M&G Investments

Fixed Income asset class overview

December 2024

While 2024 saw central banks finally beginning to ease policy, with both the Federal Reserve (Fed) and the European Central Bank (ECB) cutting rates by 100 bps, cuts took longer than expected. This saw sovereign bonds struggle to gain traction, with the 10-year treasury yield moving up for a fourth consecutive year for the first time since the 1980s.

Month in review

In December, the US Federal Reserve signalled only half of a percentage point of interest rate cuts in 2025, more hawkish than expected. As a result, the 10-year Treasury yield ended the year at 4.57%, its highest monthly close since April.

In corporate debt, global investment grade (IG) spreads were flat over the month. European and UK corporate debt credit spreads tightened, outperforming US spreads. However, with sovereign yields on the rise, total returns were negative across the board. Global IG was down 1.3% over the month, with the dollar market down 1.8%, euro down 0.4%, and sterling down 0.6%.

Global high yield (HY) markets returned -0.2% during the month, with European HY outperforming US HY in December, returning +0.7% versus -0.4%, mostly due to rates and better behaved spreads. HY floating rate notes (FRNs) were immune to renewed rate volatility, returning 0.8% during the month thanks to carry and marginally tighter spreads. December also saw spreads widening in the US (ending at 292 bps), but tightening in Europe (ending at 316 bps) and the HY FRN market (ending at 386 bps).

In emerging markets (EM) the hard currency sovereign market underperformed its hard currency corporate counterpart, with both IG and HY segments recording negative returns. With generally robust spreads throughout the month and significant tightening over the year, the HY segment markedly outperformed IG over the year, with the performance gap between the two being the widest since 2015. For 2024, the HY segment of the market delivered a return of 13%, while IG posted a relatively flat return of 0.3%. Finally, the local currency market continued to underperform, affected by the strengthening US dollar.

Inflation

US inflation once again came in exactly in line with expectations. Either economists are suddenly becoming really good at forecasting, or inflation is becoming very predictable and boring. If the latter, we do not expect this predictability to persist for long, as 2025 is likely to reintroduce some volatility, both upwards and downwards.

November's headline consumer price index (CPI) increased by 2.7% year-over-year, while core inflation remained steady at 3.3%. Although still above target, inflation is gradually trending in the right direction, with limited inflationary pressures on the horizon.

The best way to analyse this report is to examine its three major components:

Core goods: previously, we noted that core goods inflation was unusually low, even by historical standards, and a normalisation was needed. This normalisation is now occurring, with core goods inflation rebounding from extremely low (negative) levels. While some further normalisation may be ahead, significant inflationary pressure from this category is unlikely, in our view, due to the ongoing struggles of the Chinese economy and the strength of the US dollar.

Rents: this is the largest and 'stickiest' category in the inflation basket. We have long held the view that rents were slowly (very slowly!) going to normalise, reflecting the actual dynamics of the rental market. This trend is currently unfolding, and we believe the disinflation trend in rents is likely to continue over the coming months.

Core services excluding rents: often referred to as 'super-core', this category is closely monitored by the Fed, as it is largely driven by wages. If a wage-price spiral were to occur, it would manifest here. The latest report indicates that while inflation in this category remains elevated, it is trending in the right direction, providing some reassurance to Fed officials.

In summary, core goods inflation is normalising upwards, while rents continue to normalise downwards. The 'super-core' category, which is the most closely watched by the Fed, is gradually moving in the right direction. Overall, this report continues to suggest a gradual, yet very slow, decline in inflationary pressures.

Developed market sovereigns

In December, markets experienced another downturn, marked by a broad-based selloff across various asset classes following the Fed's shift to a more hawkish stance.

In December in the US, the Fed reduced rates again, bringing the total cuts for 2024 to 100 basis points (bps). It only indicated a further 50 basis points of cuts for 2025, which was more aggressive than anticipated. This led to Treasury yields rising in response.

While the CPI indicated a continued rise in inflation, the unemployment rate remained relatively stable (4.2% versus 4.1% prior), while non-farm payrolls and JOLTS data showed better trends in December. This suggests a resilient labour market without significant changes in joblessness.

The European Central Bank (ECB) also cut rates in December, but investors were disappointed by the absence of a more dovish approach. Consequently, sovereign bonds sold off, and the 10-year bund yield increased slightly.

In France, the government led by Michel Barnier fell after the first successful no-confidence vote since 1962. This development added further pressure on French assets, and the Franco-German 10-year spread reached its widest levels since the euro crisis in 2012.

Eurozone CPI increased to 2.2% from 2.0%, while the unemployment rate remained unchanged at 6.3% (historical lows). The eurozone economy grew by 0.9% YoY in Q3 2024, the same as in the previous quarter and as largely expected.

