Allianz Global Investors

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Fixed Income Forward

Long-term bond yields turn higher

Bond markets kicked off 2025 with a focus on rising term premia. Investors are now demanding more compensation for the risk of holding longer-dated bonds. The UK is a case in point. In early January, 10-year Gilt yields hit 17-year highs as the pound weakened. More recently, a rather benign batch of inflation data from the US, the UK and the euro area provided some relief but has yet to counter the upward march of core government bond yields.

We believe term premia are still too low for the US and Germany. In yield-curve strategies, we maintain a steepening bias, with the exception of Japan, where we see flattening ahead as the country's central bank is tightening monetary policy further. Also, we favour owning Treasury inflation-protected securities (TIPS) given the risk that the new US administration's policies on taxes and trade will be inflationary.

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In the near term, we prefer holding shorter-dated Treasuries as a resilient US economy does not bode well for duration risk. In December, the US Federal Reserve (Fed) cut rates by 25 basis points as expected, but its latest dot plot projections indicated only two cuts in 2025. Back in September, it was concern over the job market that had prompted the Fed to cut by a jumbo 50 basis points. Fast forward to 2025 and US job data are strong, with 256,000 nonfarm payrolls added in December and the jobless rate down to 4.1%.

The European Central Bank (ECB) cut rates by 25 basis points too, taking the deposit rate down to 3%. Euro area growth has continued to disappoint, with future tariff risks adding another layer of uncertainty for growth prospects. Before the turn of the year, short term interest-rate markets had already begun to price the downside growth risks for the region. Yields on two-year Bunds ended the year at 2.08%.

In the UK, a poor macroeconomic outlook and attractive bond valuations make a somewhat better case for Gilts, both on an outright basis and compared with German Bunds, where a lot more policy easing is already priced in. Gilt yields continued their ascent into 2025 and hit several other milestones, including the highest 30-year yield since 1998. The rise in yields means the government's already limited fiscal headroom is set to be wiped out by the increased cost of borrowing.

Meanwhile, we continue to look to investment-grade credit for higher income. Primary markets remain very active; the start of the year was the second best on record in terms of the volume of new US dollar issuance. High bond yields have not impacted spreads materially, since the recent pullback in rate cut expectations was driven by a strong economy that is supportive of earnings growth, and not by resurgent inflation. The easing trajectory of monetary policy seems more important for credit risk – more so than the precise timing of cuts.

Despite the recent rise in bond yields, demand for high-yield credit also remains firm. While new issue flow in the high-yield market is still relatively low, primary market deals are performing well. The US and emerging markets are doing better year-to-date than Europe, but spreads were tighter across the board, even for Asian high yield, when excluding Hong Kong and Sri Lanka.

For emerging market debt, we think the return of trade tariffs to the geopolitical agenda is likely to bring greater volatility. Inflation is no longer trending lower so emerging-market central banks have limited room to ease. While the spread between US Treasury and emerging-market yields is relatively tight, there is a big enough

bond carry to provide a cushion against any spread widening.

In emerging Asia, we pared down some of our active exposure in India and Philippines in view of rising core government bond yields and US dollar strength. In terms of valuation, rate cuts are well-priced at the front-end and yield curves are flat across most Asian markets. In China, even though the economy ended 2024 on a better footing, supported by an array of stimulus measures, we see room for 10-year government bond yields to decline further until domestic demand and the property sector show further signs of revival.

Fixed income market performance

Indicative market indices Data as at 17 January 2025	**Total return YTD 2025** (%)	**Total return Dec 2024** (%)	**Total return FY 2024** (%)	**Yield-to-worst*** (%)	**Effective duration** (years)
Global convertible bonds	1.64	-1.95	9.37	-0.3	1.7
US high yield	0.86	-0.41	8.22	7.2	3.1
Global emerging-market sovereign bonds	0.40	-1.40	6.54	7.9	6.5
US floating-rate notes	0.24	0.46	6.42	4.9	0.0
US Treasury bonds 1-3 years	0.16	0.22	3.98	4.3	1.6
Asian investment grade	0.08	-0.84	4.22	5.4	4.7
US aggregate	-0.02	-1.64	1.25	4.9	6.1
US investment grade	-0.04	-1.94	2.13	5.4	7.0
Asian high yield	-0.05	-0.58	15.18	10.5	2.6
Euro high yield	-0.09	0.64	8.63	5.6	2.7
Euro government bonds 1-3 years	-0.14	0.00	3.16	2.3	1.9
Global aggregate	-0.16	-0.77	3.40	3.7	6.6
Euro investment grade	-0.31	-0.42	4.67	3.3	4.4
Euro aggregate	-0.69	-1.04	2.63	2.9	6.4
Global government bonds AAA-AA	-0.70	-1.19	1.95	3.2	7.5

