M&G Investments

Fixed Income asset class overview

May 2023

It was back to excitement in May after the respite of April. There were losses in global bonds and equities, although technology stocks performed well in light of the excitement surrounding Artificial Intelligence (AI).

Month in review

Market concerns around US regional banks returned and we began the month with First Republic Bank being acquired by JPMorgan. For now, the story seems to have remained relatively confined. The credit analysts' view is that larger, high quality banks remain generally in a strong fundamental position, better regulated and better capitalised than pre-Global Financial Crisis.

US inflation dropped to 4.9% in April, continuing its downward trend. Core inflation also moderated to 5.5% YoY. Nonetheless, the Fed, ECB and Bank of England did not disappoint versus expectations, with all the banks hiking in May. Fed Chair Powell dropped the 'some additional policy firming may be appropriate' statement, which could indicate a nearing of the end of the hiking cycle, although subsequent data showed that there continues to be strength in the US economy, implying that there may be further hikes to come. In any case, the team is of the view that rates will remain in restrictive territory for longer than the pre-2024 cuts that market pricing suggests.

Sovereign bonds generally struggled in May. The big story was the US debt ceiling. Tensions rose as Republicans in the House sought concessions from the Biden administration. There was the political brinkmanship on show that we have become accustomed to, which translated into yields on T-bills rising to 5.7% as the market priced in concerns of a default. Following the agreement between Speaker McCarthy and the President, 1m T-bills rallied 50bps overnight. Following the upside surprise in April UK CPI, coming in at 8.7% rather than the expected 8.2%, gilts underperformed on the month. At least three further hikes are now being priced in.

Corporate bonds generally underperformed as a result of the increase in both rates and spreads.

AI caused much excitement in the market as demand for AI processors soared, Nvidia being the biggest winner from this – its market cap briefly touching the US$1 trillion mark. AI is in the sights of many investors and companies as integration into working patterns and the potential of regulation develop.

Developed market sovereigns

It was an eventful time for markets in May, with fresh concerns about regional banks, another rate hike from the Fed and ECB and negotiations around the US debt ceiling. Financial assets put in a weak performance over the month as a whole and developed market sovereign bonds were not an exception, except for German bunds.

Over the month in the US, the Fed delivered another 25bp hike on 3 May, thus bringing the total amount of hikes in this cycle to 500bps. Notably, it dropped the phrase in its statement that "some additional policy firming may be appropriate", and Chair Powell himself described this as a "meaningful change" in the press conference. With concerns about regional banks still prominent, the consensus view at the time was that this would be the final hike of the cycle, ahead of a pause at the next meeting in June.

However, as the month developed, it became clear that the US economy was proving more resilient than many had expected. On 5 May, the jobs report for April showed that a further +253k nonfarm payrolls had been added, and the US unemployment rate fell to a 53-year low, at just 3.39%. Then the CPI report on 10 May showed that core inflation had remained stubborn in April, and was still running at +0.41% on a monthly basis. In turn, this helped to drive growing expectations that the Fed might still deliver at least one more hike, with futures pricing in a 36% chance of a hike in June, and an 83% chance of a hike by the July meeting.

The biggest underperformer were gilts following a significant upside surprise in the UK's April CPI report, which came in at +8.7%, rather than the +8.2% expected by the consensus. That led investors to dial up the number of rate hikes expected from the Bank of England over the months ahead, with more than three further hikes now priced in.

Past performance is not a guide to future performance.

Government bond total returns

	10-year yield %	Total return % (1m)	Total return % (ytd)
Treasuries	3.6	-1.2	2.4
Bunds	2.3	0.3	1.9
Gilts	4.2	-3.4	-3.1

Source: Bloomberg, 31 May 2023

Inflation

US inflation dropped to 4.9% in April, continuing its disinflationary trend. Core inflation also moderated to 5.5% YoY. Overall this was another good report with three key very positive themes worth highlighting:

- **Inflationary pressures are easing**: the core of the distribution is moving to the left, meaning it is not just a few items that are pushing overall inflation lower, but rather it is a broader trend. An increasing number of categories are coming off the boil and starting to move in the right direction. This is particularly evident when you look at median CPI, which focuses on the core of the distribution, avoiding the noise caused by the outliers.
- **Rents seem to have peaked**: this report confirmed the deceleration in rents. This is important as rents represent by far the biggest component of the inflation basket and as a result are its main driver. If they go down, inflation will likely go down too. It is still unclear how low rents can actually go given the increase in wages. However, the softness in the housing market will likely keep them on the right trajectory for some time. House prices usually lead rents by about 18 months.
- **Powell's preferred indicator moves lower: "core service ex-shelter" declined further**. This is the most important indicator for Powell as this is where we could see a wage-price spiral. Most of the items in this sub-category are heavily impacted by wages. So far it seems the wage-price feedback is weakening and this is also really good news as it reinforces the idea that the Fed is done hiking, at least for now.

Elsewhere, UK CPI fell to 8.7% but remains relatively elevated. In particular, sticky components of inflation remain persistent. Euro CPI continues to fall, currently sitting at 6.1%.

Investment grade credit

Uncertainty around the US debt ceiling, coupled with excitement around AI, resulted in a fairly volatile month for bonds.

The Global Investment Grade index ended the month lower as a result of an increase in both rates and spreads. The Global Investment Grade Index is currently trading with a spread of 150bp, up marginally compared to the previous month and relatively unchanged for the year. Overall yields remain historically high. Currently, the EUR IG index offers a yield of 4.2%, the GBP IG index has a yield of 6.2%, while the US market is yielding 5.5%.

