M&G Investments

Fixed Income asset class overview

December 2023

The year-end 'Santa rally' came in force with November's positive market sentiment continuing into December. The Bloomberg Global Bond Aggregate Index followed up its 5.0% gain in November with a 4.2% gain in December, turning around the story for the year. Only two months prior, some portions of the fixed income market were facing the prospect of a third successive year of negative returns. Equities also rallied strongly into the end of the year.

Month in review

Gains in November and December helped the bond market avoid a third successive year of negative returns. Given the hawkish nature of developed market central banks in 2023, risk-free rates were the highest they had been in a long time. As a result, US Treasury bills (T-Bills) returned 5.1% over the year, signalling the strongest performance for the asset since 2000. The Federal Reserve's (Fed) December 'dot plot' took investors by surprise; it took a far more dovish tone with 75 basis points (bps) of interest rate cuts being signalled for 2024. In turn, investors' expectations for inflation returning to target without incurring a recession- a scenario which would allow central banks to cut rates - grew.

The increased optimism about an economic soft landing set the foundation for the rally we saw in November to continue into December, although the market has been pricing in approximately double the amount of rate cuts that the dot plot is suggesting. Inflation continues to trend in the right direction, reflecting the decline in the money supply. However, the path back to target will not be a straightforward one, in our view, with wages being a key area of resistance.

December was a strong month again in investment grade (IG) credit with spreads and rates falling, driven by optimism around rate cuts in 2024. The spread on the global IG index tightened approximately 10 bps. High-beta names, cyclicals, financials and BBBs were the outperformers. 'All-in' yields remain historically high, offering a positive real yield for investors. The EUR IG index is offering a yield of 3.6%, while both the GBP IG and US IG indices offer 5.2%.

High yield (HY) also had another good month as hopes of a soft landing and rate cuts gained momentum. Lower sovereign bond yields and spread compression (c.-40 bps) helped the global HY market deliver gains of 3.4% over the month. November and December helped 2023 returns considerably, taking total 2023 returns to 12.5%. The slightly longer duration US HY led the way (13.5%), European HY delivered c.12% and emerging market (EM) HY lagged at 8.7%.

Global HY floating rates notes (FRNs) were much steadier for investors across the year and posted very strong returns of 13.6% (USD). This signified an outperformance versus the comparable US leveraged loans market (13.3%).

EM bonds followed the trend of other asset classes as the rally continued. November and December provided the highest two-month return of the JPM hard currency (HC) index since the Global Financial Crisis (GFC). Expectations of rate cuts, on the back of lower CPI figures and more dovish central bank rhetoric, drove the rally. HC government bonds outperformed due to their longer duration profile.

Local currency (LC) EM sovereigns returned 12.7% over the year, HC sovereigns returned 11.1% and HC corporates returned 9.1%. The frontier-centric NEXGEM Index returned 21.0% in 2023.

In FX, the Argentinian peso moved from being the strongest performing currency in November to being the weakest performer in December following President Javier Milei's devaluation of the currency.

Inflation

Part 1: Disinflation has been the recent theme, could stickiness be the theme in 2024?

In the US, November's inflation figures came in line with expectations: headline CPI fell to 3.1% year-on-year (YoY) (+0.1% month-on-month(MoM)), while core inflation was also slightly lower at 4.0% YoY (+0.3% MoM).

Overall, inflation continues to trend in the right direction, reflecting the sharp decline in liquidity in the system. But beware of the details.

Inflationary pressures are easing and will continue to do so for some time, but the path towards 2% is unlikely to be as smooth as some expect. While the decrease in money supply will continue to exert downward pressure on inflation, the increase in velocity will partially offset that impact. Velocity tends to manifest itself in wages.

While overall inflation is decreasing, wage-sensitive items are moving in the opposite direction. 'Supercore' inflation

(core services less housing), which tracks the most wage-sensitive sectors, reaccelerated last month.

In order to bring supercore inflation back to 2%, we may need a more significant decline in wages. However, leading indicators for wages are currently showing a reacceleration. Two of the most important leading indicators we monitor are compensation plans and job leavers. The former is based on a survey conducted on approximately 800 small businesses and it aims to understand whether companies, in general, are planning to increase or decrease wages in the future. The latter tracks the number of people who voluntarily leave their job, usually to pursue higher salaries elsewhere.

In summary, disinflation has been the key theme for this year. While inflation is down, stickiness might become the key theme for next year.

Part 2: The sky is full of doves

The long awaited 'pivot' has finally materialised. Last month's Federal Open Market Committee (FOMC) meeting was more dovish than previous meetings. Fed Chair Powell and other members revised down their projections for growth and inflation, resulting in an expectation of 75 bps of rate cuts in 2024.

While FOMC members expect to ease monetary policy by cutting rates, they also intend to tighten monetary policy by continuing to reduce the central bank's balance sheet (quantitative tightening). Powell justified this choice by stating that it is simply an adjustment of monetary policy and not a reaction to a recession (in which case the Fed would be expanding its balance sheet).

