Back From Summer

Key Themes for Global Bond Markets

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September 2021

As we move into the latter stages of 2021 fund manager Jim Leaviss, CIO of M&G Public Fixed Income, assesses the state of play in global bond markets and discusses some of the key themes that are likely to drive sentiment over the rest of the year and beyond.

The value and income from a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

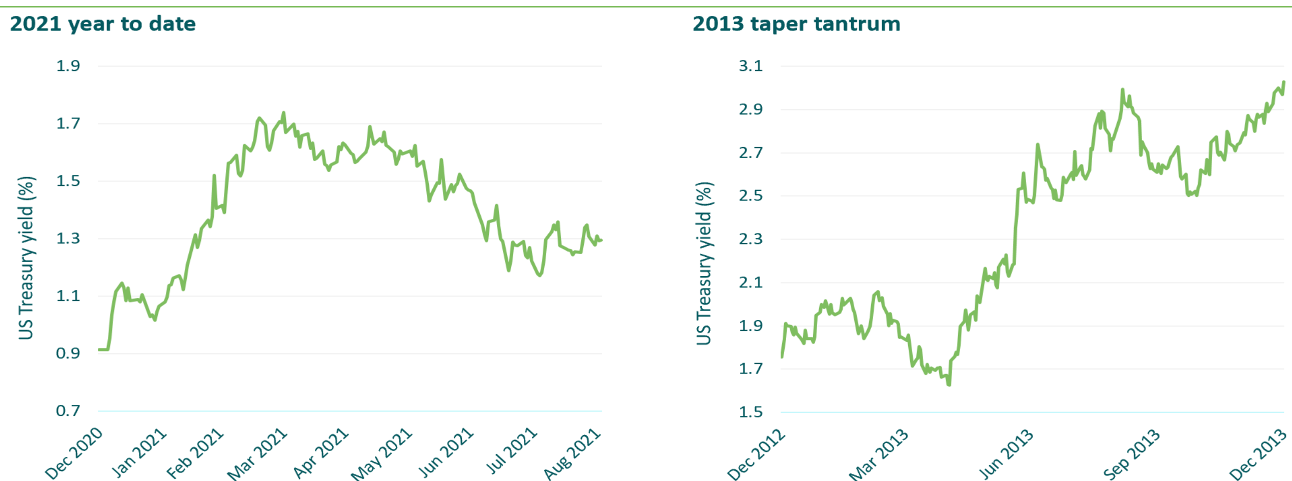
Talk of tapering takes centre stage

Tapering of central banks' asset purchases remains the dominant theme in global bond markets, with recent Fed talk indicating a slowing of bond buying by the end of the year. This is on the back of a resurgent US labour market, with the US having now recouped around half of the jobs lost seen during the COVID-19 pandemic. The US unemployment rate is now just above 5% - well below 2013's level of 6.9%, which led to that year's tapering announcement. Under normal circumstances, the US economy would be considered close to full employment.

A number of Fed officials have also expressed concern over the danger to financial stability posed by excessive risk-taking as investors pile into higher-yielding assets in search of better returns. It now appears likely that tapering will begin either in November or December this year, with the aim of ending purchases completely by the end of the 2022. In terms of the first rate hike, the Fed's 'dot plots' suggest this is likely to occur in 2023, although the futures market is being slightly more aggressive and pricing in the first hike to take place in the second half of 2022.

Despite the prospect of a tightening in monetary policy, moves in Treasury yields have been relatively muted this year. There has certainly been no repeat of the 'taper tantrum' of 2013, when 10-year Treasury yields spiked by around 120 bps, peaking at 3% by the end of the year. As it stands, 10-year yields are currently around 1.3%, having drifted some way below a peak of 1.75% earlier in the year.

Figure 1. Moves in Treasury yields have been relatively muted this year



Past performance is not a guide to future performance.

Source: Bloomberg, 31 August 2021

There are a number of reasons why yields have failed to move higher this time around, although the main factor is likely to be the rapid spread of the COVID-19 delta variant in the US and parts of Asia. This appears to be already having an impact on recent economic data, such as a slowdown in US consumer confidence and weaker-than-expected retail sales in China. Fed watchers will therefore be looking closely for any further signs of economic deterioration or a resurgence of the virus during the autumn months.

Inflation – transitory or persistent?

The outlook for inflation is the other key talking point, with opinion still divided as to whether the recent rise in consumer prices will be transitory or more permanent. While I am of the view that the structural drivers that have kept inflation low for many years – such as demographics, globalisation and technology – remain in place, I do think investors are right to be wary for perhaps the first time in many years.

