Fixed Income asset class overview

March 2024 (Data as at 29 February 2024)

As highlighted in a recent Bloomberg article, there's a saying about the Federal Reserve's (Fed) approach to interest rates: they go up in an escalator and down in a lift. This time it looks to be the exact opposite; rates shot up at the fastest pace in four decades over 2022-23, but we have seen Fed officials signal a slower and less predictable pace of rate cuts – despite easing price pressures and the continued strength of the economy.

Month in review

Economic growth data remained strong in February, with revised Q4 US GDP showing an annual expansion rate of 3.2%, as at 28 February 2024. Meanwhile, the Fed's preferred inflation gauge, the core PCE Index (personal consumption expenditures), which excludes food and energy costs, came in line with expectations at +0.4% month-over-month in January. The year-over-year core inflation rate declined to 2.8%, a sharp decrease from 4.9% a year ago, demonstrating progress towards the Fed's 2% inflation target and indicating potential room for interest rate cuts. These are now anticipated by the markets to take place in the summer.

As investors pushed out the timing of future rate cuts, sovereign bonds sold off. However, equity markets reached record highs, with the S&P 500 Index going above the 5000 mark for the first time, and Japan's Nikkei 225 Index surpassing its prior record from 1989.

In another addition to the record books, February was the busiest month for US bond issuance. US companies issued $172 billion of debt as falling yields spurred investors to buy bonds, pushing companies to take advantage of relatively cheaper borrowing costs. For investment grade (IG) bonds, most deals were noted to be oversubscribed, suggesting strong demand for the asset class at present. The asset class continues to offer a historically elevated level of yield, with the EUR IG index at 3.9%, GBP IG at 5.6%, and US at 5.5%.

The Global High Yield (HY) Index saw a 0.5% return in February, primarily driven by carry offsetting the negative duration move caused by rising government bond yields. Spreads tightened around 40 basis points (bps), except for emerging market (EM) HY that saw greater compression, with US HY underperforming (+0.3%) versus European HY (+0.4%) and EM HY (+1.4%). HY floating-rate notes (FRNs) continued to benefit from the lower duration, but spreads did not fall as much as they did in January, with monthly returns for the index at 0.3%.

In EM, high yield spreads have found themselves at pre-Covid levels, with only those on bonds rated CCC wider due to the increase in distressed countries. Hard currency bonds were the strongest performing, with those in the sovereign space (+1.0%) outperforming corporates (+0.7%). The frontier-centric NEXGEM Index returned 1.5%, making it the strongest performing segment of the EM universe. These returns signal a recovery to positive territory following January's slight retreat, although year-to-date returns remain broadly flat.

Inflation

US inflation came in higher than expected mid-month, resulting in a decline in both equity and bond prices. The headline Consumer Price Index (CPI) for January showed a year-on-year increase of 3.1%, surpassing the anticipated 2.9%. Additionally, Core CPI, which excludes energy and food prices, also exceeded expectations at 3.9% compared to consensus forecasts of 3.7%. Once again, US inflation proved to be stickier than expected, primarily driven by the services sector. As we have mentioned numerous times, it will take time for this category to return to the target level. This is due to the fact that wages, which are key input costs for services, are still relatively strong. Furthermore, rents, a significant component of the services CPI basket, are traditionally extremely slow to move.

However, while we have been saying for some time that inflation will encounter some resistance, we do not believe inflation is reaccelerating; inflationary pressures are still easing, just not as quickly as people were hoping for.

Here are some useful things to keep in mind:

- **US inflation is still moving in the right direction:** While it came in higher than expected, inflation is still going in the right direction.
- **Money supply versus inflation:** The significant injection of liquidity into the system was the catalyst for the post-Covid rise in inflation. Now the reverse in happening: central banks are withdrawing money from the system, leading to a reduction in inflationary pressures. If central banks persist in draining liquidity from the system,

the potential risk will not be higher inflation, but rather deflation.

- **Inflation ex-rents remains below target:** We know rent inflation is very slow moving, partially due to the way it is calculated. However, if we remove rents, inflation is already back below the 2% target and it has been there for a few months.
- **Rent inflation is on a downward trajectory:** Rent is a category that tends to change slowly, yet it holds substantial weight within the CPI basket. Therefore, when rents move, they can exert a notable and enduring influence on overall inflation. Rents typically lag house prices by about 18 months. As a result, we can expect that throughout most of 2024 rent inflation will likely continue to decrease, exerting downward pressure on overall CPI.

