Allianz
Global Investors

NOVEMBER 2023

Fixed Income Forward

Divergence by country and credit getting stronger

The change in bond market sentiment from October to November has been fast and sharp. Yields on 10-year German Bunds and US Treasuries had climbed to 3% and 5%, respectively, but have since dropped 30-40bp below those levels. These are large moves for just a couple of trading sessions, but for good reasons. For one, the European Central Bank (ECB), the US Federal Reserve (Fed) and other major central banks opted to pause rate hikes. Moreover, there are signs of moderation in inflation and job data.

Much of that news was mostly in line with consensus and should not have caught many by surprise. If anything, rates volatility for now seems to be driven by lack of policy conviction and market nerves. Even more so when it comes to near-term inflation expectations. Shorter-maturity yields have pulled back less going into November, as it seems too early to talk about rate cuts. Behind those moves in nominal rates we see cross-country divergence in real rates. We favour sovereign debt that yields well above inflation and is less vulnerable to a fiscal squeeze – let alone one imposed by markets.

We believe the ECB has not yet arrived at its terminal rate. That merits a cautious stance on euro area yields and core-periphery spreads, which have helped Italian debt outperform Germany year-to-date (YTD).[1] Official statistics showed year-on-year (YoY) core inflation fell in October, but it was still high at 4.2%.[2] So was YoY wage growth at 4.6% in Q2[3], despite climbing unemployment which rose to 6.5% in September.[4] Collective wage bargaining and widening fiscal deficits remain inflationary overhangs that shouldn't be ignored. Neither should the tail risk of an oil price shock from a Middle East conflict.

UK Gilts are still the notable laggard this year.[1] A performance turnaround seems contingent on a narrative shift from stagflation to deflationary recession. While the Bank of England has kept policy rates unchanged for two months in a row and price inflation is decelerating, wage inflation remains robust. We cannot exclude the possibility of a rebound in inflation and a follow-up rate hike, as was the case with the Reserve Bank of Australia at its November policy meeting.

In the US, we think the Fed is done with hiking as inflation looks better contained. Official statistics showed YoY growth in core inflation fell to 3.7% at the end of Q3.[5] Even though US GDP growth was just shy of 5% in Q3[6], that was led by consumer spending which has probably peaked – the Atlanta Fed recently cut in half (to 1.5%) its forecast for Q4 YoY growth in inflation-adjusted spending.[7] The US job market's role as a tailwind for consumer spending is set to diminish. In October, hiring for non-farm jobs slowed by much more

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Fixed income market performance

Indicative Market Indices Data as of 31 October 2023	**Total return YTD 23** (%)	**Total return Oct 23** (%)	**Yield-to-worst** (%)	**Effective duration** (years)
Euro high yield	5.84	-0.25	7.8	2.9
US floating-rate notes	5.55	0.47	6.2	0.0
US high yield	4.67	-1.22	9.5	3.7
Global convertible bonds	2.91	-2.38	3.1	2.2
Euro investment grade	2.76	0.41	4.5	4.5
US Treasury bonds 1-3 years	1.94	0.33	5.1	1.7
Euro government bonds 1-3 years	1.62	0.54	3.3	2.0
Asian investment grade	1.04	-0.67	6.3	4.4
Euro aggregate	0.99	0.40	3.7	6.3
Emerging-market sovereign bonds	0.39	-1.35	9.4	6.3
Global aggregate	0.38	-0.71	4.3	6.5
Global government bonds AAA-AA	-0.22	-0.06	3.7	7.4
US investment grade	-1.86	-1.87	6.4	6.8
Asian high yield	-1.93	-0.51	15.3	2.5
US aggregate	-2.77	-1.58	5.6	6.1

Sources: Bloomberg, ICE BofA and JP Morgan indices; AllianzGI; data as at 31 October 2023. Index returns in USD-hedged except for Euro indices (in EUR). 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.

than consensus, and the yearly increase in average hourly earnings fell further to 4.1%.[8]

Japan is a different story altogether as it's only now beginning to flirt with policy normalisation. The country's central bank announced it was relaxing its hard 1% yield cap on 10-year government bonds, as it continues to review its yield-curve-control policy amid inflationary pressures. However, the 10-year yield is still hovering below 1%,[1] likely supported by domestic buyers who may be shunning USD or EUR debt due to the prohibitive cost of hedging back to a weak JPY.

China government and policy bank bonds have outperformed YTD[1] due to continued monetary and fiscal loosening, though the nearly 3% total return in local currency has coincided with roughly a 5% depreciation of CNY against the USD. Elsewhere in Asia and in emerging markets, greater stability in US rates should favour select local currency bonds which are backed by high positive real yields as well as resilient budgets and current accounts.

