Fixed Income asset class overview

September 2024

September saw the Federal Reserve (Fed) finally settle the monumental '25 bps or 50 bps' debate for its first rate cut, after 14 months of keeping rates on hold. The Fed kickstarted its cutting cycle with a 50 bps reduction, lowering the fed funds target to the 4.75%-5.00% range. With unemployment rising from its low of 3.4% in April 2023 to 4.2% in August, Fed officials made it clear they weren't prepared to tolerate further economic weakening, and were keen to move rates back to less restrictive levels.

Month in review

Despite hawkish communication from the Fed following the September cut (with Chair Jerome Powell stressing this should not be seen as "the new pace" of easing), markets continue to price in a 35% chance of another 50 bps reduction in November. The belief is that the Fed will be more aggressive, with c.70 bps in cuts priced in by year-end and another 120 bps priced in by the end of 2025.

August's core Personal Consumption Expenditure (PCE) inflation came in softer than anticipated at 0.1% month-on-month (MoM) and 2.7% year-on-year (YoY), giving the Fed room to focus on the other side of its dual-mandate: in this case, maintaining a full-employment soft landing. Overall, the shift in investors' expectations for interest rates saw government bonds perform positively over the month, with US Treasuries and German Bunds both returning 1.2%.

September also saw global investment grade (IG) spreads tighten by 2 bps, with credit markets performing well as inflation softened and interest rates moved lower. Credit spreads tightened across most sectors, though the auto sector underperformed due to concerns over slowing growth. Overall, global IG returned 1.5% for the month, with US corporates returning 1.7%, European credit 1.2%, and sterling corporates a more modest 0.3%.

Helped by the Fed's cut and lower government bond yields, September saw strong performance in high yield (HY) markets, with the global HY index returning 1.6% over the month. Spreads tightened further, reaching historically low levels (US HY: 303 bps, EU HY: 350 bps, EM HY: 368bps), while CCC rated distressed bonds posted solid gains. Gross issuance surged, particularly in the US, with US$36.5 billion raised. Market technicals remain supportive, driven by supply-demand imbalances and high carry. Year-to-date (YTD), global HY has returned 8.4%, despite concerns about recession risks at the beginning of the year.

Emerging market (EM) debt continued to perform well during the month, with local currency sovereigns returning 3.4% and hard currency sovereigns returning 1.8%. EM FX gained strength as the US dollar weakened, supported by the Fed's rate cuts. Asia FX led local currency returns, while Africa outperformed in hard currency debt. Corporate sectors saw positive returns, with real estate leading at 15% YTD. While Fed rate cuts generally boost EM debt, tight spreads could limit the extent of the rally this time.

Inflation

Inflation around the world continues to trend in the right direction, with the eurozone leading the way. Eurozone inflation is now below target, at 1.8% YoY in September. This is the lowest reading in over three years. UK inflation is also approaching its target, with the consumer prices index (CPI) recording a 2.2% YoY increase in August. The US is lagging behind, but arguably this is mostly due to the different methodology used to calculate inflation. When using the European methodology (Harmonised Index of Consumer Prices (HICP)), US inflation is also below target, and has been at or below 2% for over a year now.

Looking closer at the US market, the latest inflation report showed some mixed results. While overall Consumer Price Index (CPI) inflation cooled to its lowest level in over three years (2.5%), core inflation proved to be stickier, posting a 3.2% increase, marginally higher than expected.

Once again, rents, which are a very lagging indicator, dominated the scene. Contrary to expectations, rent inflation reaccelerated slightly in August, causing core inflation to remain sticky. However, we do not see this as a cause for concern. Rents are on a downward trajectory and we think they will continue to be. There will be some months when they might tick up or down more than expected, but most likely that can be attributed to the methodology used. It is always best to focus on the trend and not panic about a single data point.

The Bureau of Labor Statistics (BLS) All Tenants Rent Rate Index is a relatively new measure introduced by the BLS to provide more timely insights into the rental market. It typically leads the official numbers by roughly one quarter. According to this measure, rents should soon resume their downward trend.

Outside of rents, things look much brighter, and there are clear signs of broadening disinflation. Median inflation continues to trend lower, suggesting that inflationary pressures are indeed easing. Additionally, with the exception of rents, most items today are already experiencing inflation below 2%.

In conclusion, the picture looks much better than the overall US inflation numbers suggest. The stickiness in core inflation can be attributed to rents, which were likely distorted by some unusual seasonal adjustment. However, their downward trend will likely resume over the course of this year, in our view. Outside of rents, we continue to see signs of broadening disinflation, and most items are now experiencing inflation below the 2% target.

