Fixed Income asset class overview

September 2024 (Data as at 31 of August 2024)

August is often regarded as a quieter month – a brief pause before the year's final sprint. This year, any hopes of a late summer lull quickly faded as weak US economic data stoked fears of an impending slowdown. The catalyst was a disappointing US jobs report, showing softer-than-expected nonfarm payrolls and a rise in the unemployment rate.

Month in review

The month had a tumultuous start, with a sharp spike in volatility on the back of underwhelming economic data out of the US. US nonfarm payrolls increased by 114,000 in July, versus a consensus of 175,000. This was combined with a rise in the unemployment rate to 4.3%, triggering the so-called 'Sahm Rule' indicator, which suggests that a recession is underway when the three-month average unemployment rate rises by 0.5% from its lowest point in the past year.

The jobs report came shortly after a Bank of Japan (BoJ) interest rate hike, which had hawkish elements and sparked an unwinding in the yen carry trade and a sharp sell-off in Japanese markets. This saw the Topix fall by over 12% on 5 August, its worst day since the crash in 1987. In addition, the VIX, a measure of US equity market volatility, peaked at 66 points, its highest intraday level since March 2020.

But calm swiftly returned, helped by more positive data on the US economy with the US core consumer price index (CPI) showing core inflation falling to 3.2%, its lowest level since April 2021. This, combined with a dovish message from Federal Reserve (Fed) Chair Jerome Powell, who said "the time has come for policy to adjust" at the Jackson Hole conference, helped to solidify expectations that interest rate cuts from the Fed were finally on the horizon. According to futures market, a 25 basis-point (bps) reduction in interest rates is more likely, though a larger 50 bps cut is also being priced in with a 41% probability (as at 6 September).

As investors priced in more aggressive rate cuts, it was a strong month for sovereign bonds, and US Treasuries in particular. US Treasuries were up 1.3% over the month, with euro sovereigns up 0.4%.

Within investment grade (IG) markets, despite spreads widening slightly (1 bp globally), lower government bond yields led to positive returns for credit markets. The global corporate bond market returned 1.1%, led by US corporate bonds returning 1.5%, and euro and sterling markets both up 0.3%.

Looking ahead, with inflation trending downwards and central banks signalling more rate cuts, we believe the macroeconomic environment appears supportive for fixed income, offering compelling yields despite historically tight credit spreads.

Despite the initial turbulence, August resulted in a positive month for high yield (HY) markets driven by duration (as investors priced in more rate cuts) and tighter spreads. The Global HY index returned 1.5%, in US dollar terms, with US HY outperforming at 1.6% and European HY at 1.2%. HY floating rate notes (FRNs) also performed well, driven by carry/coupon.

Within emerging markets (EM), the local currency government bond market was the strongest performing asset class, returning 3.1% in August as the US dollar weakened. Hard currency sovereigns returned 2.3%, while corporate bonds returned 1.7%. Regional performance was led by Asia, followed by the Middle East, with Latin America lagging due to weaker performance in Mexico and Brazil.

Inflation

Inflation around the world continues to trend in the right direction and is generally approaching central banks' targets. In the UK and eurozone, headline inflation is currently at 2.2%, while in the US it has recently moved below 3%.

Looking more closely at the US market, CPI inflation recently came in at 2.9% versus the 3% expected. This is the first time in over three years that the year-on-year growth in inflation is below 3%. Core inflation, which excludes the most volatile items, was also slightly below expectations and is now at 3.2%, down from the 3.3% recorded the previous month.

The key themes remain very much unchanged from previous months: there is ongoing deflation in goods items, while services inflation continues to trend lower, driven by a normalisation in rents. It is unlikely that goods will remain so deep in deflation, and we should expect some reacceleration in this space, particularly as the US dollar, a key input cost for goods, is currently falling. However, rents will likely continue to trend lower, and given that rents represent 36% of the inflation basket, they will easily outpace any potential bad news coming from goods inflation. Moreover, wage inflation appears to be slowing, which could contribute to further downward pressure on services inflation.

The bottom line is that inflation is still moving in the right direction. While core goods could start to provide some upward pressure to overall inflation, services inflation, which has a much larger weight in the inflation basket, will likely continue to trend downwards, supported by a normalisation in both rents and wages.

Developed market sovereigns

A weak US jobs report released in early August raised fears that the US could be heading into a downturn. That interacted with an unwinding of the yen carry trade, and there was a massive slump in Japanese markets and a dramatic spike in volatility. Calm returned after better data and a dovish message from Fed Chair Powell at Jackson Hole helped to reassure investors.

