Fixed Income asset class overview

June 2023

M&G Investments

June was a less eventful month for financial markets than May, with less volatility and tightening credit spreads. Rates did move higher following sticky inflation prints, hawkish central bank sentiment and data that continue to look generally strong despite some uncertainty. Risk assets were generally well behaved, however, with spread tightening and income making up for the rates sell-off within most corporate debt asset classes.

Month in review

While the Fed paused its rate hikes, it kept sentiment hawkish and signalled further rate hikes to come. The European Central Bank (ECB) hiked in line with expectations, while the Bank of England (BoE) effected a higher-than-expected hike of 50bps after UK inflation continued to surprise to the upside. UK inflation remains the highest in the G7.

In credit, investment grade spreads continued to grind tighter, with cyclicals generally outperforming. Despite rising bond yields, carry and spread tightening meant the global IG index posted positive returns on the month. Overall yields remain historically high. Currently the EUR IG index offers a yield of 4.4%, the GBP IG index has a yield of 6.6%, while the US market is at 5.6%. High yield (HY) also delivered a strong total return performance in June, with YTD performance in global HY standing at 5.4%.

In emerging markets, June saw the 2023 rebound in the EMD asset class continue, with positive returns posted across all segments (hard and local currency sovereigns, and hard currency corporates). This was helped by broad positive sentiment in the asset class during the month.

Developed market sovereigns

In June we saw rates moving aggressively higher following sticky inflation prints, hawkish central bank speech and economic data sending mixed signals but holding up generally well. The Fed paused in June for the first time in over a year, although their dot plot signalled two further rate hikes for the rest of 2023. Meanwhile the ECB hiked by 25bps in June, taking its deposit rate up to 3.5%. Upside inflation surprises in the UK continue, where the CPI inflation rate is the highest in the G7. This led to an unexpected 50bp hike from the BoE in the month.

Over the month in the US, the ISM services for May came in at 50.3 (vs. 52.4 expected), so just above the 50-mark that separates expansion from contraction and the second lowest since the pandemic. Core CPI has still been stubbornly persistent, with mid-month seeing another +0.4% monthly rise. That's the sixth consecutive month where core CPI has been at least +0.4%, and it meant that the year-on-year rate only fell back to +5.3% (vs. +5.2% expected).

The eurozone continues to weaken (although slowly) with activity data slowing and downside surprises broadening (eg, PMIs, IFO survey). This can be seen acutely across manufacturing areas, but now also in services. Suffice to say, we are now seeing the effects from tighter monetary conditions in both financing conditions (loan volumes are down, lending rates are up, and standards are tighter) and economic activity. Inflation continues to slow, which is encouraging, yet core inflation still remains stubbornly high with wage growth strong.

Ultimately, this keeps the ECB committed to tightening (and to its hawkish messaging) which has led to some aggressive flattening in European government bond curves. The bund 2s10s has now flattened to record lows of -0.80%.

Past performance is not a guide to future performance.

Government bond total returns

	10-year yield %	Total return % (1m)	Total return % (ytd)
Treasuries	3.8	-0.7	1.6
Bunds	2.4	-0.7	1.2
Gilts	4.4	-0.4	-3.5

Source: Bloomberg, 30 June 2023

Inflation

US inflation was broadly in line with expectations, declining to a 4.0% annual rate in May. This is the lowest level in two years. Core inflation (which excludes energy and food) also edged lower to 5.3%. This reinforced the case for a pause in rate hikes, although sentiment from the Fed remains on the hawkish side. While it is true that inflation is going in the right direction, the labour market remains tight and risky assets are rising. Powell is keeping the door open to further rate hikes if required.

Back to the inflation report, the story continues to be about disinflation. Similar to the previous month, inflationary pressures are easing, while rents and wage-sensitive sectors keep moving in the right direction. The question, though, is how fast these inflation components fall from here. Given the tight labour market and the undersupply of housing, disinflation in these components might not be as fast as some are predicting. As a result, the road to 2% inflation might prove more difficult than what is currently priced in.

In the UK, the latest inflation report shocked the market as it came in higher than expected. This will add further pressure on the BoE to maintain a hawkish stance. The BoE hiked 50bps, surprising markets which broadly expected a 25bp rise. The UK seems to be facing greater risk of stagflation, albeit money supply is falling and sterling has been strengthening recently which should help reduce pressure on import prices. The UK currently has the highest CPI of the G7.

Turning to Europe, the German PPI (Producer Price Index) dropped to 1% year on year, suggesting inflation for producers is now back to normal. This is important as PPI usually serves as a leading indicator for the CPI inflation numbers. Clearly, there are some compositional differences between CPI and PPI, but nevertheless this reading increases the chances that inflationary pressures could be past their peak. However, for the time being the ECB is pushing ahead with its hiking agenda, increasing rates in line with expectations during the month.