Developed market sovereigns

After Chair Jerome Powell's statement at Jackson Hole "The time has come for policy to adjust", the Fed delivered and cut rates by 50 bps at its meeting in September, marking the first rate cut since March 2020. That decision to cut by a larger amount than 25 bps helped to reassure investors that the Fed would react quickly to any economic deterioration, although accompanying the larger cut was a signal of a fundamentally strong economy with no suggestion that continued 50 bps cuts were likely.

Over the month in the US, a pickup in economic data was welcome as a signal that a recession or a sharper downturn was unlikely for the time being.

We saw a rise in manufacturing ISM employment (although still below 50) and the job openings rate fell more than expected in July, to 7.7 million from a downwardly-revised 7.9 million, moving the job openings rate down to 4.6% from 4.8% prior. The Beige Book (a summary of economic conditions) points to a slowdown in economic activity and supports a story of more selective hiring. The Fed's September iteration of the Beige Book showed only three districts reporting increasing economic activity and nine reporting declining activity.

Payrolls rebounded in August (headline 142k versus 89k in July, and private 118k versus 74k) and the unemployment rate (4.2% versus 4.3%) retraced some of its prior rise with average hourly earnings increasing (+0.4% versus +0.2%) alongside a one-tenth increase in the work week.

Headline CPI came in at 0.19% on the month, which took the YoY rate down to 2.5% as expected. That's the lowest annual inflation rate since February 2021.

In the eurozone, the nomination of Michel Barnier as the new French Prime Minister is likely to reduce political uncertainty somewhat.

The European Central Bank (ECB) delivered an expected 25 bps rate cut. That rate cut took the ECB's deposit rate down to 3.50%, marking its second cut of this cycle after an initial move in June, and markets continue to anticipate further cuts over the months ahead. We also had its latest forecasts, which showed growth projections a tenth lower each year relative to June.

Industrial production fell more than expected in both Germany and France. The eurozone CPI print stayed at 2.2% and the unemployment rate ticked down to 6.4%.

In the UK, the unemployment rate moved to 4.1% versus prior 4.2% and CPI YoY remained at 2.2%. However, and as expected, Core CPI rebounded to 3.6% from 3.3% in July. Services CPI increased to 5.6%.

The Bank of England kept its rate steady at 5% during the September meeting, in line with expectations. The decision to maintain the policy rate was backed by a clear majority, with eight members voting in favour and only one member advocating for a 25 bps reduction.

Japan's export growth slowed sharply in August, rising 5.6% YoY (versus 10.6% expected), up for a ninth straight month and against a downwardly revised 10.2%. The Bank of Japan decided to keep its interest rate unchanged at the end of its first policy meeting since it raised borrowing costs in July.

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	3.8	1.2	4.0
Bunds	2.1	1.2	1.1
Gilts	4.0	0.1	-0.3

Source: Bloomberg, 30 September 2024

Investment grade credit

September saw a continuation of macroeconomic themes, with inflation continuing to soften, allowing central banks to refocus on economic growth. Headline inflation is nearing central bank targets. However, core inflation remains elevated, primarily driven by the cost of services. In the US, for instance, core goods have been deflationary every month this year, but with added pricing pressures from the services component. While the persistence of inflationary pressures in the services sector warrants attention from central banks, the monetary policy path is now much more likely to be influenced by the growth outlook instead.

On the growth front, the US labour market has shown signs of weakness, with non-farm payrolls trending lower and job openings, which are typically negatively correlated to unemployment, also weakening. The Fed addressed this backdrop by cutting interest rates by 50 bps in their September meeting, the first cut since March 2020 during the onset of the COVID-19 pandemic. Subsequent comments from Fed officials suggested that the size of this cut is likely a one-off, although continued softness in the labour market weakness could alter this stance.

In Europe, the growth outlook is deteriorating significantly. Purchasing Manager Indices, which are forward-looking indicators of economic performance, declined in September, suggesting further economic contraction ahead. Other sentiment surveys, such as the German IFO business indicators and the European Commission economic sentiment indicator, also point to an economic slowdown. The market's interpretation of the latest economic data implies that the ECB will steadily cut interest rates in upcoming meetings, reaching a policy rate of 2% by April next year.

Credit markets look to be relatively stable into year-end. Current levels of spread indicate little concern about macroeconomic developments. Global and US spreads are now trading through levels prior to the early August sell-off, induced by weak labour markets. US dollar spreads finished the month at 92 bps, with euro and sterling at 116 bps and 120 bps respectively. The small tightening was broadly consistent across sectors, however autos were a notable underperformer across all jurisdictions, likely driven by a number of issuers highlighting the slowdown in growth as a significant headwind for pertinent credit metrics.

Overall, credit market returns were positive, largely driven by interest rates moving lower.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	92	1.7	5.8
Euro IG	116	1.2	3.8
UK IG	120	0.3	2.3

Source: Bloomberg, 30 September 2024

High yield credit

September is typically a weak month for high yield markets, but thanks to the much-anticipated Fed rate cut, global high yield markets delivered one of their best September return in years. Courtesy of government bond yields, slightly tighter credit spreads plus the carry effect, the Global HY index returned 1.6% in the month. HY FRNs also fared well; despite the lack of duration, the asset class returned 0.7%, driven by its elevated carry.

