YTD performance at 3.2%.

The LC sovereign market continues to underperform its HC counterparts, albeit only the corporate portion is positive YTD. The US dollar is continuing in its strengthening against almost all currencies in emerging, and developed, countries which has been a notable headwind for the asset class in 2024. For this course to reverse, we would need to see signs of softer numbers in the US and clearer signals from the Fed that it is to start its cutting cycle.

There wasn't much in the way of sectoral winners within the corporate market as most sectors performed negatively over the month. Similar to the sovereign market, HY outperformed IG (-0.3% and -1.1%, respectively). Again, this highlights a dynamic of spreads broadly tightening but duration weighing on performance given the move in US rates.

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	-2.1	-4.2
Hard currency government	382	-2.1	-0.1
Hard currency corporate	264	-0.9	1.4

Source: Bloomberg, 30 April 2024

Currencies

The US dollar continued to strengthen as markets pushed out expectations for interest rate cuts.

Meanwhile, the Japanese yen weakened further against the dollar.

Past performance is not a guide to future performance.

Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-1.0	-1.9
GBP/EUR	0.1	1.5
EUR/USD	-1.1	-3.4

Source: Bloomberg, 30 April 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.