Investment grade credit

A less eventful month for financial markets resulted in diminishing volatility and tightening credit spreads. The Global Investment Grade index saw spreads tightening by 10bps in June, from 150bps to 140bps.

Cyclicals generally outperformed, driven by the sectors which have been under the spotlight in recent months (such as financials and real estate). Physical secondary markets generally lagged as a result of supply headwinds – companies are still rushing to get deals done before the summer lull.

Across regions, the UK market continues to underperform driven by its duration component as gilts remain under pressure. However, from a pure credit point of view, the sterling corporate bond market is generally outperforming, in part supported by the end of the quantitative tightening programme conducted by the BoE.

Overall yields remain historically high. Currently, the EUR IG index offers a yield of 4.4%, the GBP IG index has a yield of 6.6%, while the US market is at 5.6%.

Going forward

Despite the sharp rise in interest rates, economies generally continue to display robust growth driven by a solid labour market. Consumers are spending and there are signs that the housing market is rebounding. Meanwhile, inflation is generally moving in the right direction and companies continue to report decent earnings.

A recession, while still possible, doesn't seem imminent at this stage and this is good news for credit as it lowers the probability of defaults. To be clear, defaults will rise, although the number of companies going under might not be as bad as investors expect.

Furthermore, technical factors could support spreads in the coming months. Bond volatility (as calculated by the MOVE index) remains historically high, although it will likely decline as we approach the end of the tightening cycle.

This is important as bond volatility is usually very correlated with spreads: a low volatility environment makes investors more willing to take on credit risk. Currently, there are many investors underweight risk and if we do get a reduction in volatility, without a recession, plenty of investors will likely jump back in the credit market driving spreads lower.

Finally, the overall yield available on investment grade bonds remains historically attractive, while also providing investors with an implicit diversification benefit thanks to the combination of duration and credit risk, which historically move in opposite directions.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	130	0.3	3.2
Euro IG	161	-0.4	2.0
UK IG	175	-1.2	-1.0

Source: Bloomberg, 30 June 2023

High yield credit

High yield markets closed June with a bang, delivering around 140bps in total returns – the second strongest month year to date. The Global HY index has now returned 5.4% year to date – an impressive result given all the interest rate volatility, and concerns over late cycle dynamics and rising interest costs.

Regionally, Euro HY lagged the US and emerging markets given ongoing rate volatility. A fair amount of inversion in the 5-10yr part of the European sovereign curve continued to pressure HY assets given their shorter duration profile. There was also some stock-specific news (such as the Casino Guichard restructuring) which weighed heavily on the European index.

Performance was led by lower quality bonds, with US CCCs outperforming in June (+3.2%). Most sectors were up last month, led by consumer cyclical and utilities, while pharma, supermarkets, food & beverage and chemicals lagged on a relative basis. HY telcos names also saw a recovery after a challenging May.

Primary markets remained active in June. We feel inclined to participate in new issues given most credits coming to market are healthy and pricing is attractive. The FRN primary market also saw a couple of new deals relating to re-financing activity.

Current views

- We are generally neutral on valuations after recent spread moves
- Technical elements (supply/demand imbalance, attractive all-in yields) should provide further support to valuations
- Fundamentals are generally supportive for now, although there is a need to avoid issuer-specific blow-ups. Expect a more shallow default cycle vs what is priced in by markets
- We are generally concentrating on defensive trades (eg, non-cyclicals over cyclicals, and higher credit quality)
- We are closing out our overweight in Europe after recent outperformance to rebalance towards US.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	405	1.6	5.4
Euro HY	458	0.5	4.4

Source: Bloomberg, 30 June 2023

Emerging market bonds

June saw an extension of emerging market debt (EMD) rebound during 2023, posting positive returns across all segments. The general market trend was for riskier assets to perform well, but EMD, and EMD high yield (HY) in particular, benefited the most from broad positive sentiment but also several idiosyncratic stories.

The Federal Reserve paused its rate hiking cycle in June but set a more hawkish tone for the remainder of the year, signalling to markets that further rate hikes should be expected during 2023. Whilst inflation in the US has begun to subside, the labour market remains tight suggesting that the Fed still has room to manoeuvre and that the impact of the rate hikes is yet to be fully felt by the economy. Historically, a lag of five to six quarters could be expected before the impact manifests itself but given the velocity of this hiking cycle, the norms should not be seen as a reliable guide.

Hard currency (HC) EMD continues to be weighed down by its naturally longer duration, despite rates remaining the same, but benefited markedly by the HY, frontier, and distressed names within the index which really drove performance in June.