We believe this is positive; rates should be lower in our view, reflecting the slowdown in both inflation and growth, while simultaneously continuing to shrink the balance sheet which should help to prevent future inflationary spikes.

However, this is easy to say, but hard to achieve in practice. Pressure to return to quantitative easing (QE) is likely to increase in the future, testing the nerves of FOMC members.

Developed market sovereigns

December continued where November left off, as hopes of a soft landing and rate cuts from central banks fuelled a rally in developed market (DM) sovereigns. Across the globe, DM government bonds avoided a third successive year of losses as the rally into the end of the year left treasuries, bunds, gilts and Japanese government bonds (JGBs) in positive territory.

Over the month in the US, inflation data continue to move in the right direction, with core and headline both slowly falling. Despite some pushback from Fed speakers, the market continues to price in over 150 bps of rate cuts in 2024. The labour market remains strong and December marked the 36th consecutive month of job creation for the US economy. These factors assisted the continuing rally from sovereigns that we saw into the end of the year and US treasuries ended the year in positive territory, a scenario that looked unlikely at the end of October. However, expectations going into 2024 are that we may start to see some weakness, which will call for support from the Fed.

In the eurozone, as at the end of December, the market is pricing in a cut by the European Central Bank's April meeting, and six cuts by year end. This supported European sovereign bonds in finishing the year up 7.2%. Towards the end of December, yields on bunds, French OATs and Italian BTPs reached their lowest levels in 12 months.

In the UK, CPI slowed to 3.9% (versus 4.3% expected). Core inflation also surprised to the downside at 5.1% (versus 5.6% expected). This assisted gilt outperformance, relative to other sovereigns, over the month. Soft labour market data also fuelled market expectations for Bank of England rate cuts in 2024.

In Japan, the Bank of Japan (BOJ) decided to leave its ultra-loose monetary policy as it is. Governor Ueda said that the BOJ will not be signposting an end to its negative interest rate policy (NIRP). However, the market is pricing in a 75% chance that NIRP will come to an end by April.

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	3.9	3.4	3.9
Bunds	2.0	3.4	5.1
Gilts	3.5	5.4	3.7

Source: Bloomberg, 31 December 2023

Investment grade credit

December was another strong month for corporate credit, as both spreads and rates fell, driven by increasing investor optimism regarding central banks cutting rates in 2024 and the possibility of an economic soft landing. 10-year treasury yields decreased by 45 bps, while the spread on the global IG index compressed by approximately 10 bps.

Similar to the previous month, high-beta names generally outperformed, with cyclicals outperforming non-cyclicals and financials generally outperforming industrials. BBBs and longer-dated names were the top performers. In terms of regional performance, the UK generally outperformed, while Europe slightly lagged behind.

Despite the decline in both rates and spreads, overall yields remain historically high and well above expected inflation, providing investors with a positive real yield. Currently, the EUR IG index offers a yield of 3.6%, while the GBP IG index and the US market both have a yield of 5.2%.

Going forward

Declining inflation has led to the likely end of monetary tightening, and rate cuts are now expected in 2024. Although growth is showing signs of easing, it is happening slowly due to continued consumer spending supported by a robust labour market and rising real wages. This positive environment is favourable for IG and financial assets in general, in our view.

While spreads may not appear historically attractive, the stabilisation of rates could lead to a greater allocation to IG, further pushing spreads lower.

Moreover, it is important to highlight three features that we believe make this asset class attractive today:

1. Historically high yields: while credit spreads have generally returned to normal levels, rates remain historically attractive, providing investors not only with an attractive level of income but also with a cushion in case of an economic downturn.

2. Positive real yields: not only are overall yields historically attractive, but real rates are also appealing, offering investors a positive return after accounting for inflation. The key challenge investors always face is not recession but inflation. Recessions come and go, while inflation is a permanent feature of our system. If not properly addressed, it can gradually erode our purchasing power over time. Positive real rates can help investors mitigate the impact of inflation.

3. Improving credit quality: IG companies exhibit sound fundamentals, limited refinancing risk, as they have secured long-term/low-cost funding, and have historically elevated levels of cash. As a result, many companies in this sector have been upgraded by rating agencies in 2023, while only a few have been downgraded, resulting in better quality IG indices.

In summary, while spreads may not appear historically attractive, we believe the positive macroeconomic environment, combined with the aforementioned features, makes this asset class particularly attractive for investors. Furthermore, active investors can continue to capitalise on market dislocations, mitigating the impact of tighter spreads and potentially achieving better performance.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	104	4.0	8.4
Euro IG	136	2.8	8.0
UK IG	137	4.9	9.7

Source: Bloomberg, 31 December 2023

High yield credit

December was another strong month for HY markets as hopes for a soft landing and expectations of rate cuts in 2024 gained further momentum. Lower sovereign bond yields and tighter spreads (-40 bps) helped the global HY market deliver 3.4% during the month.