HY spreads tightened further in September with current levels sitting very close to historical lows. Rating-wise, distressed segment CCCs continue to see strong gains, with many of the gains concentrated in a handful of large distressed capital structures.

Gross issuance was very strong, particularly in the US, with US$36.5 billion pricing in September, the strongest month in three years. Issuance in Europe was also strong with a gross €10.4 billion / net €3.5 billion in September. Refinancing still accounts for the majority (c.75%) of primary activity which, YTD, has been well split between BB rated and B rated names. Only 1% of YTD issuance has been CCC, as the segment still faces high refinancing costs.

Market technicals remain supportive. With all-in yields still elevated, the balance between yield buyers and spread sellers keeps the market in relative equilibrium. Importantly, the broader market continues to shrink, with issuers seeking capital from leveraged loans and private credit or being upgraded to IG. This, coupled with the income-generating nature of the asset class and low levels of new issuance, creates a supply/demand imbalance which helps contain spreads.

YTD, the global HY market has returned 8.4% which is quite exceptional in a year that started off with recession worries, elevated funding costs and steep maturity walls for many high yield issuers. Going forward, absent a major market/macroeconomic shock, the power of carry alone means the asset class could still generate reasonable returns even during a mild economic slowdown (soft landing).

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	303	1.6	8.1
Euro HY	350	1.1	7.0

Source: Bloomberg, 30 September 2024

Emerging market bonds

The local currency market saw its third consecutive month of positive returns, delivering 3.4%. Whilst YTD performance still lags the hard currency corporate and sovereign market, local currency returns are picking up pace, with EM FX finally being provided with a breathing space from a very strong USD, which is beginning to show signs of unwinding, particularly now the Fed has begun its rate-cutting cycle. Within the sub-asset class, Asia FX very much led the way in terms of performance.

Within the hard currency sovereign market, we saw another month of positive returns from all regions with Africa continuing to deliver the strongest returns YTD. Latin America outperformed Asia, which is the oppositive to what we have seen from the local currency market given the EM FX rally in Asia over the past couple of months. Spreads were broadly tighter over the month although we did see some widening in Angola and Tajikistan with spreads, interestingly, ending marginally wider in the IG space. Nonetheless, returns in the IG space were positive, as were those in high yield (1.3% and 2.4%, respectively).

In the corporate space all sectors had positive returns with little variance: the 'worst' performing sector delivered 1.1% with the 'best' returning 1.8%. Real Estate is still leading YTD returns at 15%. with that having the potential to extend even further, in our view, given the recent China stimulus.

Market

EM fundamentals continue to be robust in both the sovereign and corporate space, with the market now being provided breathing space by the US Fed. The rate cut in September was widely anticipated. However, the market was split as to whether it would be a 25 or 50 bps cut, and it was the latter. Typically, the Fed rate-cutting cycle is positive for EM debt; but with spreads being as tight as they are, the rally may be slightly dampened. For EM to continue performing well, the US would be need to achieve some form of a soft-landing, otherwise risk-off sentiment would prevail. There is also the matter of the US election taking place in November, which may also weigh on sentiment prior to the conclusion -- although so far, we have not seen much being priced into the market.

With spreads tightening over the month, there are portions of the market continuing to look very expensive, particularly the IG space in Asia. Notwithstanding this, we are still in a period of elevated yields relative to historic norms. On a forward-looking basis, we could expect to see local currency continue to perform very well, considering local currency bonds tend to deliver the strongest returns during periods of Fed rate-cutting cycles. In this regard, there could still be a decent amount of room for EM FX to run into and we note that the USD is down c. 5% over the past three months as measured by the DXY index.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	3.4	4.9
Hard currency government	365	1.8	8.6
Hard currency corporate	263	1.2	8.5

Source: Bloomberg, 30 September 2024

Currencies

The US dollar, as measured by the DXY index, was down 0.9% in September, bringing the third-quarter return to -4.9%. On a spot basis, the USD was down against all G10 countries' currencies and against those of most major emerging markets with the exception of the Argentine peso and the Russian ruble, which continued to underperform.

Broadly speaking, the strongest-performing region was Asia, with a number of currencies appreciating strongly relative to the USD. This trend has been in play for the past couple of months, and more recently it has been spurred on by stimulus in China. However, Latin American currencies were among those that benefited the most after the Fed's 'jumbo' 50bps interest rate cut.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	1.9	5.1
GBP/EUR	1.1	4.1
EUR/USD	0.8	0.9

Source: Bloomberg, 30 September 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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