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Fixed income asset class overview

M&G Investments

May 2024

May began positively as the Federal Reserve's (Fed) meeting proved less hawkish than anticipated with Chair Jerome Powell expressing doubt that its next policy move could be a hike. The easing of US inflation and a calmer geopolitical environment contributed to renewed positive sentiment with an increased sense of stability.

Month in review

May saw geopolitical tensions ease somewhat, providing some respite to rising oil prices, with Brent crude oil falling sharply over the month, in line with the trend year-to-date (YTD).

While the latest US jobs report showed a slowdown in job growth, allaying fears of an overheating economy, global inflation data were a bit more mixed towards the end of the month. This resulted in a sell-off of sovereign bonds in a number of countries, with the Fed expressing a more hawkish tone. In Europe, the eurozone flash Purchasing Managers' Index (PMI) for May hit a 12-month high, and wage data from the European Central Bank (ECB) showed an acceleration in negotiated pay. However, the core consumer price index (CPI) figure ticked up by 2.9% in May. Investors reduced expectations of ECB rate cuts, pricing in 55 basis points (bps) of cuts by the December meeting (down from 66 bps at end of April).

The USD investment grade (IG) market performed well, partially driven by the outperformance of US Treasuries. The Global Investment Grade Index currently offers a spread of 95 bps, which is three bps lower compared to the previous month. While spreads continue to grind tighter across all areas of credit, the asset class continues to provide historically elevated levels of yield. Presently, the EUR IG index offers a yield of 4.0%, while the GBP and USD IG indices have yields of 5.7% and 5.6% respectively.

The global high yield (HY) market returned 1.2% with the US and Europe regions returning 1.1% and 0.9%, respectively. The broad positive performance came, in part, from US Treasuries being supportive. Over the month spreads tightened across regions although European spreads remain wide versus US levels, but are getting closer to historic ranges. In the US and Europe we have seen the primary market roar back to life. Given strong demand supply could be easily absorbed, with tight pricing reflecting this.

For emerging markets (EM), in line with other asset classes, May was a much more positive month following April's risk-off environment. EM continue to deal with geopolitical events and the historically busy election cycle. However, much of the former is now in the price with the latter nearing its end. Local currency assets staged a comeback in May, although YTD they remain negative with much of this stemming from a very strong dollar. Another trend which reversed in May was for IG to outperform HY in the hard currency sovereign space, whereas the returns for hard currency corporates were more or less equal.

Inflation

Inflation is still moving in the right direction… slowly but surely

The disinflationary process appears to be back on track. After some higher-than-expected reports, US inflation finally came in lower than expected. Headline inflation decreased to 3.4% year-on-year in April compared to the reading of 3.5% for March, while core inflation stands at 3.6%, the lowest level in the past three years.

There are two key themes worth highlighting:

1. **Rents and car insurance continue to play a significant role.** Similar to the previous month, rents and car insurance have been the primary drivers of inflation, accounting for approximately 80% of the monthly core CPI. However, it's important to note that these two components will have limited impact on the Personal Consumption Expenditures (PCE) index, which is the Fed's preferred measure of inflation. Rents have a much smaller weight in the PCE, while car insurance is calculated differently and, according to the PCE, is currently decelerating.
2. **There is no evidence of inflation reaccelerating.** One of the main concerns in recent months has been the fear of inflation picking up speed; however, April's data provided evidence against this view. Most items in the inflation basket are experiencing disinflation. This is evident when looking at median CPI, which has been declining for the 14th consecutive month.

What can we expect from inflation going forward?

The key driver of inflation is money supply. Throughout history, periods of significant inflation have all been characterised by excessive money-printing, and the Covid-19 pandemic was no exception. Today, we find ourselves in the opposite situation: money has been withdrawn from the system and inflation is falling as a result. Money supply tends to lead inflation by approximately 18 months. Inflation excluding rents has already returned to 2%, consistent with what is predicted by money supply.

There are four key subcategories of inflation, each driven by different factors:

1. **Food and energy:** this category represents 20.3% of the inflation basket and is typically the most volatile component, influenced by commodity prices. Specifically, energy inflation is driven by oil prices, while food inflation is closely correlated to the agriculture index. Both oil prices and the agriculture index are on a downward trajectory, suggesting that energy and food inflation are likely to decrease in the coming months.
2. **Rents:** This is by far the largest component of the inflation basket, accounting for 36.1% of the index. Understanding the direction of rents is crucial for forecasting US inflation. Fortunately, rents are slow-moving and fairly predictable due to the way they are calculated. A simple way to gauge where rents are heading is to look at house prices, as they typically lead rents by 18 months. Rent inflation is expected to further moderate, although it may pick up again towards the end of this year or the beginning of next year.
3. **Core services excluding rents:** this category, often referred to as super-core inflation, represents 24.9% of the inflation basket and is heavily influenced by wages, as labour costs are a key input for these sectors. If you are looking for a wage-price spiral, this is where you should focus. It is why the Fed is particularly concerned about this category. Currently, wage growth is moderating, and leading indicators suggest it will likely continue to moderate in the coming months.
4. **Core goods:** This category accounts for 18.7% of the inflation basket, and since the US economy largely relies on imported goods, the key driver here is the US dollar. A weaker dollar will make imports more expensive, pushing core goods inflation higher. Conversely, a stronger dollar will likely exert downward pressure on core goods prices. Currently, the USD remains strong, thus exerting downward pressure on core goods inflation.

In conclusion, inflation is moving in the right direction, albeit slowly. Rents may cause a reacceleration towards the end of the year, but from a lower level compared to where we are today. The question then becomes what will happen to money supply. If money supply continues to rise, inflation will likely remain above its 2% target. On the other hand, if money supply remains constrained, deflation may become a key topic of discussion.

Developed market sovereigns

May was a better month for developed market (DM) sovereigns. The month started positively with US Fed Chair Jerome Powell pushing back on the view that further hikes were on the table after some hot recent CPI prints. The Fed also announced they would be slowing the pace of quantitative tightening. The Swedish Riksbank became the second G10 currency central bank to cut rates, with their first cut since 2016. It is anticipated that other central banks will soon follow suit, with the ECB expected to cut in June.

The month started positively for US Treasuries. Slowing inflation and jobs data comforted markets that the economy was not overheating, which was supportive for the asset class. However, more resilient data in the second half of the month cemented the 'higher-for-longer' view on interest rates and that the Fed is likely to push cuts out towards the back end of the year, which led to a slowing of momentum. Nonetheless, May was a strong month for Treasuries, returning 1.5%.

In the eurozone, the market became increasingly confident that the ECB would become the first major central bank to cut rates at its June meeting. However, eurozone flash PMI data hit a 12 month high and wage inflation accelerated. This led to the amount of total cuts being priced in by the December meeting being reduced from 66 bps at the end of April to 55 bps. This meant that eurozone sovereign bonds sold off over the month and declined by 0.1%. German bunds (-0.3%) and French OATs (-0.2%) fared slightly worse than the area as a whole.

In the UK, there was a significant fall in the April CPI print, with the year-on-year figure falling from 3.2% in the March print to 2.3% in the latest numbers. This marked the lowest UK inflation rate since summer 2021. Although this represented a significant fall and progress towards target, it missed market expectations and yields rose off the back of this. Prime Minister Rishi Sunak called a general election for July 4, which lifted some of the political uncertainty and allowed markets to focus on the rates outlook and economic conditions. Overall, gilts had a good month, finishing up 0.8%.

Japanese Government Bond (JGB) yields continued to rise, with the 10-year yield passing the major milestone of 1%, ending the month at 1.06%. This is the first time that the

10-year JGB yield has been above 1% since 2012. The market continues to price in a more hawkish position from the Bank of Japan (BOJ), and is currently pricing in 29 bps of hikes by the December meeting, which is an increase from 20 bps at the start of the month. The JGB index lost 1.7% 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	4.5	1.5	-1.8
Bunds	2.7	-0.3	-3.4
Gilts	4.3	0.8	-3.8

Source: Bloomberg, 31 May 2024

Investment grade credit

It was a positive month for IG indices as both spreads and rates moved lower. This was supported by positive inflation reports and resilient economic growth.

In terms of total return, the USD IG market performed well, driven by the outperformance of US Treasuries. However, from a credit perspective, performance was generally similar across regions. Financials were the leading sector, followed by some cyclical businesses such as real estate. Higher-beta names, particularly BBBs, showed strong performance from a rating standpoint.

Going forward:

The macroeconomic environment remains supportive for the asset class, in our view. Inflationary pressures are slowly easing, while growth remains supported by a healthy labour market.

Many IG companies remain in a solid position, having taken proactive measures to hedge against rising inflation during the Covid period. By locking in low financing costs for an extended period, these companies have insulated themselves from potential interest rate increases. Furthermore, their large cash balances are now earning attractive interest rates, allowing them to benefit from rising rates. As a result, despite higher rates, most IG corporates' balance sheets remain healthy, in our opinion. Credit metrics are generally normalising, but they remain historically decent. Moreover, cash balances and profit margins remain historically high.

