Allianz Global Investors

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Fixed Income Forward

Spread assets maintain advantage over rates

Fixed income assets have generally shown resilience against market volatility emanating from the Trump administration's business diplomacy. Although a challenged fiscal outlook and heightened rates volatility has left core government bonds scrambling for direction, spread assets have performed well, with high-yielding Asian and emerging market debt leading the pack. This outperformance may reflect hopes for a more measured trade conflict, as well as the fact that China, and many emerging economies, are less vulnerable to global shocks than in the past.

Asian high-yield sovereign issuers have posted strong gains year-to-date. Sri Lanka restructured its Eurobonds successfully, introducing a mix of new variable-rate instruments.

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Ongoing fiscal reforms under the new government have helped reduce external vulnerabilities and improve liquidity. Meanwhile, an IMF mission is visiting Pakistan for the first formal discussions regarding a USD 7 billion bailout package. Additionally, the country is expected to receive USD 20 billion in loans from the World Bank under a 10-year programme aimed at supporting inclusive and sustainable development.

Turning to corporate credit, we see no pressing case to chase beta amid heightened interest-rate volatility globally. Instead, we're focused on bottom-up sector and single-credit analysis with a view to adding incremental, relative value. Credit spreads continue to grind tighter, supported by attractive yields and a slower primary market amid another relatively rosy earnings season. In investment grade, we remain overweight financials, especially large banks with strong balance sheets, and we still favour US utilities for their stable cash flows.

In high-yield credit, many stressed issuers continue to find support from creditors allowing them either to "amend and extend" or access alternative capital. As a result, weak issuers can reemerge with extended debt maturities and rerated bonds which eventually get reincluded in market indices. With this in mind, we have added cautiously-sized tactical exposure to what we call "sinners turned saints". These include several companies in the construction and services sector, for example, where we see near-term improvement in their debt dynamics.

Higher-for-longer rates in the US have raised some concerns about interest coverage ratios for corporate issuers, but we don't see major fundamental risks outside of the CCC-rated segment. Many analysts no longer foresee any US rate cuts this year. Minutes from the US Federal Reserve show policymakers are worried about the possibility of new tariffs hampering disinflation. We see front-end rates staying well-anchored and longer-dated Treasuries underperforming if a deteriorating fiscal outlook drives up term premia. That is why we prefer exposure to US yield-curve steepening rather than outright duration risk.

Core rates look more attractive in Europe, with derivatives markets still

pricing in three more rate cuts this year from the European Central Bank – despite some hawkish comments lately from executive board member Isabel Schnabel. The recent euro government bond sell-off, partly in response to concerns about higher defence spending, seems to favour adding exposure to substitute or spread instruments such as supranational, sub-sovereign, agency and covered bonds, which may be less volatile.

Meanwhile, the German elections produced a rather fragmented political landscape that seems to favour the scenario of a "grand coalition" forming between the Conservatives and the Socialists. The Christian Democratic Union of Germany (CDU) and its sister party, CSU, got some 28.5% of the votes, while the Alternative for Germany (AfD) came in second with around 21% and the Social Democrats (SPD) recorded their worst ever result at about 16.5%.

We maintain our higher conviction in UK Gilts. This is partly due to more attractive real yields but also because we think that, unlike in other markets, the possibility of future rate cuts is not fully priced in. Recent data, including still strong wage growth and better-than-expected retail sales growth, have strengthened the Bank of England's case for remaining cautious for now in its rate-cutting cycle. Headline consumer inflation for January surprised to the upside, at 3% year-on-year, boosted by a rise in airfares and the introduction of VAT on private school fees, widening the gap with the central bank's 2% inflation target.

Fixed income market performance

Indicative market indices **Data as at 20 February 2025**	**Total return YTD 2025 (%)**	**Total return Jan 2025 (%)**	**Yield-to-worst* (%)**	**Effective duration (years)**
Global emerging-market sovereign bonds	1.91	1.44	7.7	6.5
Asian high yield	1.80	0.08	10.2	2.6
US high yield	1.69	1.38	7.2	3.0
Global convertible bonds	1.55	2.62	-0.9	1.7
Euro high yield	1.40	0.60	5.3	3.0
US investment grade	1.15	0.55	5.3	7.0
Asian investment grade	1.07	0.52	5.3	4.7
US aggregate	1.03	0.53	4.8	6.2
US floating-rate notes	0.76	0.44	4.9	0.0
Euro investment grade	0.55	0.48	3.2	4.4
US Treasury bonds 1-3 years	0.54	0.45	4.3	1.6
Global aggregate	0.48	0.39	3.7	6.6
Euro government bonds 1-3 years	0.23	0.14	2.3	2.0
Euro aggregate	-0.18	-0.03	2.9	6.4
Global government bonds AAA-AA	-0.20	0.10	3.2	7.5