Turning to corporate credit, the backward-looking picture based on Q3 corporate earnings so far looks rosy overall. As with rates markets, differentiation in credit is emerging in undertones rather than headlines. At a sector level, there is not much meaningful divergence YTD when looking at spread moves as a key measure of credit risk (see Chart of the Month below). At the index level there are no obvious signs of stress, with spreads on both investment grade (IG) and high yield (HY) corporates tighter YTD.[9]

We see clear signs that credit differentiation should matter more going forward. For instance, the average share price reaction to earnings misses has been more punishing than usual this earnings season. In IG, dispersion between average spreads for the top and bottom quartile companies has grown YTD.[9] And in HY, higher-quality issuers are beginning to outperform as spread widening now looks skewed towards the most vulnerable CCC-rated issuers.[9] The good news is that yields overall have reset substantially along with rates, meaning investors no longer need to reach for the riskier parts of the credit market in search of higher income.

WHAT TO WATCH

1. Tighter financial conditions

Upcoming economic activity data will tell us whether central banks can indeed rely on tighter financial conditions to do the inflation-fighting for them from here on – or whether the recent leg down in yields has been a touch too early, ironically undoing some of the money tightening required to arrest inflation once and for all.

2. Lower profit-led inflation

As Q3 earnings wrap up, we'll be looking at the extent to which companies can continue to take advantage of excess demand and labour shortage (eg. in leisure and hospitality) to pass on higher input costs to customers. The longer vacancies and wage growth stay elevated, the harder it will get to sustain profit margins as demand begins to ease.

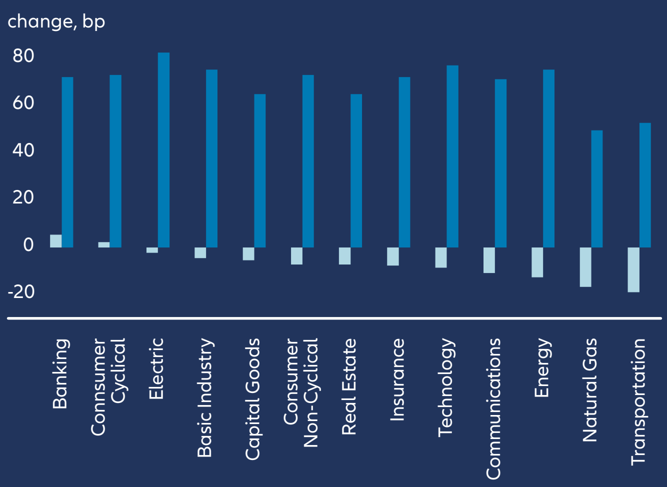
3. Diversified Asian high yield

Asian high yield credit is not only about China, which now accounts for less than half of overall issuance. Default rates are very low when excluding China property. As the latter sector continues to reboot, we're keeping an eye on improving fundamentals in Macau gaming, renewables in India, and financials more broadly.

CHART OF THE MONTH

Resilient earnings have meant calm spreads despite higher yields

YTD change in option-adjusted spread (OAS) & yield-to-worst (YTW) by sector



Source: AllianzGI, Bloomberg Global Aggregate Credit Index Statistics (USD unhedged), data as at 31 October 2023.

In contrast to rising yields, the broad-based calm in IG spreads looking back on this year does not stack up so well with an upcoming turn in the credit cycle. However, resilient corporate earnings can help explain why that's the case.

Of the 80% of S&P 500 companies that have reported results for Q3, more than 80% have beat consensus estimates for earnings per share (EPS), led by the Consumer Discretionary sector.[10] In Europe only a minority of companies making up the STOXX 600 have reported so far. A little more than half of those beat EPS estimates, with more resilience evident in profit margins than in sales.[11]

Spreads may also be getting some support from fewer share buyback announcements. That should favour bondholders if earnings go into shoring up balance sheets instead.

1) Bloomberg benchmark government bond indices, data as at 31 October 2023.
2) Eurostat, 31 October 2023
3) Eurostat, 15 September
4) Eurostat, 3 November
5) Bureau of Economic Analysis, 27 October 2023
6) Bureau of Economic Analysis, 26 October 2023
7) Federal Reserve Bank of Atlanta, 1 November 2023
8) Bureau of Labor Statistics, 3 November 2023
9) IG = Bloomberg Global Aggregate Credit Index, HY = ICE BofA Global High Yield Index, data as at 31 October 2023.
10) FactSet, data as at 3 November 2023.
11) London Stock Exchange Group, data as at 31 October 2023.

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