Fixed Income asset class overview

August 2024 (Data as at 31 of July 2024)

Towards the end of July, three of the world's largest central banks – the Bank of Japan, US Federal Reserve (Fed), and the Bank of England (BoE) – all announced their eagerly-awaited interest rate decisions. In Japan, officials lifted rates to 0.25%, whereas in the US, Chair Powell signalled that a cut was possible as soon as September, but only if current cooling trends continue. In the UK, the BoE started its easing cycle with a 'hawkish' quarter of a percentage point cut.

Month in review

The US consumer price index (CPI) report showed headline inflation declined by 0.1% month-on-month (MoM) in June (versus the +0.1% expected), putting the 12-month rate at 3.0%, its lowest level in more than three years; as a result, rate cut expectations were turbocharged. Investors dialled up the amount of rate cuts priced in by December by 28.4 basis points (bps) to 72.5 bps. This saw sovereign bonds rally, with both US Treasuries (+2.3%) and Euro Sovereigns (+2.4%) having their strongest month in 2024 so far, according to data from Deutsche Bank.

Global investment grade (IG) spreads tightened marginally in July, led by a recovery in the euro and sterling markets. Performance was positive on the whole, with spreads tighter and interest rates moving lower. This saw the Global IG market returning 2.1%, with US IG returning 2.4%, while both euro IG and sterling IG returned 1.7%.

In high yield (HY) markets, it was a positive month driven by the rates rally. The Global HY index delivered 1.8% in dollar terms, and in Europe, weak PMIs led investors to grow more confident that the ECB would cut rates in September. US HY outperformed (2.0%) euro HY (1.3%) and emerging market (EM) HY (1.7%) counterparts. Finally, despite their lack of duration, HY floating rate notes (FRNs) also fared well and delivered 0.5% in July.

July was a strong month for EM debt, with all portions of the universe from a regional and sectoral perspective performing positively. While spreads marginally widened, rates drove performance. Local currency EMD sovereigns (unhedged in USD) returned 2.3% (1.5% YTD), whereas hard currency sovereigns and corporates returned 1.9% and 1.5% respectively (4.3%, 5.4% YTD).

Inflation

US inflation came in much better than expected, leading market participants to price in a rate cut in September. US inflation declined 0.1% in June, putting the 12-month rate at 3.0%, which is around its lowest level in more than three years. Even when excluding the most volatile items (energy and food), the core CPI increased by a mere 0.1%, bringing the year-on-year number to 3.3%. This encouraging inflation report was once again supported by the ongoing deflation in the core goods category. The strong dollar, coupled with economic weakness in China, is pushing down goods prices, reaching their lowest year-on-year level since 2004. However, it is important to note that this level of deflation is unlikely to persist for much longer. These are volatile items, and if the situation in China stabilises and/or the dollar weakens, we could quickly see a reversal in this deflationary trend.

Moving away from core goods, the most significant development arguably came from the largest component in the inflation basket: rents. We have repeatedly argued on this channel that rent inflation is decelerating and will continue to do so. June's numbers were very encouraging for our view and better than many expected, contributing to the positive surprise.

To make things even better, the All Tenants Rent Rate index, a relatively new measure introduced by the Bureau of Labor Statistics (BLS) to provide more insights into the rental market, is showing signs of a further sustained deceleration in rents. The index, which typically leads the official numbers by roughly one quarter, dropped from 5.5% to less than 4%. While this index is subject to revisions, it does indicate that rent inflation is likely to decelerate further in Q3, in our view, helping to bring overall inflation closer to the target.

In summary, inflation is still moving in the right direction, fuelling speculations of rate cuts by the Fed. Looking ahead, we can expect goods inflation to provide some upward surprises. However, overall inflation will likely continue to trend in the right direction, in our view, supported by a continuous deceleration in rents.