In the UK, the Bank of England (BoE) kept its interest rate unchanged at 4.75%, however Monetary Policy Committee (MPC) divisions increased, with three dissenters calling for an imminent rate cut. Still, for the majority of the MPC, a gradual approach to removing policy restraint was still the preferred route – particularly given the stickier price and wage data we saw earlier in December. This vote split marked a dovish pivot.

Inflationary pressures are still persistent in the UK with November’s headline CPI at 2.6% (from 2.3%) and core CPI at 3.5%.

The UK economy grew by 0.9% year-on-year in Q3 2024 and was flat quarter-on-quarter.

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	4.6	-1.7	0.5
Bunds	2.4	-1.6	0.5
Gilts	4.6	-2.2	-3.4

Source: Bloomberg, 31 December 2024

Investment grade credit

December proved to be a challenging month for fixed income assets, as sovereign yield curves climbed higher and steeper, particularly in the US after the Fed’s surprisingly hawkish turn.

Against this backdrop, global investment grade (IG) credit spreads were virtually flat in December. The US market was flat, Europe tightened by 5 bps, and the UK outperformed with a 11 bps tightening. However, with sovereign yields on the rise, total returns were negative across the board. Global IG was down 1.3% for the month, with the US dollar market down 1.8%, the euro down 0.4%, and sterling down 0.6%.

So, was 2024 the year of the bond? Not quite. IG indices delivered less than the yield they promised at the start of the year, despite credit spreads moving meaningfully tighter. The real culprit was the move in sovereign yields. Markets were expecting a significant easing cycle in 2024, but that didn't happen. For context, at the end of 2023, markets were pricing in 6.3 rate cuts by the Fed – only four materialised. In Europe, 6.5 cuts were expected, but again, only four occurred. In the UK, nearly seven cuts were anticipated, but only two were delivered by the BoE. The repricing of the yield curve, both higher and steeper over the year, resulted in positive but relatively modest returns for IG credit investors.

However, there's a silver lining: the current yield on offer presents a compelling entry point, in our view. As the year came to a close, the yields on US and sterling IG indices were 5.4% and 5.6%, respectively, with euro IG at 3.3%. With central banks setting a low bar for a significant number of rate cuts in 2025, if the labour market continues to weaken steadily, it may become clear to central banks as well as the market that far more easing is required than currently priced in. Could the easing cycle expected for 2024 actually happen in 2025? Might 2025 be the year of the bond?

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	82	-1.8	2.8
Euro IG	101	-0.4	4.7
UK IG	96	-0.6	1.9

Source: Bloomberg, 31 December 2024

High yield credit

Markets stumbled in December, with a cross-asset sell-off following the more hawkish than expected rethoric from the Fed.

Global HY markets returned -0.2% during the month. In a reversal of recent fortunes, EU HY outperformed US HY in December returning +0.7% versus -0.4%, mostly due to rates and better behaved spreads. HY FRNs were immune to renewed rate volatility returning +0.8 % during the month thanks to carry and marginally tighter spreads.

During the month spreads widened in the US (ending at 292 bps) but tightened for Europe (ending at 316 bps) and the HY FRN market (ending at 386 bps). Euro HY spreads remain wide of the US but still historically rich and tighter versus the start of the year. In the meantime, demand for HY credit remains exceptionally strong and is showing few signs of softening, given the combination of good yields and solid recent performance.

2024 Performance

On a year-to-date (YTD) basis, it was a strong year for HY overall with the Global HY Index returning an impressive 8.9%, similar to last year and higher than our initial expectations. Despite having lagged in recent months, European HY managed to outperform US HY by end of the year (8.9% versus 8.2%). We would expect returns to moderate in 2025, but still expect a decent year thanks to elevated carry and fundamental soundness in HY.

The most notable rating category outperformer in 2024 was US CCCs, which returned 18.2%, consistent with the risk-on tone that permeated throughout most of the year. All the US sectors posted positive YTD returns, led by Retail (+12.4%) and Healthcare (+11.2%). Even Cable (+8.5%) and Telcos (+7.9%) manged to post solid positive returns despite some significant volatility during the year. We remain marginally underweight credit and rate risk. We do not find valuations compelling, especially on a spread basis, although there remains reasonable appetite for risk in the market given yields. Cognisant of this demand dynamic, plus the strong technicals that helped propel spreads tighter in 2024 (which we expect will continue in 2025), we are keen to stay reasonably close to neutral in terms of risk appetite, with a bias to add risk as levels potentially improve.