As for the US jobs report, a sizable deceleration in payrolls and the fourth consecutive increase in the unemployment rate triggered the Sahm Rule (see our ' Bond Vigilantes' blog on the topic here). Subsequently, the number of Fed interest rate cuts priced in by year-end rapidly jumped a stunning 30.5 bps to 116 bps, bringing the expected rate for December to its lowest since early February.

The jobless claims was the first main piece of US labour market data after nonfarm payrolls. In contrast to the weak payrolls, initial claims fell below expectations, coming in at 233,000 (versus 240,000 expected), a decline of 17,000 from the previous release, their largest drop since September. Reduced fears over the US economy saw the number of Fed rate cuts expected by year-end fall 6.6 bps to 104 bps. This drove two-year government bond yields back above 4%. (Bond yield and prices move in opposite directions).

The US CPI print was just about good enough to cement the disinflation narrative that the producer price index (PPI) helped encourage. A dovish speech from Chair Powell at Jackson Hole kept the door open to a 50 bps rate cut in September.

In the eurozone, German June factory orders rose 3.9% month-on-month (versus 0.5% expected), the first solid data point for German industry for some time, and the first positive print for this indicator since December.

Eurozone purchasing managers indices (PMIs) were notably stronger than expected, with the composite PMI up to 51.2 (versus 50.1 expected).

In the UK, the Bank of England cut the policy rate by 25 bps to 5.0%, in a 5-4 decision, in line with expectations. However, policymakers were marginally more hawkish at the press conference, which could suggest a gradual pace of easing.

UK CPI data saw headline inflation rise 2.2% year-on-year, below the 2.3% expected, while core inflation rose 3.3% (versus 3.4% expected). Services inflation dramatically fell back, from 5.7% in June to 5.2% in July (versus 5.5% expected), well below consensus expectations.

In Japan, the BoJ's Summary of Opinions from the Monetary Policy Meeting on 30 and 31 July showed that members of the central bank discussed further rate hikes, with one member of the policy board stating that interest rates would have to reach around 1% to attain a level neutral to the economy.

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	1.3	2.7
Bunds	2.3	0.4	-0.1
Gilts	4.0	0.5	-0.4

Source: Bloomberg, 31 August 2024

Investment grade credit

Overall, government bond yields moved materially lower in August with the expectation that central banks (and especially the Fed) would need to reduce interest rates faster and in greater size than was previously planned, to fend off the economic weakness that the most recent data points were implying.

Contained within the short episode was a rather compelling endorsement of credit markets, as the move wider in spreads was relatively contained.

Overall, global IG spreads widened by 1 bp over the month, led by weaker performance in euro and sterling bonds which were 5 bps wider. Spreads on the US dollar IG market tightened slightly. However, despite the slight overall weakness in spreads, it was a positive month for credit markets given the move lower in government bond yields. The global IG market returned 1.1%, with the US market returning 1.5%, and both the euro and sterling markets returning 0.3%. The global investment grade index closed the month with a yield of 4.6%, a compelling level, in our view, relative to history.

Going forward:

Despite the market volatility earlier in the month, markets have been somewhat reassured with subsequent data releases. Globally, inflation has continued to trend in the right direction: for instance, the US core inflation has fallen to 3.2% – the lowest since April 2021. Rhetoric from central banks remains supportive for further monetary easing. At the Jackson Hole Economic Symposium, bond markets welcomed comments in Fed Chair Powell's speech such as "we do not seek or welcome further cooling in labour market conditions" and "the time has come for policy to adjust".

At the end of August, the market was pricing in four cuts from the Fed by year-end. Given there are only three policy decisions left, that implies an unusual 0.5 percentage point cut is on the horizon. Elsewhere, the market expects the European Central Bank to carry out a further 2.5 cuts and the Bank of England 1.5 cuts by year-end.

The macroeconomic backdrop is positive for fixed income, in our view, save for any significant inflationary shocks which could potentially derail central banks from their path of monetary easing. Credit spreads are not necessarily attractive from a historical perspective, as they reflect solid credit fundamentals and a supportive policy backdrop. However, as is typical in the IG universe, we believe investors are being well compensated for default risk. The all-in yield on offer remains compelling, in our opinion.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	96	1.5	4.0
Euro IG	115	0.3	2.6
UK IG	120	0.3	1.9

Source: Bloomberg, 31 August 2024

High yield credit

Despite some initial market turbulence, August resulted in a positive month for high yield markets driven by both duration (as investors priced in more rate cuts) and tighter spreads. The Global HY market returned 1.5% in dollar terms during the month, with most HY regions performing similarly. US HY saw 1.6% returns, mostly benefiting from strong US Treasury performance, whilst European HY delivered 1.2%, benefiting from greater spread compression. HY FRNs fared well and delivered a positive return mostly driven by carry/coupon.