Developed market sovereigns

In July, developed market (DM) sovereign bonds rallied as expectations regarding the Fed cutting rates in September increased. This was supported by the June US CPI report coming out weaker than expected at 3%. On the back of the weaker inflation data, investors increased their expectations of Fed rate cuts, with the total number of cuts expected by year-end rising by 12.6 bps to 63 bps. Although, the latest number is a bit lower.

July saw the US report stronger-than-expected economic growth in the second quarter (2.8% QoQ) relative to consensus (2.0%). This revealed a rapid build-up in inventories that offset a drag from trade, leaving a picture of robust underlying growth in the US economy intact. There was also an upside surprise in the JOLTS jobs opening print (8184k versus 8000k consensus).

In the eurozone, the ECB decided to keep rates unchanged. ECB President Christine Lagarde reinforced the ECB's data-driven policy and highlighted how, despite the bumpiness, inflation is heading in the right direction. The next cut is priced for September and markets expect a further cut in December. Inflation is a priority for the ECB, and July's eurozone inflation is expected to show stickiness as progress in services remains slow.

In the UK, Labour secured a landslide victory in the UK election. GDP data for May reported growth of 0.4% MoM, well above consensus expectations (0.2%) and up from a stagnant growth reading in April.

In Japan, the BoJ enacted one of its most hawkish moves as the central bank decided to hike rates by 15 bps and to reduce its pace of Japanese Government Bond purchase to 3.0 trillion yen (from 6.0 trillion yen currently) by early 2026.

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	4.0	2.3	1.4
Bunds	2.3	1.6	-0.5
Gilts	4.0	1.8	-0.9

Source: Bloomberg, 31 July 2024

Investment grade credit

July was a story of two halves for credit spreads, with a rally at the beginning of the month partially reversing the widening in June. From then on, however, sentiment was more two-way, with spreads on the whole creeping a little wider. Overall, global IG spreads tightened, led by a recovery in the euro and sterling markets. The US dollar investment grade market was virtually flat. From a sector perspective, there was little to note in the US or global indices, with most sectors moving a few bps tighter apart from energy, which traded softer, partially explained by weaker commodity prices. However when looking at specific geographies, sector dispersion was more evident. For example, whilst most sectors in the sterling market meaningfully tightened, utilities drifted wider on the back of the downgrade to Thames Water and general weakness in other names in the sector. The energy sector was also wider. In Europe, spreads tightened across the board but it was a standout month for real estate names, with the sector tightening from 171 bps to 151 bps over the month. Performance was positive overall with spreads tighter and interest rates moving lower. The global IG market returned 2.1%, with the US market returning 2.4%, and both the euro and sterling markets returning 1.7%. The global index closed with a spread of 101 bps, with the US, euro and UK markets at 97 bps, 110 bps and 115 bps respectively. Despite credit spreads tightening and the move lower in interest rates resulting in positive performance from credit markets this month, to us the yield on offer still looks compelling. The global IG index closed the month with a yield of 4.7%.

Going forward:

From a macroeconomic perspective, we believe the current backdrop is supportive for IG credit. Inflation has continued to trend towards central bank targets, and a period of monetary policy easing (where central banks reduce interest rates) is forthcoming. Indeed, the Fed elected to hold interest rates at current levels towards the end of July, but signalled the first cut was on the horizon. The ECB cut rates in early June, and the BoE followed suit on 1 August. Market pricing suggests a further two to three cuts for each of the main central banks throughout the rest of 2024.

