Allianz Global Investors

MAY 2025

Fixed Income Forward

Asian and emerging markets in pole position

Asian and emerging markets continue to defy the global trade turmoil by outperforming other fixed-income asset classes. Among regional credit markets, Asian corporate bonds issued in US dollars maintained their pole position year-to-date, helped by higher yields and despite suffering recently from spread widening. Among sovereigns, emerging-market government bonds denominated in local currencies lead by a wide margin, with a total return of more than 9% on an unhedged US dollar basis (see Chart of the Month). Stronger local currencies against the US dollar explain roughly half of that performance, with the remainder due to falling local yields, across a diverse set of countries including Brazil, India, Mexico and South Korea.

Michael Krautzberger
Global CIO
Fixed Income

Georgios Georgiou
Global Head
Product Specialists
Fixed Income

An expectation that the US economy will underperform other major markets in 2025, and concerns about US policy credibility, are sustaining downward pressure on the US dollar. This situation benefits our negative US dollar stance and our corresponding long positions in the euro, Korean won and Brazilian real. We are also long the Indonesian rupiah – a relative underperformer that we expect to catch up with gains made by other emerging-market currencies. Additionally, as a hedge against possibly higher US tariffs on China, we are positioned to gain from a depreciation in the Chinese yuan.

In core rates markets, we continue to anticipate yield-curve steepening in the US and the euro area. While euro sovereign long-end yields are showing increased correlation with long-end US Treasury yields, short-term rates are better anchored as the European Central Bank and the US Federal Reserve stay on diverging paths. US rate cut expectations have been pushed out towards year end, whereas the euro area may cut rates again in June. In the meantime, China lowered benchmark lending rates for the first time since October.

In May it was Moody's turn to downgrade the credit rating of the US by moving it one notch lower from the highest possible rating. Moody's is the third major rating agency to do so. This development, along with a Congressional Budget bill containing a series of unfunded tax cuts, helped push up the 30-year US Treasury yield to 5.15% – a level not seen since October 2023. Also, a 20-year US Treasury bond auction saw softer-than-usual demand and priced around 5%, which compares with an average of around 4.6% from the previous six auctions.

Imminent monetary policy easing remains a greater likelihood in Europe. Annual euro area headline and core inflation in April came in rather contained, at 2.2% and 2.7% respectively. Together with weaker manufacturing survey data, that leaves room for the European Central Bank to deliver yet another 25-basis-point cut at its next meeting in early June. Another motivation to cut is the possibility that, unless there is a breakthrough in trade negotiations, the US may raise tariffs on EU imports to 50% starting on 9 July.

In contrast, UK monetary policy is likely to remain restrictive for a while longer. Annual headline inflation data for April surprised to the upside, at 3.5%, which was up from 2.6% in March. Higher UK public sector borrowing in April did not make for pleasant reading as the government seeks to meet its fiscal rules. Still, we see greater gains up ahead for 10-year Gilts compared with Bunds and Treasuries due to higher starting yields, tighter fiscal policy and a softer growth outlook, which may add pressure to cut rates in the second half of 2025.

Turning to corporate credit, earnings this season were solid across regions and above estimates for most sectors – excepting cyclicals such as autos, chemicals, homebuilders and retail. Companies largely confirmed guidance but with caution due to uncertainty around tariffs. Credit spreads have mostly returned to early April levels amid robust demand for high all-in-yields and more limited supply. We continue to favour financials and to focus on name-by-name selection with a tilt toward non-cyclicals, while generally avoiding issuers with notable refinancing needs and low equity cushions.

We would be remiss not to mention convertible bonds, which, due to their inherent quality of providing exposure to equity markets with a degree of downside protection, have had a smoother journey through this year's bouts of volatility. With their lower sensitivity to interest-rate risk, and intrinsic "cushion" against falling equity prices, convertibles have delivered stable income and lower exposure to equity drawdowns while benefiting from the recovery in equity markets.