They key underperformer this month has been the UK market where rates increased on the back of a higher-than-expected inflation. At the same time, spreads remain generally under pressure due to quantitative tightening (QT) operations conducted by the Bank of England. This is creating some very interesting opportunities in this market, particularly as QT is now coming to an end leaving the GBP IG market with far lower supply of bonds, while demand will likely stay stable.

Going forward

The macroeconomic picture remains very bifurcated. From one side, growth remains low or even negative. Germany has now posted two consecutive quarters of negative real GDP, while the US has experienced negative growth (calculated using the average between GDP and GDI) in four out of the last five quarters. On the other hand, the labour market remains historically tight and this in turn continues to support consumption.

As long as the labour market remains stable, the overall economy should continue to carry along with no actual recession and this is clearly good for credit as it limits the risk of defaults. The risk, however, is that central banks overtighten without realising that inflation is falling more than they initially thought. Higher real rates together with tighter fiscal policy could finally impact the labour market and push the economy into a recession. However, if that were to happen, investment grade investors should benefit from the duration component of their investments as rates would most likely start to fall. In addition, investment grade companies tend to be more resilient to economic downturns and are unlikely to experience many defaults.

Finally, the yield provided to investment grade investors should provide a good cushion against future uncertainty, while the likely reduction in new issues (ie, lower supply) should provide a positive technical factor supporting spreads.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	142	-1.3	2.9
Euro IG	169	0.2	2.5
UK IG	175	-2.4	0.2

Source: Bloomberg, 31 May 2023

High yield credit

High yield markets were affected once again by interest rate volatility which dragged on returns. The Global HY index delivered a -0.58% total return, outperforming IG assets which were more affected by the US Treasury sell-off. Regionally, Euro HY outperformed (+0.6%) thanks to lower rate pressures, while EM HY lagged (-1.2%).

Rating quality performance was somewhat mixed, with single Bs outperforming in Europe, and lower quality CCCs doing better in the US. Sector performance was mixed, with telco, healthcare and banking still lagging other spaces. Conversely, Super Retail had a strong month driven by the strong performance of Rakuten Bank (after a large IPO) and Carvana (a strong set of results from the automobile retailer)

Primary markets remained active in May, especially in Europe. We feel inclined to participate in new issues given most credits coming to market are healthy and pricing is attractive. The FRN market also saw new deals and refinancing activity.

Current views

- We remain broadly neutral on valuations, albeit with a preference for higher quality companies and non-cyclical sectors. We continue to be underweight lower quality CCCs. We are also underweight in real estate, although we may look to add exposure here if we see further weakness
- We believe technical elements (supply/demand imbalance, attractive all-in yields) remain supportive and this should help contain spreads.
- Fundamentals are still generally supportive - earnings have been pretty decent and margins robust as companies have been able to pass through higher prices.
- We expect a more shallow default cycle versus what is currently being priced in by markets.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	469	-0.9	3.7
Euro HY	494	0.6	3.9

Source: Bloomberg, 31 May 2023

Emerging market bonds

Performance of emerging market bonds was overall lacklustre in May, finishing the month in slightly negative territory alongside many other fixed income, equity and commodity asset classes. While in April global headline events explained a large portion of EMD returns, May seemed to respond to more idiosyncratic factors and allowed for more differentiation within emerging market bonds, especially in the local currency space.

After being the outperformer so far this year. EM local currency bonds gave back some of their relative returns in May, with the JPM GBI EM index returning -1.6%. Hard currency sovereigns and hard currency corporates both returned -0.6% for the month.

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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	4.4
Hard currency government	492	-0.6	1.8
Hard currency corporate	378	-0.6	2.5

Source: Bloomberg, 31 May 2023

Currencies

May was a month of USD appreciation following the stronger-than-expected core inflation print and further robustness in the labour market. This sent rate expectations up again, signalling that we may not have reached the end of the hiking cycle just yet. USD strength came at the expense of the EUR, which was down 3% versus USD.

GBP was off by around 1% versus the USD as we saw further evidence of sticky and sky-high inflation. Three more rate hikes have been priced into the UK futures market, compared to just one more in the US and possibly two more in Europe. Getting to grips with inflation appears to be the number one priority for all three central banks, even if this comes at the expense of economic growth.

EM local currencies suffered on the back of the USD strength, with the EM local index falling by around 1.25%. Overall, it was a mixed bag with the main LatAm currencies (COP MNX and PEN) holding up well, while many Asian currencies were weaker (INR MYR and TWD). The South African rand (ZAR) was the standout underperformer this month as the US accused the country of funding Russian arms deals. The Turkish lira (TRY) also reacted negatively to the re-election of President Erdogan.

The NOK and SEK were also weaker in May. Sweden and Norway are struggling on growth differentials versus the eurozone and also have large amounts of floating rate personal and corporate debt, which means monetary policy passes through very quickly to foreign exchange rates. Higher rates, higher inflation and weaker currencies are hurting imports and consumer prices, while house prices are also coming down in value. Norway seems more robust than Sweden as a higher savings ratio exists, but even so both currencies are having a shocker right now.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-1.0	3.0
GBP/EUR	2.1	3.0
EUR/USD	-3.0	-0.1

Source: Bloomberg, 31 May 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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