Fixed Income Briefing

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Franck Dixmier
Global CIO
Fixed Income

Time to turn more tactical as bond market outlook gets messier

September's outsized sell-off in UK government debt and the Bank of England's gilt purchases that followed can be seen as highly idiosyncratic – both Britain's rather unorthodox debt-funded tax cuts and structurally poor liquidity conditions in the gilt market. At a more general level, though, the event helped propel "financial stability" among the ranks of "sticky inflation" and "deep recession" as yet another tail risk to contend with. With that, the outlook for bonds just got messier. To declutter that outlook and make it investable, it helps to think through the shape of government bond yield curves.

Many of those yield curves are flat to inverted. One can buy short-maturity bonds and lock in yield income as high as, or even higher than, what longer-maturity debt offers. Yield curves can invert even more from here and have done so in past crises. If terminal policy rates end up higher than markets expect, the price of short-duration bonds can drop further. That is less of a worry for patient investors since the market value of those bonds should recover fully to their face (pull-to-par) value on a not-too-distant maturity date.

Buying shorter-duration bonds is not an argument for outright bets against longer-duration debt. Yes, there is hardly any term premium left to compensate for holding debt further into the future. But why are so many yield curves not re-steepening? For one, inflation is still running hot and the spectre of more rate hikes to cool it down is keeping short-term yields from falling. Even if inflation starts declining and a deep recession takes hold, duration could be the main beneficiary from flight to safety. The more policy-sensitive front end of the curve may need to stay higher for longer since it would take inflation quite a while to average down to central bank targets.

At the same time, yield curve flattener and inversion trades are not a sure thing either. More inflation shocks could cause the long end of curves to spike too. We think some markets are underestimating the probability that central banks will have to hike rates by much more to achieve price stability – particularly in the euro area where fiscal stimulus measures risk accentuating inflationary pressures. Then there's quantitative tightening to consider. If central banks go ahead and accelerate the run-off of their bond holdings, liquidity conditions could turn sour and longer-dated bonds might not behave as expected in a flight-to-safety scenario.

The gilts market turmoil has raised another, more unorthodox, possibility. While continuing to hike short-term rates, central banks may have to delay quantitative tightening to restore liquidity at the long end of the curve. The US Federal Reserve and the European Central Bank should have more firepower than the Bank of England to pull off such a policy coup. They might argue that bond purchases in that context do not necessarily encourage lending and spending, so they should not be seen as inflationary. Bond and currency markets may beg to differ.

Given the outsized bond volatility and inherent macro uncertainty at this juncture of the rates and credit cycle, this is not a great time to aggressively increase portfolio beta in our view. We believe bond investors should consider more tactical and relative-value positioning, seeking to profit incrementally from cross-country and cross-asset spread moves across the yield-curve spectrum.

Allianz Global Investors

Fixed-income asset allocation views in summary

Core rates	Country	Focus on cross-market spread trades, eg. favour US, Canada, New Zealand over Germany, Italy, Japan
	Duration	Underweight headline duration, less conviction in large directional positions given outsized yield volatility
	Yield curve	Scope for flatter / more inverted curves in the euro area and US, though more limited given recent moves
	Inflation	Overweight euro area, ready to reduce exposure when inflationary pressures ease or are better priced in
	Currency	Bias for USD strength but risks becoming more symmetric, EMs vulnerable as financial conditions tighten
Corporate credit	Investment grade	Historical analysis suggests 3 months into a recession provides more favourable entry points to add risk
	High yield	Heavily underweight CCC and Asia, overall underweight beta reduced gradually via higher-quality names
	Hybrids	Stay cautious on convertibles despite steep discounts, floating-rate preferreds can help dampen rates risk
	Securitised	Spread over corporates less attractive now, prefer higher-rated tranches where banks retain some risk
	Region	US high-yield spreads look more appealing than euro spreads, vice versa for investment-grade spreads
	Sector	Cautious on energy-heavy and cyclical sectors, prefer eg. banks, healthcare, consumer staples, telecoms
Emerging market debt	Hard currency sovereign	Higher-yielding segment has cheapened substantially, though still no clear catalyst for sustained rebound
	Local currency sovereign	Headwinds from Fed policy stance and strong USD, very few standout opportunities, eg. Brazil, Mexico
	Hard currency corporate	Highly selective and country risk-sensitive, greater default risk (especially in China) vs. developed markets

These views are updated regularly to reflect changing market conditions and are independent of portfolio construction considerations. Past performance is not a reliable indicator of future results.