However, most of the good news is priced into the market, as spreads, the extra compensation investors receive to own corporates, are trading near historically tight levels. Yet this, we believe, doesn't mean investors should ignore the asset class. Spreads can remain tight for a prolonged period of time, as was the case between 2004 and 2006. The currently supportive macroeconomic environment, together with healthy balance sheets, suggests that spreads might well remain tight or even tighter for longer

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	88	1.9	-0.6
Euro IG	107	0.2	-0.2
UK IG	117	1.0	-0.9

Source: Bloomberg, 31 May 2024

High yield credit

May was a good month for HY. The Global HY index returned 1.2% (in USD terms), with US HY (+1.1%) and EM HY (+2.0%) outperforming Europe (+0.9%) thanks to a supportive backdrop in US Treasuries. HY Floating Rate Notes (FRNs) returned 0.9% (led by spread compression and carry) and synthetic HY markets (HY CDX index) gained 1.4% outperforming HY cash markets. Spreads closed the month at 320 bps (US) and 341 bps (EU). EU spreads remain wide of US levels but close to historic ranges. We will monitor for any dislocation to potentially add on European weakness. Primary markets in both the US and Europe have roared back to life but demand is more than sufficient to absorb new supply and most deals are pricing at or inside the tight side of guidance.

Current views

- From a macroeconomic perspective, we expect the US to outperform Europe with regards to growth expectations. We could potentially see multiple rate cuts from the ECB. The lack of US rate cuts likely means the higher yield environment will persist and continue to attract demand.
- In terms of market technicals, spreads remain very tight yet yields are relatively attractive, creating a balance between sellers of spread and buyers of yield, suggesting the market will remain in relative equilibrium (spreads range bound) barring any macroeconomic disruption or event.
- HY spreads are rich versus history and versus higher-rated credit, with spreads outside of distressed tails tracking at post-Global Financial Crisis (GFC) tight levels. But in our view, current levels still compensate investors for an ‘average’ default cycle. Currently, the EU HY market is pricing in a five-year implied default rate of 22%, assuming a 40% recovery rate. By contrast, the actual five-year default rate in the index

was on average cca13%, with the worst five-year default rate of 38%.

- BB and B spreads have compressed, limiting attractive relative value opportunities. There may be some opportunities in CCC but it is important to be selective. Even with moderating growth, there is potential for the asset class to generate reasonable returns in 2024, possibly mid to high single digits, given the power of carry, expected low defaults, reasonably strong corporate balance sheets and lower rate volatility.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	320	1.1	1.7
Euro HY	341	0.9	2.7

Source: Bloomberg, 31 May 2024

Emerging market bonds

May was a much more positive month for emerging markets following April's risk-off environment. The US, particularly the Federal Reserve, remains in focus for much of the broader market with EM being no exception.

While Ems continue to deal with geopolitical risk and the busy election cycle, much of the former is now in the price, with the latter nearing the end.

The major EM economies that had elections this year have now, more or less, concluded their electoral process although the necessary coalition in South Africa is yet to be formed.

Local currency assets staged a comeback in May, although YTD remains negative. Much of the YTD performance has stemmed from a very strong dollar, supported by markets pushing back expectations for the Fed to cut. In May, however, we saw the majority of EM currencies appreciate relative to the dollar. With a very decent level of carry left in EM FX, currencies generally had positive total returns in May, with the only major EM currencies delivering negative returns being the Philippine peso and Brazilian real. From a rates perspective, with EM being well ahead of DM peers, the continuation of the cutting cycle has also added to returns.

Another trend that reversed in May was for investment grade to outperform high yield in the hard currency sovereign space, whereas for hard currency corporates the returns were more or less equal. For sovereigns, this reverses a trend we have seen compound over 2024 as well as during most of 2023. The IG and HY portions returned 2.1% and 1.6% respectively in May but the one-year number highlights that May was indeed the exception, rather than the rule, with IG returning 2.4% over the past 12 months, while HY returned 20.5%. The return of the HY segment is only beaten by the frontier-centric NEXGEM index which has returned 21.8% over the same period, with May returns standing at 1.9%.

Corporates also finished the month up with all sectors positive. The standout performer was the real estate sector returning 3.8% and the worst performing sector, infrastructure, still well within positive territory, returning 1.6%. In fact, there was very little to split returns within the corporate universe in terms of regions/sectors although it is noteworthy that the BBB sector outperformed BB and B.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	1.6	-2.7
Hard currency government	389	1.8	1.7
Hard currency corporate	262	1.5	2.9

Source: Bloomberg, 31 May 2024

Currencies

The US dollar was the worst performing G10 currency in May as investors expect the Fed to maintain the 'higher for longer' narrative.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	2.0	0.1
GBP/EUR	0.3	1.8
EUR/USD	1.7	-1.7

Source: Bloomberg, 31 May 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.

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