At current levels, all-in yields are attractive from a historical perspective. Whilst it can be argued that credit spreads, i.e. the compensation investors receive to own corporate bonds rather that government bonds, are tight (low compensation), we argued last month there are reasons for this. Company balance sheets are in healthy positions, with strong cash balances, and profit margins remain high. The current macroeconomic backdrop and where we are in the monetary cycle, combined with the relative health of IG issuing companies, and the all-in yield on offer, in our view results in a compelling entry point for the asset class.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	97	2.4	2.4
Euro IG	110	1.7	2.3
UK IG	115	1.7	1.6

Source: Bloomberg, 31 July 2024

High yield credit

July was a positive month for HY markets, driven in large part by the rally in government bonds. The global HY index delivered 1.8% (in US dollar terms) after a positive US CPI report and growing expectations for Fed cuts this year. Over in Europe, the weak PMIs also led investors to grow more confident that the ECB would cut rates in September. US HY outperformed (+2.0%) euro HY (+1.3%) and EM HY (+1.7%).

Despite their lack of duration, HY FRNs fared well and managed to deliver 0.5% during the month. Returns were driven by carry and the general recovery of European credit markets since mid-June's French/European election-driven sell-off.

By rating quality, US HY CCC rated bonds outperformed in the risk rally. In Europe, preference for higher quality prevailed, with a number of ongoing issuer-specific stories and the recent softening of economic data.

Primary markets in both the US and Europe remain active albeit slowing into the summer months. 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 anticipated M&A/LBO activity.

Current views

Our base case is for the status quo to persist; a gradual unwinding of tight monetary policy along with improving growth provide what we see as a decent backdrop for HY. We believe that from the current entry point, 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.

Stock selection remains the key to avoiding distress and to capturing improving stories. With our strong analyst coverage, we can find opportunities across a truly global opportunity set: Europe, UK, US and EM names.

Technicals remain very strong, in our view, with issuance levels lagging the pace of inflow 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.

There is no doubt that HY spreads are rich versus history and versus higher rated credit, with spreads outside of distressed tails tracking at post-Global Financial Crisis (GFC) tight levels. 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%.

Market distress for US/euro HY has been drifting higher since March, rising to 7.3% for the US as of July. It is worth noting distressed companies remain concentrated in the media and healthcare sectors, representing over 50% of distressed debt. Current distress levels remain in line with those witnessed in 2019 and consistent with a default rate environment of around 3% over the next 12 months

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	325	2.0	4.6
Euro HY	365	1.3	4.6

Source: Bloomberg, 31 July 2024

Emerging market bonds

July was a stronger month for EM debt, with all portions of the universe, from a regional and sectoral perspective, performing positively. Whilst spreads marginally widened, sovereign bonds drove performance.

It was a positive month for hard currency sovereigns, which outperformed hard currency corporates, reversing a trend we've broadly observed throughout the year. There was little to separate returns between the IG and HY portions of the market, which returned 1.4% and 1.8%, respectively. YTD, however, high yield continues to outperform (3.4% versus -1.8% for investment grade).

The local currency market continues to jump in and out of positive performance on a monthly basis, with July reflecting a more positive period. Despite the strong returns during the month, YTD performance still lags the rest of the market, with hard currency bonds outperforming their local currency counterparts. EM FX continues to be weighed down by a very strong dollar, although there was a slight reversal in July, with a number of EM currencies (mainly Asia) strengthening versus the USD on a spot basis.

In a similar vein to June, the corporate index was up, with returns across all regions and sectors being positive. The returns of the HY and IG portions of the market were 1.4% and 1.3%, respectively. From a sector perspective, real estate was once again the strongest alongside technology, media and telecommunications, which continues its strong performance from June.

Whilst EMD fundamentals remain strong, sentiment is hampered by the Fed, who very recently signalled that cuts are coming, but are yet to begin, and more importantly by the US presidential election due to take place in November.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	2.3	-1.5
Hard currency government	408	1.9	4.3
Hard currency corporate	279	1.5	5.4

Source: Bloomberg, 31 July 2024

Currencies

The Japanese yen strengthened significantly against the dollar and was the strongest-performing major currency in July as the BoJ raised interest rates.
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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	1.7	1.0
GBP/EUR	0.6	2.9
EUR/USD	1.1	-1.9

Source: Bloomberg, 31 July 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.

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