Fixed Income asset class overview

August 2023

A strong bond sell-off at the start of the month caused a spike in yields to their highest levels in more than 15 years. Real yields have been behind the move higher, with the 10-year Treasury bond real yield passing through 2% intraday. This had an impact in the real economy, with the average US 30-year fixed mortgage rate climbing to 7.31%, its highest level since 2000.

Month in review

In August, 12 years on from S&P becoming the first ratings agency to downgrade the US federal government's debt from AAA to AA+, Fitch followed suit. The agency downgraded the US from AAA to AA+, citing concerns around the handling of the debt ceiling and budget deficits that are projected to run at high levels over the coming years.

Although increasingly it is looking like there will not be any rate cuts soon, fixed income markets did recover somewhat towards the end of the month, as part of the market raised hopes around a soft landing. This was supported by another CPI print showing the slowest rate of inflation since February 2021. Jackson Hole saw a far less hawkish speech from Fed Chair Powell than the one he gave 12 months previously, which gave hope to investors that we may have seen or be close to the last of the rate hikes. The JOLTS survey showed that there was easing in the tightness of the labour market. The quits rate fell back to pre-pandemic levels, and job openings are at their lowest levels for 18 months.

The PMI data from Europe and the UK didn't paint such a positive picture and CPI was resilient. There was still concern for China, partly driven by the property sector, but there were disappointing data releases too in industrial production and retail sales. This led to the People's Bank of China cutting its medium-term lending rate by 15bps to 2.50%

In credit, it was a month of two halves, with spreads initially widening in the context of concerns over rate hikes. In the second half, the softer data led to spreads tightening and pricing in dovish central banks. This meant that overall spreads were largely unchanged on the month. Global investment grade (IG) is trading with a spread of 133bp, which reflects a 50bp fall from the peak last year. However, overall yields remain historically high: currently the EUR IG index offers a yield of 4.3%, the GBP IG index has a yield of 6.3%, while the US market is at 5.7%.

It was a quiet month in high yield (HY), with no new EUR issuance, although we did see a few new AT1s as that part of the market continues to recover from earlier in the year. In terms of spreads, the Global HY index remained anchored around its 430bp level with little movement.

In EM, bottom-up selection was important, with spreads widening and issuer-specific stories dominating headlines whilst the market rally paused in the face of core rates and USTs selling off. Hard currency (HC) corporates outperformed sovereigns, reversing a recent trend, which came predominantly as a result of the HC index having greater duration, more exposure to sub-Saharan Africa, and a lower rating profile. In the corporate space, the Middle East and Europe were the top performing regions, with Europe being driven by Turkey's surprise rate hike.

Developed market sovereigns

August was a rough month, marked by the prospect of interest rates remaining higher for longer and the 10yr US Treasury yield reaching its highest level of this cycle so far.

In the US, we saw the move by Fitch Ratings to downgrade the US credit rating from AAA to AA+. There was also an increasing focus on budget deficits, which are projected to remain at elevated levels for the foreseeable future and growing scepticism that the Fed were about to cut rates anytime soon. Activity data remained robust despite some easing in the labour market and markets are pricing right now a pause in rate hikes in September to see a final hike in November.

In Europe, there were renewed concerns about the economy after the flash PMIs for August were released. For example, the euro area composite PMI fell back to 47.0, which was worse than expected and the lowest reading since late 2020. But at the same time, the inflation data remained fairly resilient, with the flash CPI reading for the euro area in August still at +5.3%. We also saw an uptick in European natural gas prices again, which rose +23.5% on the month amid concern about a strike at Australian LNG facilities. Consensus views are consistent with the ECB keeping rates on hold for a while.

In the UK, the composite PMI fell to 47.9, which was the first contractionary reading since January.

Past performance is not a guide to future performance.

Government bond total returns

	10-year yield %	Total return % (1m)	Total return % (ytd)
Treasuries	4.1	-0.6	0.6
Bunds	2.5	0.4	1.2
Gilts	4.4	-0.4	-3.2

Source: Bloomberg, 31 August 2023

Inflation

It's not just us: inflation needs a rest from time to time too. So far this summer, US inflation has been surprising to the downside and in August we got another encouraging report. Headline CPI rose 0.17% MoM while core was up 0.16% MoM. These numbers are consistent with 2% annual inflation.