US inflation has been well above target for several months, with CPI currently running at above 5%. While some of this is clearly due to transitory factors such as base effects and used car prices – which increased following the shortage of computer chips that has affected global auto manufacturers -- it does appear likely that inflation will remain above target for at least the rest of the year. One factor in particular which should keep upward pressure on inflation is the significant tightness in the US labour market, with the Job Openings and Labour Turnover Survey (JOLTS) report showing a record 10.9 million unfilled jobs in the US on the last business day in July, which compares with a more typical reading of around 5.0 million.

We could therefore shortly reach the point where the Fed has in effect met its symmetrical inflation target, with this year's high inflation readings fully offsetting last year's period of low inflation. This is another factor that could increase calls for interest rates to be raised.

Figure 2. Inflation since 1970

US CPI YoY, %

Source: Bloomberg, 31 July 2021 (Latest available).

UK – 'some modest tightening' may be necessary

Tapering is also a closely followed topic in the UK, with the Bank of England recently surprising markets by announcing that reducing the stock of assets purchased by ceasing to reinvest maturing UK government bonds could begin once interest rates reach 0.5%, rather than the previously assessed level of 1.5%. Therefore monetary policy in the UK could start to be tightened much sooner than previously thought, with markets pricing in a first rate hike to occur in the second half of 2022. Even more surprisingly, the Bank indicated that it would consider starting to sell gilts back to the market once rates are increased to 1.0%. This has clear implications for gilt markets, although as with Treasuries, the moves in yields have been relatively subdued, with 10-year gilt yields currently standing at around 0.7%.

Europe – a new inflation target, but awaiting further clarity

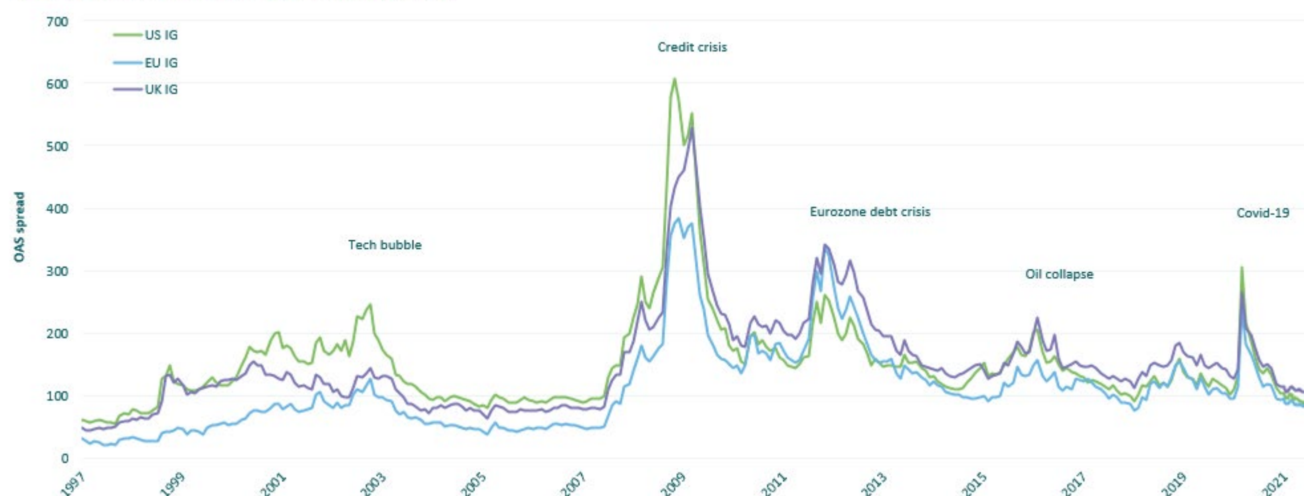
The European Central Bank (ECB) under its new President Christine Lagarde, has recently shifted its inflation target from 'below but close to 2%' to a plain 2% target. At the moment, the ECB has sent rather mixed messages as to whether this will involve flexible average inflation targeting, which would allow for a period of above-target inflation to make up for an earlier period of low inflation. A number of ECB Governing Council members have taken a decidedly hawkish stance, with German Bundesbank President Jens Weidmann warning against keeping interest rates low for too long due to the risk of stoking inflation. Weidmann has also called for the scaling back of the ECB's coronavirus stimulus program, known as the Pandemic Emergency Purchase Programme (PEPP), although other members have expressed concern over an early removal of these measures. The ECB at its September monetary policy meeting announced a moderate slowing in the pace of PEPP purchases, but it still looks like the real decisions on the future of the programme will be left until later meetings. Overall, it feels like more work needs to be done by the ECB to clarify its monetary policy strategy as we move into a post-pandemic world.