The bottom line: while inflation came in hotter than expected and will likely remain "sticky" for some time, it is important to put things into context: inflation is softening slowly, but it is not reaccelerating.

Developed market sovereigns

February saw some hot inflation data which led to markets pushing expectations of rate cuts out for a second successive month. Market expectations of Fed cuts to the end of the year fell by 61 bps over the course of the month from 146 bps to 85 bps. In turn, this caused sovereign bond yields to rise, further eating into the gains from the November/December rally. Developed market (DM) sovereigns appear to be the asset class that is the exception to the 'everything rally' we have seen at the start of the year.

Over the month in the US, there was yet more resilient economic data, with labour and manufacturing continuing to surprise in an elevated rate environment and supporting the narrative that the US economy is in good shape. However, the final stages of returning inflation to target remain challenging, with more upside surprises in February. Three-month annualised core CPI rose to +0.4%.

Consequently, the market feels that rates may need to remain at current levels a little longer and dialled back the number of cuts being priced in. Following the significant fall in expectations for rate cuts in 2024, US Treasuries (-1.4%) had their worst monthly performance since September.

In the eurozone the story was very similar. Country-level flash CPI prints came in mostly as expected. The trend was slowing, but still above-target inflation with expectations of cuts to the end of the year being reduced from 160 bps to 91 bps. Euro sovereign bonds ended the month down 1.2%. The implied probability is now that there is little chance of movement from the European Central Bank (ECB) before summer, with most of the rate-cutting action expected to take place in the second half of the year.

The UK's GDP release showed it had entered a technical recession after a second successive quarter of negative growth. However, inflation continues to appear sticky, with headline CPI remaining at 4.0% for a second month. Inflation seems to be the priority over growth at the moment, and so rate-cut expectations were also pushed out in the UK. The Bank of England is expected to make their move at the August meeting based on the latest market data. Like their European and American peers, gilts had a poor month, down 1.2%.

In Japan, expectations grew that the Bank of Japan (BOJ) may bring its negative interest rate policy (NIRP) to an end as early as April, coinciding with the crucial Shunto wage negotiations. At the end of the month, the market was predicting a 58.3% chance of a hike from the BOJ at the April meeting. The market is just shy of pricing in a full hike at the June meeting. Yields on 2-year Japanese Government Bonds (JGBs) rose to 0.17%, their highest level since 2011, an increase of +9.7 bps over the month.

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	4.3	-1.4	-1.5
Bunds	2.4	-1.6	-2.3
Gilts	4.1	-1.2	-3.3

Source: Bloomberg, 29 February 2024

Investment grade credit

Despite a historically large supply of IG corporate bonds, investors have been able to easily absorb the increased supply, pushing spreads even lower. Most deals were oversubscribed, suggesting a strong demand for the asset class at present.

On the other hand, bond yields, or rates, continued to reprice higher as macroeconomic indicators surprised to the upside, prompting investors to reduce their bets on interest rate cuts.

Consequently, IG indices were generally lower in February as the positive contribution from spread compression was outweighed by the increase in rates. The USD IG index lost 1.4%, while the EUR and GBP indices lost 0.9% and 0.5% respectively.

The Global IG Index now offers a spread of 107 bps, marginally lower compared to the previous month. Higher beta names generally continued to outperform and are now looking relatively expensive, in our view. The asset class continues to provide a historically elevated level of yield. Currently, the EUR IG index offers a yield of 3.9%, the GBP IG index has a yield of 5.6%, while the US market yield stands at 5.5%.

Going forward

Duration is likely to be the primary factor driving future returns for IG bonds. Currently, approximately 75% of the total yield is attributed to rates, while only about 25% comes from the spread component. Historically, spreads accounted for around 40% of the total IG yield.

An environment characterised by slowing growth and contained or falling inflation is expected to support duration and, consequently, IG corporates. Even in a recessionary environment, the asset class may not be significantly impacted as the likely increase in spreads could be (at least partially) offset by a decline in rates. Conversely, a resurgence in inflation could hinder central banks from reducing rates and may lead market participants to increase the likelihood of a rate hike. This would result in both rates and spreads rising, leading to negative returns for the asset class.

Currently, it appears that the economy is gradually reaccelerating, while inflation remains “sticky”. However, there are no clear indications of a substantial inflationary surge, and as long as the money supply remains constrained, a significant increase in inflation is unlikely. Moreover, we believe the risk-reward profile remains attractive for this asset class. The downside risk (higher rates) seems limited as central banks have already tightened significantly and are not in a position to raise rates much further. On the other hand, if inflation and growth unexpectedly disappoint, IG bonds could generate attractive returns.