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 17 January 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.

WHAT TO WATCH

1 Corporate earnings

Fourth-quarter corporate earnings have kicked off, led as always by large US banks which generally presented strong results and solid forward guidance. The big tech companies are expected to post another strong quarter, driven by the growing traction of AI applications. In other sectors, we watch for the potential implications of a stronger US dollar and any new tariffs, particularly for multinationals.

2 Bank of Japan

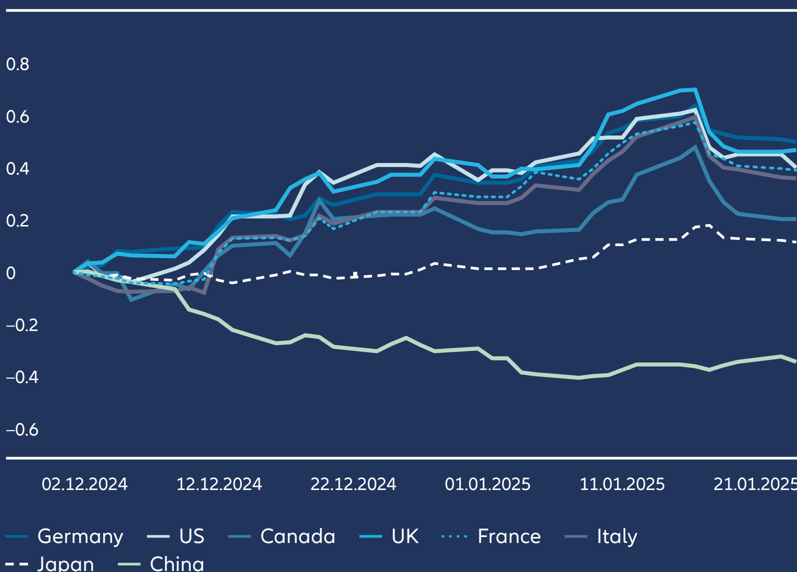
The Bank of Japan hiked rates – by 25 basis points to 0.5% – as it continues to slowly normalise policy. The bank also raised its inflation forecasts. This was the first rate increase since July 2024. The hike back then was followed by a bout of volatility in bond and currency markets. Keen to avoid a repeat, this time the bank is treading carefully with its communication strategy.

3 Trade tariffs

Markets await more clarity on the US administration's warnings about imposing new trade tariffs, including up to 25% on imports from Canada and Mexico and 10% on Chinese goods. EU products are unlikely to be left unscathed by the Trump administration's tariff-driven approach to business diplomacy. How different US trade partners respond and possibly retaliate will have important consequences for the global economy.

CHART OF THE MONTH

10-year government bond yields in major markets, percentage point change



Sources: Bloomberg, Allianz Global Investors, data from 2 December 2024 to 21 January 2025. Past performance does not predict future returns.

In recent months, rising US bond yields were the main cause of a broader sell-off in core rates markets. Robust US economic data, such as December's strong US nonfarm payrolls report, dampened hopes for sustained Fed rate cuts. Recent retail sales data suggest that the US consumer continues to support the economy, backed by strong wage growth and wealth effects. Looking ahead, higher long-term rates and a strengthening US dollar are causing a tightening of financial conditions, not just in the US but globally. This is against a backdrop of fears about the risks to both China and Europe from future US trade policy. Chinese government bonds continue to stand out as an outlier, with yields trending lower as price pressures there remain deflationary.

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