Going forward

We believe opportunities in high yield market remain, even at current valuations. Here's why :

• **All-in yields are historically attractive:** while spreads are relatively low, yields on HY bonds are still higher than they've been in previous years. Historically, yield has been a better proxy for future return than spread has been. With today's yield to worst (YTW) of c. 7.0%, there is arguably potential for the asset class to generate reasonable returns in 2025.

• **Greater confidence in the economy:** recent economic performance has shown continued strength, with corporate profits and consumer spending remaining largely resilient in the face of high interest rates. This environment suggests a benign default cycle going forward, also evidenced by diminishing levels of market distress, in our opinion.

• **HY fundamentals look resilient despite macro uncertainty:** Improved growth expectations are likely to further support fundamental metrics. It's worth noting that the interest coverage ratio (which measures a company's ability to pay off its debt), while dropping as companies have refinanced at higher rates, remains well above levels at which analysts would typically become concerned about companies' ability to pay.

• **Strong market technicals remain supportive for HY spread:** While HY spreads may be rich, all-in yields are still historically attractive, creating an equilibrium between the balance of buyers of yield and sellers of spread. Importantly, the high yield market continues to shrink, as issuers seek capital elsewhere (private markets, loans market), which further reduces supply against an ongoing robust demand backdrop.

• **Strong case for active management:** Rich valuations and rising pockets of spread dispersion provide a strong case for active management in high yield. We believe an approach that focuses on fundamental credit research and thorough credit selection is essential to navigate high yield markets in 2025.

Past performance is not a guide to future performance.

High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	292	-0.4	8.2
Euro HY	316	0.7	8.9

Source: Bloomberg, 31 December 2024

Emerging market bonds

In the context of emerging markets (EM), December was relatively uneventful in terms of news flow, with all major segments of the asset class experiencing negative returns due to broad market selloffs. This was influenced by the Fed adopting a more hawkish stance.

The hard currency (HC) sovereign market underperformed its HC corporate counterpart, with both IG and HY segments recording negative returns. With generally robust spreads throughout the month and significant tightening over the year, the HY segment markedly outperformed IG, with the performance gap between the two being the widest since 2015. For 2024, the HY segment of the market delivered a return of 13.0%, while IG posted a relatively flat return of 0.3%.

The local currency market continues to underperform, affected by the strengthening US dollar.

Despite a positive growth narrative and improving inflation dynamics within many EMs, sentiment remains subdued following the US election, even as the Fed continues its rate-cutting cycle—a development typically viewed as a bullish turning point for EM debt. The uncertainty associated with Donald Trump's return to the global stage as US president is already evident, though not entirely surprising given the precedent set between 2017 and 2021. Although his inauguration is scheduled for January, Trump has already intensified tariff rhetoric on goods from Mexico, Canada, and China, only to retract the tariffs on Mexico following discussions with Mexico’s president, Claudia Scheinbaum.

Considerable attention is being directed towards the potential impact of Trump’s tariffs on EMs. However, as observed during his first term, there will be both beneficiaries and adversely affected parties. The broader global trade landscape has evolved since the initial trade wars, and many EMs have taken measures to reduce their vulnerability to shifts in US trade policy. Additionally, 2024 witnessed a robust performance by the US dollar, a trend likely to persist into 2025 given the strength of the US economy and a more hawkish Fed. A strong dollar will invariably exert downward pressure on EM currencies, which may help mitigate the impact of higher prices resulting from tariffs. This effect can be significant; during the 2018 trade war, two-thirds of the tariffs imposed on Chinese imports were offset by a sharp depreciation in the renminbi during the same period.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	-1.9	-2.4
Hard currency government	325	-1.4	6.5
Hard currency corporate	241	-0.5	7.6

Source: Bloomberg, 31 December 2024

Currencies

2024 has been a robust year for the US dollar, which has strengthened by 7.1% YTD, as measured by the DXY index. And while November's USD narrative was largely driven by the US election result, with the Trump trade in full swing, in December, the dollar further strengthened due to the expectations of a more hawkish Fed in 2025. A strong US economy, combined with a more hawkish Fed, has ensured the dollar ends the year on a very strong note. While USD strengthening was fairly broad-based over the month, the Philippine peso, Israeli shekel, Peruvian sol, and Hong Kong dollar appreciated relative to the dollar.

Perhaps unsurprisingly, one of the worst performing major currencies in December was the South Korean won, which came under significant pressure following the controversial implementation of martial law by the now-impeached and no longer sitting South Korean president. It was also a very weak month for the Japanese yen, which fell 4.58%, bringing YTD depreciation relative to the dollar to 9.68% reflecting the disparity in expectations of monetary policy and weakening sentiment.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-1.7	-1.7
GBP/EUR	0.4	4.8
EUR/USD	-2.1	-6.2

Source: Bloomberg, 31 December 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.