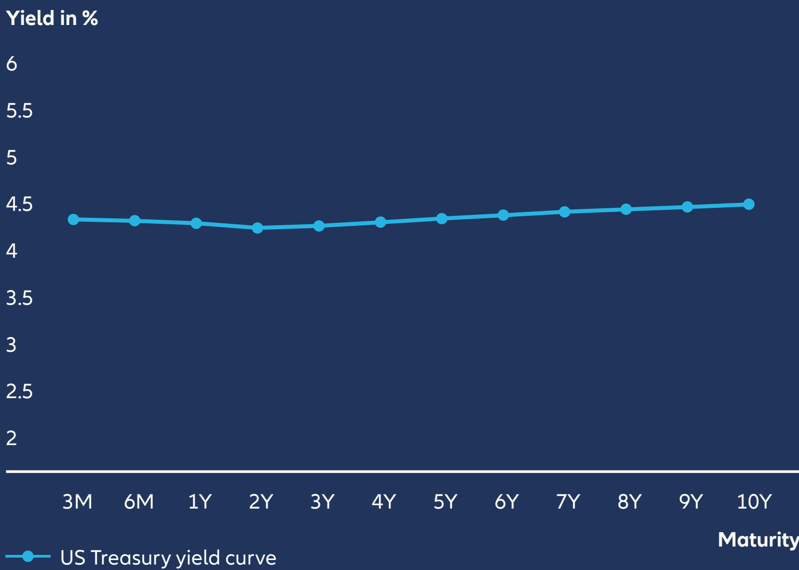
Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 20 February 2025. Index returns in USD-hedged except for Euro indices (in EUR). Asian and emerging-market indices represent USD denominated bonds. Yield-to-worst adjusts down the yield-to-maturity for corporate bonds 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". The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or as investment advice. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

* Represents the lowest potential yield that an investor could theoretically receive on the bond up to maturity if bought at the current price (excluding the default case of the issuer). The yield to worst is determined by making worst-case scenario assumptions, calculating the returns that would be received if worst-case scenario provisions, including prepayment, call or sinking fund, are used by the issuer (excluding the default case). It is assumed that the bonds are held until maturity and interest income is reinvested on the same conditions. The yield to worst is a portfolio characteristic; in particular, it does not reflect the actual fund income. The expenses charged to the fund are not taken into account. As a result, the yield to worst does not predict future returns of a bond fund.

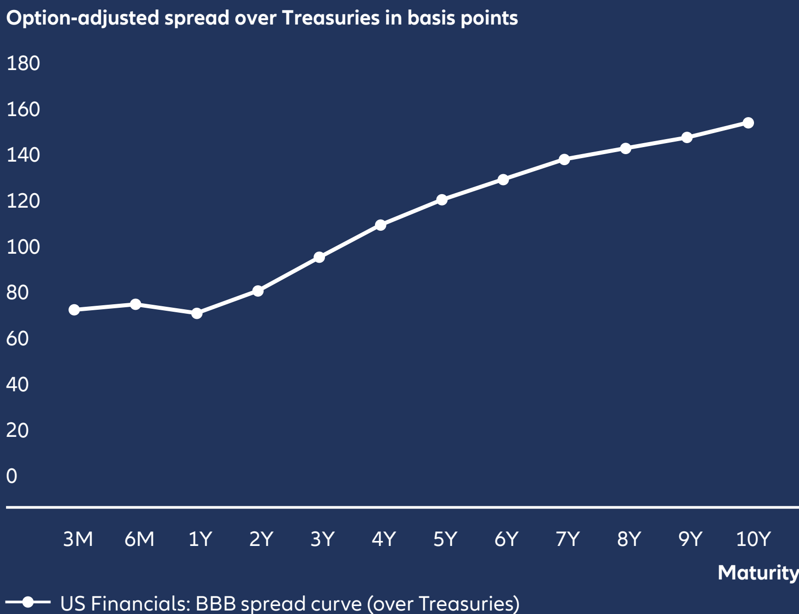
CHART OF THE MONTH

USD floating-rate notes still have legs

US Treasury yield curve



Credit spread curve



Floating-rate notes, issued mostly by investment-grade corporates, are bonds with coupon payments that periodically reset up and down according to short-term interest rates. Since they have duration risk of close to zero, due to this reset feature, we expect US dollar floating-rate notes to continue to do well amid higher-for-longer rates and uncertainty about the pace and size of future cuts. Market-implied forward US dollar cash rates remain elevated as US rate cut expectations have repriced down since the peak last September. Floating-rate notes remain attractive also from a "carry" perspective, since they offer the prevailing market interest rate plus an additional yield (spread) which is fixed over the life of the note and specified at issuance based on the issuer's credit risk. As credit spread curves are currently steeper than the US Treasury yield curve, these notes offer a unique way to lock in higher nominal yields by extending spread duration – the sensitivity of a bond's price to changes in the credit spread – instead of interest rate duration, which doesn't offer much yield pick-up right now.

Sources: Bloomberg, Allianz Global Investors, data as at 20 February 2025. The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or as investment advice. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

WHAT TO WATCH

1 German coalition

The German elections yielded a splintered landscape which poses challenges for building a strong coalition government – one that can deliver a significant policy-driven stimulus to the German economy. The most likely outcome looks like a "grand coalition" between the CDU/CSU and SPD, which have governed together many times before. Whether such a coalition can muster a joint mandate to reform Germany's strict public debt limits remains to be seen.

2 Ukraine ceasefire

US President Donald Trump announced a second round of talks between US and Russian delegations about a ceasefire in Ukraine. Preparations are reportedly underway for a face-to-face meeting between Trump and Russian president Vladimir Putin, which would mark a shift away from Russia's diplomatic isolation. Any indication of an imminent ceasefire could push core yields higher and prove generally supportive for risk assets.

3 US inflation

The January reading of the US Federal Reserve's preferred inflation metric, the personal consumption expenditures (PCE) price index, will be released on 28 February. Another annual inflation measure, the US Consumer Price Index (CPI), rose by a higher-than-expected 3.3% in January. The PCE print should have an impact on interest-rate futures markets, which are currently pricing in only one or two rate cuts in 2025.

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