While much of 2023 was a struggle for HY markets with ongoing rate volatility, the last two months of the year contributed a powerful total return, taking year-end 2023 returns to a healthy 12.5%. Returns were led by US HY (+13.5%), which, given its slightly longer duration profile and slightly lower quality bias, was buoyed by the sovereign rally and improved risk sentiment. European HY delivered 12% returns and EM HY lagged with 8.7%.

Global HY FRNs continued to deliver a steady ride for investors in 2023, posting remarkable returns of 13.6% (USD) despite macro uncertainty and continued calls for the end of the rate cycle. The asset class outperformed the comparable US leverage loan market which posted total returns of 13.3% over the period (Morningstar LSTA Leveraged Loan Index).

Current views

- High yield spreads look historically tight and we believe they may mean-revert in 2024, as the lagged effects of central bank tightening continues to transmit through the economy.
- While it is difficult to predict the pace and timing of future rate cuts, we believe interest rates may remain elevated in comparison to recent years.
- Technical elements such as supply/demand imbalance need to be respected, although it is likely that issuance will rise in 2024 considering the shorter maturity runways. 'All-in' yields remain historically high providing investors with an attractive level of income and a cushion versus wider spreads and default risk.
- We believe fundamentals are still reasonably supportive for now, but macro deterioration is anticipated. This may be worse in Europe than the US, considering recent macroeconomic data releases.
- If the current macroeconomic conditions persist (low positive growth, declining inflation, along with a low high yield default environment and credit spread stability), we believe 2024 could be positive for the asset class.
- We are cautious on current valuations but we do not want to become too underweight as spreads may find support from market technicals.
- We are generally concentrating on defensive trades (eg, non-cyclicals v cyclicals, up-in-quality, actively underweight real estate, etc.)

Past performance is not a guide to future performance.

High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	339	3.7	13.5
Euro HY	411	2.9	12.4

Source: Bloomberg, 31 December 2023

Emerging market bonds

December saw a continuation of the significant rally seen in November, with the two months combining to provide the highest two-month consecutive return of the JP Morgan HC index since the GFC. Much of the December story remained the same as November with the rally being driven by investors bringing forward their rate cut expectations on the back of lower CPI prints and more dovish central banks. As a result, the duration-heavy HC portion of the market was the strongest performing sub-asset class.

The outperformance of the HC sovereign market bucks the trend for local currency sovereign outperformance; although year-to-date performance still slightly favours the local portion. The recent two-month rally has been significant and accounts for the majority of the 11.1% annual return of the HC government bonds. The frontier-centric NEXGEM Index returned 21.0% over the year.

In the hard currency markets, Africa and Latin America were the two strongest performing regions, with Latin America alongside Europe being the two strongest regions in the local currency. In the FX space, the Argentinian peso, which was the strongest performing currency in November, became the worst performing currency in December, due to the deliberate devaluation of the currency as part of President Javier Milei's sweeping reforms since taking power.

Emerging market corporate debt underperformed the sovereign equivalent but still delivered 3.1% in December. US rate moves and spread tightening contributed 2.3%

and 0.8%, respectively, though spread returns were stronger for HY, while IG benefited more from rate moves. The outperforming sectors in December were oil & gas and consumer (21 bps and 25 bps tighter respectively), while the underperformers, in spread terms, were real estate (+8 bps as the China property rally fizzled out) and industrials (+2 bps).

By region, Europe was strong thanks to improving sentiment around Turkey, with Ukraine and Kazakhstan also enjoying a robust end to the year. Africa also benefited significantly from the risk-on environment – Zambia, Nigeria and Egypt all posted strong gains. Asia and the Middle East were December's laggards due to high credit quality and tight valuations while LatAm was a mixed bag, with a weaker performance from Brazilian corporates counterbalanced by stronger showings from their Colombian, Chilean and Peruvian counterparts. Argentinian corporate spreads were little changed as the market awaits Milei's next reforms.

Past performance is not a guide to future performance.

Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	3.2	12.7
Hard currency government	392	4.7	11.1
Hard currency corporate	312	3.1	9.1

Source: Bloomberg, 31 December 2023

Currencies

It was a mixed December, with fairly modest moves in most currencies.

The yen finished the year as one of the weakest performing DM assets.

The pound and euro ended the year up, against the US dollar.

Past performance is not a guide to future performance.

Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	0.8	5.4
GBP/EUR	-0.5	2.1
EUR/USD	1.4	3.1

Source: Bloomberg, 31 December 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.

For Investment Professionals only and Institutional Investors. Not for onward distribution. No other persons should rely on any information contained within. The views expressed represent the opinions of M&G Investments which are subject to change and are not intended as investment advice or a forecast or guarantee of future results. Stated information is provided for informational purposes only. It is derived from proprietary and non-proprietary sources which have not been independently verified for accuracy or completeness. While M&G Investments believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions which may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. This financial promotion is issued by M&G Luxembourg S.A. The registered office is 16, boulevard Royal, L-2449, Luxembourg. **JAN 24 / 1144701**