Current views

After a brief period of volatility at the beginning of August, spreads have retraced and are not especially compelling at the moment. EU HY spreads remain wide of US levels but close to historic ranges, and potentially overvalued should the European growth outlook disappoint.

While spreads may be tight, all-in yields are relatively attractive, in our view, creating a balance between sellers of spread and buyers of yield, suggesting the market will remain in relative equilibrium barring any macroeconomic disruption or event.

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 could help contain spreads.

While there are indications of US growth slowing, we are not anticipating a recession in the intermediate term. We also expect anticipated rate cuts to be supportive for high yield issuers and markets. We believe US growth could outperform that in Europe in the intermediate term.

BB and B spreads have compressed and are trading inside historical averages, limiting attractive relative value opportunities. CCCs have outperformed during the summer and while spreads are wide of historic averages, they have compressed notably, reducing the relative value opportunities in the CCC rating band that existed at the beginning of the summer. Our current preferred sectors include energy, healthcare, and non-discretionary consumer goods. We remain cautious on cable, telecommunications and real estate.

Primary activity in both the US and Europe is presently in a summer lull, but we anticipate markets to reopen after US Labor Day (2 September). We expect supply to be moderately lower than historic levels and that demand is more than sufficient to absorb new supply. Even with moderating growth, we believe there is the potential for the asset class to generate reasonable returns in 2024, possibly in 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	317	1.6	6.3
Euro HY	353	1.2	5.8

Source: Bloomberg, 31 August 2024

Emerging market bonds

For the first time this year the local currency market was the strongest-performing asset class within the EM debt universe. A significant part of this was driven by a weakening US dollar, which fell 2.3% over the month. While we saw some spread widening at the beginning of the month, with markets spooked by the BoJ's interest rate hike and US data, by the end of the month spreads were broadly tighter.

The local currency market followed up July's marginal positive return with a universe-leading 3.1% in August. While year-to-date 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 period of breathing space from a very strong USD which is now beginning to show signs of unwinding.

In terms of regions, Asia very much led the way in terms of performance followed by the Middle East, with Latin America delivering a marginally negative return, which was led by Mexico and Brazil.

The hard currency market was slightly more uniform in terms of regional returns, with all regions delivering a positive return. In contrast to the local currency market, Latin America outperformed Asia and all other regions despite a fairly material widening in Venezuelan spreads.

The investment grade portion of the market materially outperformed the high yield portion over the month (2.4% and 2.2%, respectively). Most countries saw spreads tighten over the month led by Ghana and Tunisia, although there was a notable widening in the likes of Ethiopia and Sri Lanka, both of which are facing pressure in restructuring existing debt.

In the corporate space, all sectors delivered positive returns with pulp & paper and oil & gas leading the way. Real estate continued to perform well but in August lagged the pace set in previous months.

EM fundamentals continue to be robust in both the sovereign and corporate space; we do not see much changing in this regard for the rest of the year given much of the market will be provided breathing space once the Fed begins its cutting cycle.

In this regard, the signs are certainly there for this to begin in the near term. 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 debt continue to perform very well considering local currency bonds tend to deliver the strongest returns during periods of Fed-cutting cycles. In this regard, and given the extent of USD strengthening year to date, there could still be a decent amount of room for EM FX to run into.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	3.1	1.5
Hard currency government	393	2.3	6.7
Hard currency corporate	269	1.7	7.2

Source: Bloomberg, 31 August 2024

Currencies

It was the worst month for the US dollar since November 2023 with the dollar index down 2.3% in August. While there were some notable exceptions in major world currencies, all G10 currencies strengthened versus the dollar with the main laggards being driven by fairly idiosyncratic factors.

The expectations for a weaker dollar should continue into the rest of the year, with expected Fed rate cuts driving much of this sentiment. The Japanese yen extended its strengthening run versus the dollar into another month, although year-to-date performance is still well within the red at 3.9%. Broadly speaking, most Asia FX rallied off the back of moves in the yen.

In contrast, and for a somewhat related reason, the Mexican peso was the worst-performing currency, falling 4.4% in August. This was in part due to the fallout of the great carry trade unwind at the beginning of the month, which saw investors reduce their long peso positions, predicated on cheap borrowing in yen which had been recently threatened by the BoJ's rising rates. There is also the continued pressure of judicial reforms following Claudia Scheinbaum's presidential victory with markets continuing to be worried that the strength of her party's majority may lead to market unfriendly policies being pushed through congress with ease.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	2.1	3.1
GBP/EUR	0.1	3.0
EUR/USD	2.1	0.1

Source: Bloomberg, 31 August 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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