Fixed income market performance

Indicative market indices Data as at 23 May 2025	Total return YTD 2025 (%)	Total return April 2025 (%)	Yield-to- worst* (%)	Effective duration (years)
Global convertible bonds	6.35	1.16	-0.8	1.7
Asian high yield	2.77	-1.69	9.6	2.6
Global emerging-market sovereign bonds	2.56	-0.22	7.9	6.4
US Treasury bonds 1-3 years	2.03	0.83	4.0	1.6
Asian investment grade	1.94	0.25	5.4	4.7
US high yield	1.90	0.00	7.7	3.0
US floating-rate notes	1.79	0.13	4.9	0.0
Euro high yield	1.79	0.29	5.7	2.7
US aggregate	1.56	0.39	4.8	6.1
Euro government bonds 1-3 years	1.47	0.75	1.9	2.0
Euro investment grade	1.20	0.91	3.1	4.5
Global aggregate	1.15	0.98	3.6	6.5
US investment grade	1.14	-0.03	5.3	6.8
Global government bonds AAA-AA	0.64	1.77	3.1	7.5
Euro aggregate	0.41	1.67	2.8	6.4

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 23 May 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. US Federal Reserve

Even though market expectations of a US rate cut have been pushed out towards year end, softer US inflation data and falling oil prices may mean there is still some policy easing in store for 2025. The US central bank's policy stance remains data-dependent and cautious, with a preference to cut later rather than sooner. This wait-and-see approach seems to favour a 50-basis-point cut late in the year rather a series of smaller cuts.

2. Euro area inflation

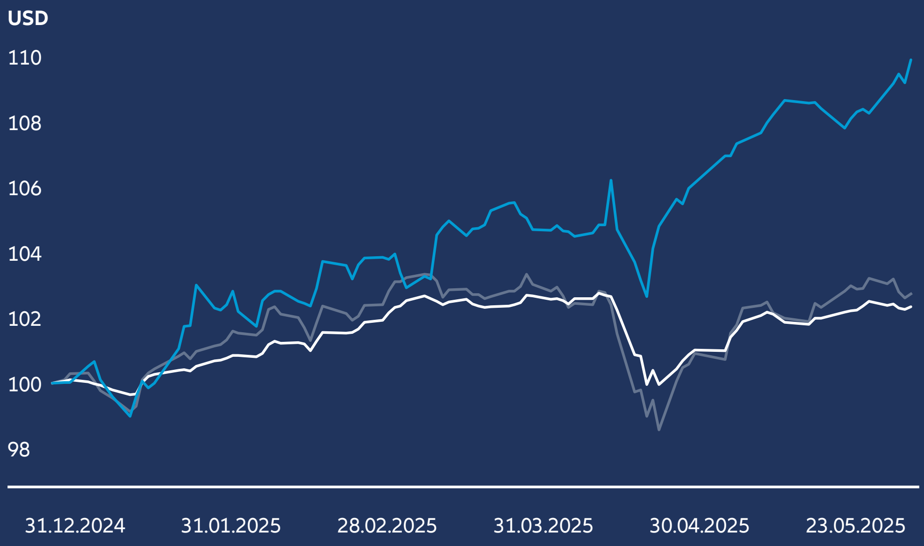
The European Central Bank is expected to cut rates by another 25 basis points in June. With the threat of higher US tariffs, the market has repriced euro area terminal rate expectations lower. The next inflation reading for the euro area is coming into focus and could fall below 2% thanks to lower oil prices and a stronger euro. The June meeting of the European Central Bank may offer more clues on how policymakers view the balance of risks.

3. Asian high yield

With many Asian credit sectors either domestic-facing or otherwise unscathed by new US tariffs, any widening in credit spreads driven by market sentiment or policy uncertainty may provide entry points for investors to lock in higher income. Asian high-yield bonds issued in US dollars continue to offer the highest carry across regional credit markets. We are watching sectors such as renewables in India and gaming in Macau where we maintain overweight positions.

CHART OF THE MONTH

Strong run in emerging-market local currency debt



- Emerging-market local currency sovereign bonds – in USD (unhedged)
- Emerging-market hard currency corporate bonds – in USD
- Emerging-market hard currency sovereign bonds – in USD

Sources: Bloomberg, JP Morgan indices; Allianz Global Investors, data as at 23 May 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.

A favourable balance between currency, inflation and growth has supported local currency bond gains in emerging markets. US dollar weakness and peaking inflation expectations, or ongoing disinflation, have given many emerging-market central banks a runway to ease policy. Central banks in India, the Philippines and Thailand have cut rates, both as a cushion to a potentially softer growth outlook, and to defend their economies from the impeding impact of new US tariffs. Current accounts generally look healthy, enabling many countries to build up their foreign exchange reserves. Hard currency debt has also posted positive performance, above US Treasuries, despite giving up some gains recently due to spread widening. Hard-currency bonds include a diverse range of sovereign and corporate opportunities. Many of these have so far escaped the brunt of new US tariffs, particularly in Latin America and the Middle East.