

# Fixed Income Briefing

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## Recession fears offer some respite for duration, but not for volatility

Annual growth in US consumer price inflation moved up to a new peak in June, making another rate hike of 75 (or even 100) basis points from the Federal Reserve ever more likely. The US dollar hit parity with the euro. But inflation prints are no longer the only game in town. US Treasury yields have swung both up and down amid fears that future rate hikes to tame inflation will bring forward a recession. This struggle for direction is reflected in the fluctuating (from flat to inverted) US yield curve, with 2- and 10-year yields near 3%, but at times 25 basis points apart. Euro bond markets are seeing outsized swings too, though yield curves there are steeper as money markets expect the European Central Bank to be more challenged in frontloading rate hikes. A recession in Europe looks greater in likelihood and magnitude, with the tail risk of a shutdown in the natural gas supply from Russia.

Another sign that markets are preparing for a hard landing is some decoupling recently between euro core/periphery sovereign spreads from credit spreads; the latter continued to widen whereas the former stabilised somewhat after the ECB indicated it may resume government bond-buying. Even a mild recession could be bad for investment-grade and high-yield corporates, despite good credit fundamentals. Yields now provides a good cushion but may not fully offset further spread or rates sell-offs, leaving expected downgrades and defaults to drive returns, especially for cyclical and lower-rated credits. Similarly, emerging markets still lack positive catalysts, such as more visibility on the terminal US policy rate and on China's economy. While it may be a bit too soon to be strategically long duration, the current risk-reward balance favours adding incrementally to longer-dated core government bonds, with steeper curves, over taking more outright risk in spread assets.

## Fixed-income asset allocation views in summary

Core rates	Country	Cross-country relative value (eg, long US vs Germany); favour markets with a lot of hikes already priced in
	Duration	Market already significantly underweight, longer-dated bonds likely to benefit earlier from flight to safety
	Yield curve	Curve slope agnostic, but biased to flattening if inflation stays higher for longer than currently anticipated
	Inflation	Overweight euro area, ready to reduce exposure when inflationary pressures ease or are better priced in
	Currency	Neutral USD, well supported by risk-off; Asia FX vulnerable, central banks behind in the rate hiking cycle
Corporate credit	Investment grade	More patience before re-risking; rates volatility and tighter financial conditions support defensive stance
	High yield	Remain underweight beta, reduce gradually via higher-quality names; heavily underweight CCC and Asia
	Hybrids	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 spreads look more appealing than euro spreads because of US market's more defensive attributes
Emerging market debt	Sector	Favour corporate entities with resilient pricing power; global financials and US utilities are well positioned
	Hard currency sovereign	Higher-yielding segment has cheapened substantially, though still no clear catalyst for sustained rebound
	Local currency sovereign	Real yields restored after aggressive rate hikes but FX vulnerable, less so where terms of trade improved
	Hard currency corporate	Very selective and country risk-sensitive, higher default risk (especially in Asia) than 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 15 July 2022	Total return YTD 2022 (%)	Total return June 2022 (%)	Total return 2021 (%)	Yield- to-worst (%)	Effective duration (years)
US floating-rate notes	-0.57	-0.37	0.52	2.92	0.2
Euro floating-rate notes	-0.72	-0.28	-0.11	0.52	0.2
China government and policy bank bonds	-4.15	-0.56	7.71	2.63	4.3
Euro inflation-linked bonds	-4.21	-3.05	6.34	-0.93	6.1
Asian investment grade	-9.53	-1.54	-0.01	5.02	4.9
US aggregate	-9.80	-1.57	-1.54	3.71	6.7
Euro investment grade	-10.36	-3.43	-1.02	2.74	4.9
Euro aggregate	-10.65	-2.34	-2.85	1.88	3.4
US fixed-rate preferred securities	-12.02	-4.02	2.24	6.01	5.3
US high yield	-12.43	-6.81	5.36	8.43	4.4
US investment grade	-13.43	-2.80	-1.04	4.63	7.9
Euro high yield	-13.90	-7.01	3.35	7.11	3.0
Global aggregate	-14.41	-3.21	-4.71	2.86	7.1
Global emerging-market corporate debt	-14.97	-3.06	0.91	7.25	4.4
Global government bonds AAA-AA	-17.61	-3.90	-7.52	2.03	8.0
Global convertible bonds	-18.09	-5.75	2.45	1.17	2.4
Global inflation-linked bonds	-18.52	-5.33	2.69	-0.07	10.3
Global green bonds	-20.20	-4.83	-7.85	2.85	7.9
Global emerging-market sovereign bonds	-22.26	-6.21	-1.80	9.02	6.7
Asian high yield	-22.92	-6.09	-11.05	15.80	2.9

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

The ICE US Dollar Index is a geometrically averaged calculation of six currencies weighted against the USD: EUR, JPY, GBP, CAD, SEK, CHF. The ICE BofA MOVE Index tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasury securities. 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 and 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 euroarea across the whole yield curve.

A rating provides no indicator of future performance and is not constant over time. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. It is not possible to invest directly in an index.

## Disclosures

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