What is important is that inflationary pressures continue to ease. The relatively low inflation print was not a function of a few outliers; rather, it was a broad-based trend. Most categories rose little in July. This is evident when looking at median inflation, which is now back to pre-Covid levels. Interestingly, excluding shelter, which tends to lag other items due to the way it is constructed, inflation is already at 0%. Essentially, most people in the US are currently experiencing no inflation!

Inflationary pressures are clearly easing and we believe they will continue to do so for some time; however, going forward there are some risks to the upside that are worth monitoring. We're keeping an eye on three things in particular:

Energy

The production cuts by Saudi Arabia and its allies caused the oil price to rise by more than 20% since mid-June. At these levels, energy, which recently has been a key detractor to inflation, will soon reverse its course, adding pressure on headline inflation. Other commodities are rising too, supported by increasing demand from hedge funds. If this trend continues, inflation expectations will likely have to be revised higher.

Airline fares

Airplane tickets continue to be a drag to inflation, down another 8% in July and-18% YoY. Incredibly, they now are below pre-Covid levels. That's somewhat surprising if you have taken a plane recently. It doesn't really feel like prices are going down in this space. We're not entirely sure what is happening here, but it's highly unlikely airfares will continue to be a drag going forward. If anything, they will probably start to move into positive territory, driven by the cost of jet fuel, which will rise reflecting higher oil prices.

Health insurance

Health insurance is one of those costs that the Bureau of Labor Statistics (the entity responsible for producing the US inflation report) struggles to properly calculate, due to the difficulty in making quality adjustments. So instead of directly looking at the price change of insurance premiums, the BLS uses an indirect methodology based on retained earnings by insurers. Essentially, the greater retained earnings, relative to the benefits paid out, the higher inflation health insurance is going to be. Usually this is not a category that really affects the overall inflation number, however, Covid disruptions have caused some really large swings in health insurance CPI. Currently, the impact is negative: as economies reopened, people started to utilise their policies again, pushing insurers' retained earnings lower. Still, things are now back to normal and the large negative impact will soon disappear, likely turning into a positive number. This should happen around October, after the new retained earnings will be reported, and will have a fairly consistent impact for the following 12 months as this number is calculated only once a year.

Taking a step back: the big picture

The huge increase in money supply during Covid caused inflation to rise as economies reopened and people had more money to spend. Now the reverse is happening: money supply is shrinking, and inflation is falling as a result. As long as money supply remains constrained, inflationary pressures will likely remain low. However, there might be a limit to how far inflation can fall as velocity (how frequently people spend their money) is rising. This is in part fuelled by still relatively high wage growth.

Finally, it is important to recognise that inflation usually comes in waves. This is because inflation always causes issues that tend to be resolved with more money printing (either through credit creation or fiscal stimulus, financed by central banks). If the money printing machine turns back on, inflation will likely make a comeback. This is not a story for the next few months, but something to keep in mind over the next few years.

Investment grade credit

It was a month of two halves. In the first half, spreads widened on worries that central banks might have to raise rates further. In the second half, sentiment turned, boosted by softer than expected numbers coming out of the US labour market. Spreads tightened as investors started to price in more dovish central banks.

Overall, credit spreads were broadly unchanged during the month. The physical IG market lagged the derivative one (CDS indices), driven in part by higher supply. Across sectors, financials underperformed non-financials, while more broadly cyclical bonds underperformed defensive names.

The Global Investment Grade index is currently trading with a spread of 133bp, down more than 50bp from the highs reached last year. Yields remain historically high. Currently the EUR IG index offers a yield of 4.3%, the GBP IG index has a yield of 6.3%, while the US market is at 5.7%.

Going forward

The latest growth and inflation numbers suggest we are now back to normal. For the quarter ending on the 30th of June, real GDP grew at an annualized rate of 2.1%, while the GDP deflator, which is the broadest measure of inflation, grew at an annualised rate of 2.0%. The US economy seems to be back to normal with about 2% growth and 2% inflation. Other developed economies appear to be on the same path.

But what hasn't come back to normal are interest rates. They still are relatively elevated compared to where growth and inflation have been recently. This creates an environment of high real rates which, if sustained, might push the economy into recession.

The risk of a policy mistake (central banks overtightening) is arguably the key risk investors should consider today, and that risk has increased recently. On the other hand, spreads have tightened this year, suggesting the market is less concerned about the risk of a recession caused by central banks overtightening.