Indicative market indices Data as at 30 September 2022	Total return year-to-date (%)	Total return September (%)	Total return Q3 (%)	Total return Q2 (%)	Total return Q1 (%)	Yield to-worst (%)	Effective duration (years)
US floating-rate notes	0,24	0,18	0,83	-0,37	-0,22	4,2	0,2
Euro floating-rate notes	-0,57	0,05	0,11	-0,35	-0,33	1,7	0,2
Euro government bonds 1-3 years	-4,10	-1,06	-1,82	-1,29	-1,05	2,1	1,9
US Treasury bonds 1-3 years	-4,57	-1,18	-1,59	-0,50	-2,54	4,3	1,7
China government and policy bank bonds	-7,64	-2,94	-4,39	-4,46	1,12	2,5	4,3
Euro inflation-linked bonds	-11,10	-6,13	-5,32	-7,44	1,44	2,2	1,9
Asian investment grade	-11,72	-2,98	-3,02	-3,78	-5,39	5,6	4,7
US aggregate	-14,61	-4,32	-4,75	-4,69	-5,93	4,8	6,4
US high yield	-14,62	-4,02	-0,68	-9,97	-4,51	9,6	4,3
US fixed-rate preferred securities	-14,74	-3,41	-0,95	-7,72	-6,72	6,9	5,5
Euro investment grade	-15,06	-3,47	-3,28	-7,31	-5,26	4,1	4,8
Euro high yield	-15,43	-3,99	-0,38	-10,81	-4,83	8,3	3,3
Euro aggregate	-16,16	-3,69	-4,59	-7,10	-5,41	3,0	6,7
Global emerging-market corporate bonds	-16,21	-3,83	-2,64	-5,62	-8,82	7,9	4,3
US investment grade	-18,72	-5,26	-5,06	-7,26	-7,69	5,7	7,4
Global convertible bonds	-19,63	-5,62	-1,58	-12,86	-6,28	2,2	2,5
Global aggregate	-19,89	-5,14	-6,94	-8,26	-6,16	3,7	6,9
Global multi-sector credit	-20,82	-5,38	-6,03	-9,07	-7,34	5,9	6,0
Asian high yield	-23,68	-6,35	-6,03	-9,62	-10,14	16,7	2,9
Global emerging-market sovereign bonds	-23,95	-6,36	-4,57	-11,43	-10,02	9,6	6,6
Global government bonds AAA-AA	-24,95	-6,42	-9,72	-10,75	-6,86	3,0	7,6
Global inflation-linked bonds	-25,98	-8,21	-9,96	-13,99	-4,42	0,8	10,0
Global green bonds	-27,31	-6,56	-9,74	-12,34	-8,13	3,9	7,4

Sources: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors. Index returns in USD (unhedged) except for euro indices. Yield-to-worst adjusts down the yield-to-maturity for corporate bonds which can be “called away” (redeemed optionally at predetermined times before their maturity date). Effective duration also takes into account the effect of these “call options”. Past performance does not predict future returns. See the disclosure at the end of the document for the underlying index proxies.