Credit - a supportive backdrop, but priced to perfection?

The backdrop is currently supportive for risky assets such as equities and credit, with around 85% of companies beating estimates at the last round of earning updates. Another supportive factor has been the low level of government bond yields, which has encouraged investors to move into riskier assets in search of yield. This has helped push credit spreads back to their pre-COVID level in both investment grade and high yield markets.

While I acknowledge that corporate default rates are likely to remain very low against a backdrop of strong economic growth and continued government support, I generally struggle to find much value in credit at current levels. I would also highlight some early signs of deterioration in key credit metrics, such as a creeping up of debt-to-earnings ratios. There are also question marks as to whether manufacturing companies will be able to fully pass on higher input costs, which has potential implications for profit margins. Therefore, while I think pockets of value can still be found in credit, I do think investors will need to be increasingly selective in this space.

Figure 3. Credit appears to be priced to perfection



An index is unmanaged and is not available for direct investment. Information is subject to change and is not a guarantee of future results.

Source: Bloomberg, ICE Bank of America indices, 31 August 2021

Emerging markets – multiple headwinds in 2021

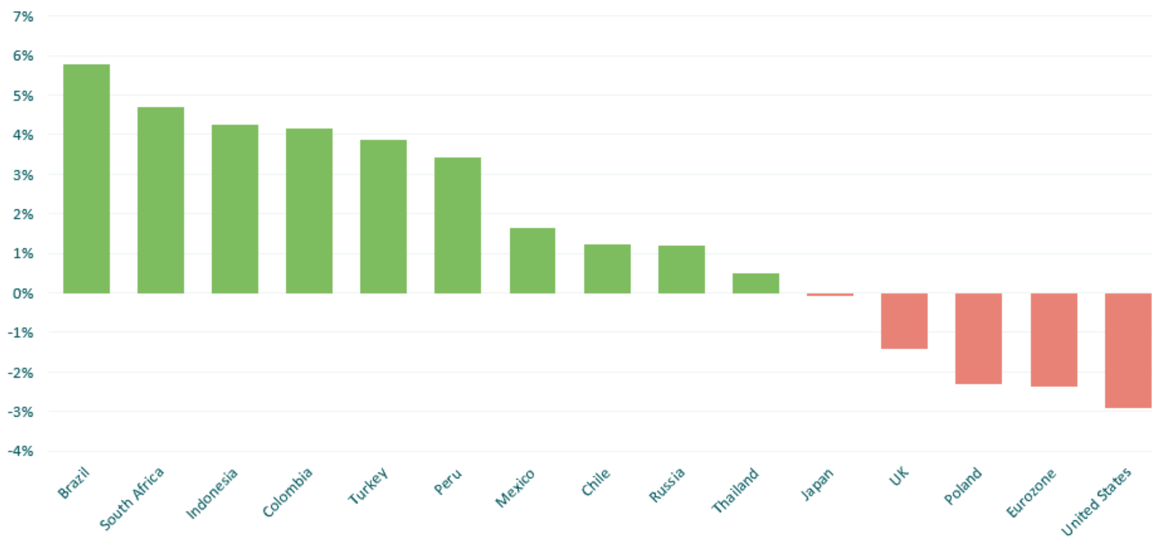
It is fair to say that emerging market bonds have endured a difficult 2021, with the asset class having faced multiple headwinds, including a stronger US dollar, a slowdown in global trade as result of the pandemic and more recently the spread of the Delta variant of the coronavirus in parts of Asia. There has also been a host of geopolitical issues to contend

with, from rioting in South Africa to rising political tensions between China and Taiwan. All this has led to some steep falls in a number of emerging market currencies, and a widening of credit spreads on hard currency bonds.

Nevertheless, this is an area of the fixed income market where I think value can still be found. The asset class continues to offer elevated real yields, while, in my view, many emerging market countries compare favourably to developed nations in terms of their longer-term economic growth prospects and debt-to-GDP ratios. While emerging markets is commonly treated as a homogenous asset class, there is actually significant dispersion in this market, with individual countries having very different growth drivers. I think this provides plentiful opportunities to uncover value.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

Figure 4. Real yields in emerging markets remain generally elevated compared to developed markets



Past performance is not a guide to future performance.

Real yield: 10 year sovereign yield minus forward-looking inflation expectations

Source: Bloomberg, 31 August 2021

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