Supporting the point on EMD HY seeing the strongest returns within EMD in June, the HY/frontier-centric JP Morgan NEXGEM index returned 5.0% during the month bringing the YTD return to 9.7% (again, leading all EMD segments).

Given the drawdown during 2022 where EMD risk assets sold off extensively, the subsequent rebound isn't particularly surprising. However, performance has been driven somewhat by country-specific stories, with Zambia, Sri Lanka, and Pakistan all performing well during June. All three were previously in distressed territory following defaults but have recently been buoyed by support provided by the IMF (Pakistan, Zambia), and individual debt optimisation plans (Sri Lanka). Other notable performers in the sovereign space were Argentina and El Salvador.

In the local currency (LC) space, returns were supported by the continuation of FX performing positively year to date. Whilst there was no overall USD trend in June, a basket of EM FX performed well against the dollar. Notable performers, in total return terms, were the Argentine peso, Colombian peso, Brazilian real, and the South African rand. Not far off the pace was the Mexican peso, meaning the LATAM region dominated the positive returns seen across EM FX. Some of the worst-performing currencies were the Malaysian ringgit, Taiwanese dollar, Thai baht and Chinese renminbi.

In part, the large divergence between the LATAM and Asia regions can be explained by the much lower levels of inflation, and rate hikes, seen in the latter. The Turkish lira was by far the worst-performing currency returning -19.36%. Whilst fundamental prospects have improved following the election and subsequent Cabinet and Central Bank changes, monetary policy remains highly unorthodox with a disappointingly small rate hike causing the lira to sell off further.

EMD corporates returned a more modest return relative to its sovereign counterparts, with tightening spreads driving most of the performance in June. Whilst the spread return was positive, the duration return was negative. In a similar fashion to HC and LC, the HY portion of the market dominated the overall level of performance. Cyclical sectors outperformed non-cyclical with the oil & gas, transportation, and manufacturing & materials sectors leading the way.

Unsurprisingly, financials and utilities underperformed in June during the 'risk-on' environment. On a regional basis, the investment grade (IG) heavy Asia and Middle East regions underperformed; conversely, LATAM was the strongest performer.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	3.3	7.8
Hard currency government	444	2.2	4.1
Hard currency corporate	350	1.1	3.6

Source: Bloomberg, 30 June 2023

Currencies

June delivered some mixed returns for hard currency. Largely speaking, the US dollar was weaker on the month as interest rate differentials are squeezed further. The euro has been rangebound with the US dollar. Rates suggest that the euro will weaken and equity markets suggest the euro is a buy. This pair is a bit of a tug-of-war right now. In Europe we now have falling energy prices, disinflationary trends and potentially a much less hawkish Fed. On balance, this is the opposite of what drove USD/EUR strength in 2022 and H1, so the combination would naturally point towards a stronger euro instead.

Swedish krona and Norwegian krone have had a tough run year to date – with housing markets looking shaky, central banks hiking into crisis and PMIs unlikely to continue the one-month surprise June delivered. Mid-month Norway did surprise the markets with a bumper 50bps hike at the end of June bolstering the currency from a low base. The central bank has come under recent pressure to protect the krona, which has been weak for the last 12 months. However, with fast pass-through to the real economy, higher rates, despite a stronger currency, is likely to hurt going forward.

Sterling was the strongest G10 currency in Q2. Sterling strength fuelled by yet more hot inflation data, another rate hike and some hawkish narrative by the BoE was probably overdone. GBP/USD reached a high of just over 1.28, the strongest level since April 2022. On the flipside, with this came a big spike in fixed-rate mortgages, with 6% breached; this is the highest since 2008. With rapid pass-through in the UK, and despite a robust labour market, UK citizens are likely to feel the pinch at the consumer level over H2.

In other G10, the Japanese yen had a poor month again mainly because yield curve control (YCC) isn't looking to be lifted anytime soon. Japan is and is becoming more and more a global outlier and thus the yen looks extremely cheap.

EM FX on the back of a slightly weaker US dollar performed well in June. And with generally higher inflation, getting ahead in the hiking cycle (and many done and into rate-cutting territory), Latin America fared better than Asia this month. Year to date, local currency rates and FX deliver reasonable returns vs their developed market counterparts. South Africa rand rallied on the back of a very bad month in May. On the flipside, a disappointing rate hike in Turkey caused the lira to roll off further. The rouble also has another weak month following a mini coup, in fact the only currency to weaken vs the Russian currency was the Turkish lira.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	2.1	5.1
GBP/EUR	0.0	3.0
EUR/USD	2.1	1.9

Source: Bloomberg, 30 June 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.

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