Disclosures

US aggregate (represented by the Bloomberg US Aggregate Bond Index): The Bloomberg US Aggregate Bond Index tracks the investment-grade, USD-denominated, fixed-rate taxable bond market. The index includes treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency); US investment grade (Bloomberg US Corporate Bond Index): The Bloomberg US Corporate Bond Index tracks the investment-grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US issuers; US High Yield (ICE BofA US High Yield Index): The ICE BofA US High Yield Index tracks USD-denominated below investment-grade corporate debt publicly issued in the US domestic market; US floating-rate notes (Bloomberg US Floating Rate Notes Index): The Bloomberg US Floating Rate Notes Index tracks USD-denominated, investment-grade, floating-rate notes across corporate and government-related sectors; US fixed-rate preferred securities (ICE BofA Fixed Rate Preferred Securities Index); The ICE BofA Fixed Rate Preferred Securities Index tracks fixed-rate, USD-denominated, investment-grade exchange-traded preferred securities ($25 par) with outstanding market values of at least USD100 million issued in the US domestic market; Euro aggregate (Bloomberg Euro Aggregate Bond Index): The Bloomberg Euro Aggregate Bond Index tracks the investment-grade, EUR-denominated, fixed-rate bond market, including treasuries, government-related, corporate ad securitized issues; Euro investment grade (ICE BofA Euro Corporate Index): the ICE BofA Euro Corporate Index tracks EUR-denominated investment-grade corporate debt publicly issued in the euro domestic or eurobond markets; Euro high yield (ICE BofA Euro High Yield Index): The ICE BofA Euro High Yield Index tracks EUR-denominated below investment-grade corporate debt publicly issued in the euro domestic or eurobond markets; Euro floating-rate notes (Bloomberg Euro Floating Rate Notes Index): The Bloomberg Euro Floating Rate Notes Index tracks EUR-denominated, investment-grade floating-rate notes across corporate and government-related sectors; Asian investment grade (JP Morgan Asia Credit Index – Investment Grade): The JP Morgan Asia Credit Index – Investment Grade tracks fixed-rate, USD-denominated investment-grade bonds issued by Asia sovereigns, quasi-sovereigns, banks and corporates; Asian high yield (JP Morgan Asia Credit Index – Non-Investment Grade): The JP Morgan Asia Credit Index – Non-Investment Grade tracks fixed-rate, USD-denominated below investment-grade bonds issued by Asia sovereigns, quasi-sovereigns, banks and corporates; China government & policy bank bonds (Bloomberg China Treasury and Policy Bank 1-10 Year Index): The Bloomberg China Treasury and Policy Bank 1-10 Year Index tracks CNY-denominated bonds issued by the Ministry of Finance of the People's Republic of China (PRC), and debt issued by Chinese policy banks (PRC government agencies which are not guaranteed by the government), that are listed on the China Interbank Bond Market (CIBM); Global emerging market sovereign debt (JP Morgan Emerging Market Bond Index (EMBI) Global Diversified): The JP Morgan EMBI Global Diversified Index tracks liquid, USD-denominated emerging market fixed- and floating-rate debt instruments issued by sovereign and quasi-sovereign entities; Global government bonds AAA-AA (Bloomberg Global Government AAA-AA Capped Index): The Bloomberg Global Government AAA-AA Capped Index tracks local currency bonds with a minimum AA rating issued by governments of developed countries worldwide; Global inflation-linked bonds (Bloomberg Global Inflation-Linked Index): The Bloomberg Global Inflation-Linked Index tracks investment-grade, government inflation-linked debt from 12 different developed market countries; Global green bonds (Bloomberg MSCI Global Green Bond Index): The Bloomberg MSCI Global Green Bond Index tracks the global market for fixed income securities issued to fund projects with direct environmental benefits. An independent research driven methodology is used to evaluate index-eligible green bonds to ensure they adhere to established Green Bond Principles and to classify bonds by their environmental use of proceeds; Global convertible bonds (ICE BofA Global 300 Convertibles Index): The ICE BofA Global 300 Convertibles Index includes 300 convertible securities and is considered generally representative of the global convertible market; Global emerging market corporate debt (JP Morgan Corporate Emerging Market Bond Index (CEMBI) Broad Diversified): The JP Morgan CEMBI Broad Diversified Index tracks the performance of USD-denominated bonds issued by emerging market corporate entities; Global aggregate (Bloomberg Global Aggregate Bond Index): The Bloomberg Global Aggregate Bond Index tracks the performance of the global investment-grade, fixed-rate bond markets and includes government, government-related and corporate bonds, asset-backed, mortgage-backed and commercial mortgage-backed securities from both developed and emerging markets issuers; Euro inflation-linked bonds (Bloomberg Euro Government Inflation-Linked Bond All Maturities Index): The Bloomberg Euro Government Inflation-Linked Bond All Maturities Index tracks the performance of EUR-denominated investment-grade inflation-linked bonds issued by governments of the euro area across the whole yield curve. Global multi-sector credit (Bloomberg Global Multiverse Credit Index): The Bloomberg Global Multiverse Credit Index provides a broad-based measure of the global corporate bond market., representing the union of the Global Aggregate Index and the Global High Yield Index and captures investment grade and high yield securities in all eligible currencies. Euro government bonds 1-3 years (Bloomberg Euro-Aggregate Treasury 1-3 Year): The Bloomberg Euro-Aggregate Treasury 1-3 Year Index measures the performance of the euro area government bond market and includes only bonds issued in euros or legacy euro currencies with a maturity between 1 and up to (but not including) 3 years. US Treasury bonds 1-3 years (JP Morgan Government Bond Index United States 1-3 Year Select Maturity): The JP Morgan Government Bond Index United States 1-3 Year Select Maturity Index tracks the performance of eligible fixed-rate, USD-denominated treasury bonds issued by the US Government with time to maturity between 1 and 3 years.

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