We believe credit investors should be more selective in this environment and avoid taking excessive risk as valuations are back to fair value, therefore leaving little room for error. Investment Grade investors, however, should take comfort from the fact that rates are higher today and can offset rises in spreads in case things were to deteriorate.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	122	-0.7	3.0
Euro IG	155	0.2	3.2
UK IG	161	-0.1	1.2

Source: Bloomberg, 31 August 2023

High yield credit

August was generally a quiet month for HY markets. The Global HY index spread hardly moved from its 430bp level, and company results were mostly mildly positive, which did not throw any surprises.

The Global HY index closed with fairly flat monthly returns. YTD it has delivered a solid + 6.2% – an impressive result, given all the rate volatility, concerns about late cycle and rising interest costs.

Rating performance continued to be led by lower quality bonds in the US and Europe, supported by technicals such as a lack of issuance and relatively thin liquidity. Sector performance was mixed last month – the worst performers were metals & mining and autos, while the top performers were retail, technology and cable.

The primary market remains quiet, with no EUR new issue in August. However, we did see a few new AT1s price, as that part of the market continues to recover.

In terms of valuations, low supply and better-than-expected fundamentals should continue to support current (tight) spread levels. However, we must bear in mind that many issuers still need to address maturity walls of "25s and 26s", and defaults are likely to creep up in the coming months.

Current views

- Positioning remains fairly close to neutral to slightly underweight credit risk
- Technical elements (eg supply/demand imbalance, attractive all-in yields) are contributing to spread containment
- Fundamentals are generally supportive for now, although near-term maturities (25s/26s) must be addressed
- In our view, default rates are unlikely to stay as low as they have been
- We are generally focusing on defensive trades (eg non-cyclicals v cyclicals, up-in-quality, etc).

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	385	0.3	7.2
Euro HY	463	0.3	5.9

Source: Bloomberg, 31 August 2023

Emerging market bonds

During August the Emerging Market Debt (EMD) beta rally that had buoyed markets in recent months ran out of steam, with core rates and USTs selling off. Macro data from China weighed on sentiment, with the policy response, thus far, being seen by the market as not strong enough.

Issuer-specific stories dominated the month, with bottom-up selection becoming ever more important in a market that became somewhat directionless during August. Political stories in Latin America dictated much of the headlines, particularly in Argentina.

In a reversal to July, local currency (LC) sovereigns underperformed the rest of the EMD market including the frontier-centric NEXGEM index, which returned -2.02% over the month, bringing year-to-date performance down to 11.02%. The Colombian Peso and Mexican Peso, while still being the strongest emerging market currencies over the year, gave up some of their gains. Following a larger than expected interest rate hike by the central bank in Turkey, the Turkish Lira become the strongest-performing currency in August on a total return basis.

In the hard currency space, spreads widened across both the investment grade and high yield segments. Events in Gabon and Niger pushed spreads wider across the region as political risk was re-priced into the market. Of the 10 worst-performing hard currency bonds, eight were those of African countries, with spreads at the regional level widening by around 100bps to c.850bps.

EMD corporates saw negative returns driven by widening spreads, although high yield slightly outperformed investment grade due to its lower duration component. Hard currency corporates outperformed sovereigns, which is a reversal to previous months and was driven primarily by the fact that sovereigns have greater duration and more exposure to Sub-Saharan Africa.

Real Estate (RE) was the worst performing sector as a result of more bad news coming out of China's RE sector. Pulp & Paper also underperformed as a result of China's gloomy macro outlook. Financials were flat, with Transport ending the month up. The Middle East and Europe were the strongest performing regions, with the latter being driven by Turkey's surprise rate hike.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	-2.7	7.9
Hard currency government	436	-1.5	4.5
Hard currency corporate	338	-0.4	4.2

Source: Bloomberg, 31 August 2023

Currencies

It was a very different month compared to July for the US dollar, with the greenback outperforming nearly all currencies in August.

This likely reflects both higher-rates-for-longer sentiment in the US, as well as some of the China weakness seen in the month.

The Euro and Yen were notable underperformers on the month (vs USD). It was also a weak month for most EM currencies.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-1.3	4.9
GBP/EUR	0.1	3.5
EUR/USD	-1.4	1.3

Source: Bloomberg, 31 August 2023

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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