Lastly, it is worth noting that companies within this asset class typically have limited default risk and are currently in a relatively strong financial position. Although some credit metrics have recently deteriorated, the pace of credit deterioration has been gradual and primarily stems from already strong levels.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	100	-1.4	-1.2
Euro IG	121	-0.9	-0.8
UK IG	125	-0.5	-1.6

Source: Bloomberg, 29 February 2024

High yield credit

The Global HY Index returned 0.5% in February, driven primarily by carry offsetting the negative duration move caused by rising government bond yields. US HY (+0.3%) underperformed European HY (+0.4%) and EM HY (+1.4%).

HY FRNs again benefited from lower duration, but spreads did not fall as much as they did in January. Monthly returns for the index stood at 0.3%.

Spreads tightened around 40 bps across HY markets, except for EM HY, which saw greater compression, and remain close to cyclical tight levels at 329 bps (US), 354 bps (Europe), and 453 bps (HY FRN). HY FRN relative spread premia versus fixed HY are currently circa 100 bps, having shrunk in the last couple of months due to a strong market technical factor.

By rating, we saw continued outperformance by lower-quality paper last month, with bonds rated CCC returning +2.2% versus +0.6% for Bs and +0.0% for BBs. Cyclical sectors did well again in February with US auto, steel and super retail among the strongest performers.

Current views

- Overall market valuations look less attractive, but we believe there are pockets of value remaining. More than ever, the focus is on credit analysis and stock selection.
- An active and open new issue market suggests a strong technical element has returned. This is supportive for the asset class and may help to contain spreads, in our view.
- We believe fundamentals are largely healthy, as many lower quality credits managed to refinance either via private credit or in the loan market. Potential future rate cuts could also help many sectors and issuers, such as real estate.
- Geopolitical risk, central bank policy and inflation remain the largest uncertainties for the HY market going forward.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	329	0.3	0.3
Euro HY	354	0.4	1.3

Source: Bloomberg, 29 February 2024

Emerging market bonds

High yield spreads (down to Bs) find themselves at pre-Covid levels. It is only CCCs that are wider than they were before the pandemic. This is a result of the increase in distressed countries. Rates outperformed FX in most markets. Local bonds underperformed on the back of increases in US yields and the pushing out of expected rate cuts later into the year.

Similar to January, EM hard currency bonds were the strongest performing, with those in the sovereign space outperforming corporates. EM local currency government bonds were down 0.6%. The frontier-centric NEXGEM Index returned 1.5%, making it the strongest performing segment of the EM universe.

The returns noted above signal a return to positive territory following January's slight retreat. Within local currency, FX underperformed rates, with currencies broadly weakening during a month of slight US dollar strengthening. FX markets were quite directionless from a regional point of view, with Asian currencies making up some of the best, and worst, performers.

In the hard currency space, the high yield segment outperformed investment grade for a second consecutive month, reflecting the overall narrative that spreads are behaving while core rates continue to be volatile. Although the Middle East was flat, it was the worst performing region for the second month in a row, reflecting the overall sentiment following geopolitical escalation. Africa was by far the best performing hard currency market, returning 4.4%.

The EM corporate bond market returned +0.7%, driven by significant spread tightening in HY credits (1.6%) while IG underperformed (0.1%). The EM sovereign dollar index (1%) outperformed corporates as HY spreads generated even stronger returns while IG posted negative returns on rates. EM local currency government debt returned -0.6% in USD.

The outperforming sectors in February were real estate, transport and metals & mining. Underperformers were industrials and pulp & paper. By region, Emerging Europe was very strong on the robust sentiment around the Czech Republic and Georgia, strong returns from Ukrainian corporates and continuing macroeconomic improvements in Turkey. Latin America also performed well in February, boosted by strong showings from Brazil, Colombia and various smaller Central America and Caribbean (CAC) economies (notably Trinidad & Tobago, Costa Rica and Guatemala). Asia and the Middle East stood out as the underperforming regions of the month due to their IG status.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	-0.6	-2.1
Hard currency government	377	1.0	-0.1
Hard currency corporate	283	0.7	1.3

Source: Bloomberg, 29 February 2024

Currencies

The US dollar rose further in February as investors adjusted their expectations for interest rate cuts.

Meanwhile, the Japanese yen weakened further against the dollar.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-0.5	-0.8
GBP/EUR	-0.4	1.3
EUR/USD	-0.1	-2.1

Source: Bloomberg, 29 February 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.