Allianz Global Investors

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Fixed Income Forward

# US economy and policy take centre stage

Some calmness has returned to global bond markets after the US elections, which were accompanied by heightened volatility and another 25-basis-point rate cut by the US Federal Reserve. The promise of lower taxes and deregulation under Donald Trump's administration, underscored by a Republican sweep, has helped strengthen the US dollar, push Treasury yields higher, and further tighten US credit spreads to pre-2000 levels. Meanwhile, the prospect of disrupted trade dynamics that might result from any new US tariffs has weakened sentiment on Europe and China.

Recent yield volatility has lent support to our approach to be tactical in calibrating the sensitivity of our portfolios to changes in interest rates – duration risk. While US Treasury yields have come down since their post-election ascent, they are still significantly higher compared with other sovereign debt markets, providing opportunities to profit from a growing yield-spread between countries. Moreover, our exposure to Treasury Inflation-Protected Securities (TIPS) has performed well post-election. The expected inflation rates derived from TIPS have gone up, given that potential fiscal and trade policy changes are largely deemed to be inflationary.

In the current market environment, we anticipate yield-curve steepening in the US and Germany and continue to position our portfolios with trades that favour short-dated bonds over longer maturities. For example, we have sold 30-year US Treasuries on an outright basis, to help convert a moderate US duration overweight held in the middle of the curve into a position that would gain from further steepening. On the other hand, we anticipate a yield-curve flattening trend in Japan. The Bank of Japan is on a path towards normalising monetary policy using rate hikes and balance sheet downsizing.

While business activity indicators are improving in the US, and moving broadly sideways in Japan, sentiment in the euro area's manufacturing and services sectors remained weak in November, with France showing a notable deterioration. In Germany, third-quarter real GDP growth was revised down to 0.1% by the country's statistical office, largely due to falling exports. With a rosier US growth outlook in mind, we're rotating some euro credit exposure into US dollars in global credit strategies. Also, floating-rate notes issued mostly by high-grade companies continue to provide an attractive yield-spread.

As we come to the end of the third-quarter corporate earnings season, the picture looks relatively healthy in the US. Sectors such as communications, utilities and consumer discretionary have performed the strongest, as the US consumer still shows signs of resilience – though the materials and property sectors have lagged. In Europe, results were in line with expectations except for cyclical sectors such as auto, chemicals, papers, luxury and consumer discretionary, which showed more pronounced weakness.

We see the recent rally in corporate credit as a chance to trim exposure to European and US issuers that may come under pressure from possible policy changes under the Trump administration. However, we are also adding risk in those sectors that are most likely to see gains, such as the US energy sector. The potential impact on Asian high-yield credit may not be as straightforward. Wider credit spreads, high all-in yields and a shorter duration profile mean that the asset class is generally less susceptible to interest-rate volatility and broad geopolitical risks.

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For China, a stronger US dollar under a Trump administration could mean further weakness in the renminbi. But we do not expect China to use acute currency interventions to retaliate against new US tariffs. With sufficient foreign currency reserves, China's central bank should comfortably manage renminbi volatility in the near term. Looking past the US political cycle, we think the renminbi will be increasingly driven by improving domestic and intra-Asia risk sentiment.

In emerging-market sovereign debt, we continue to prefer using the euro over the US dollar to fund long positions in emerging-market local currencies, such as the Indian rupee, Egyptian pound and Uruguayan peso. Meanwhile, we are long US dollar versus short Asian currencies such as the Korean won, Thai baht and New Taiwan dollar. Those currencies are more sensitive to broader risk-off sentiment than more domestic-driven markets such as India, which could also benefit from US trade protectionism and supply-chain diversification away from China.

## Fixed income market performance

| **Indicative market indices** Data as at 22 November 2024 | **Total return YTD 2024** (%) | **Total return Oct 2024** (%) | **Yield-to-worst*** (%) | **Effective duration** (years) |
|---|---|---|---|---|
| Asian high yield | 15.68 | 1.06 | 10.9 | 2.5 |
| Global convertible bonds | 10.83 | -0.66 | -0.4 | 1.7 |
| US high yield | 8.22 | -0.55 | 7.2 | 3.1 |
| Euro high yield | 7.78 | 0.61 | 5.7 | 2.7 |
| Global emerging-market sovereign bonds | 6.93 | -1.72 | 7.8 | 6.6 |
| US floating-rate notes | 5.83 | 0.51 | 5.1 | 0.0 |
| Euro investment grade | 4.42 | -0.40 | 3.2 | 4.5 |
| Asian investment grade | 4.30 | -1.34 | 5.2 | 4.7 |
| US Treasury bonds 1-3 years | 3.35 | -0.64 | 4.4 | 1.6 |
| Global aggregate | 3.09 | -1.35 | 3.7 | 6.6 |
| Euro government bonds 1-3 years | 2.95 | -0.18 | 2.2 | 2.0 |
| Euro aggregate | 2.68 | -0.75 | 2.8 | 6.5 |
| US investment grade | 2.52 | -2.43 | 5.3 | 7.1 |
| Global government bonds AAA-AA | 1.79 | -1.38 | 3.1 | 7.7 |
| US aggregate | 1.52 | -2.48 | 4.8 | 6.2 |

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 22 November 2024. 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 ECB rate cut

Weak manufacturing and services activity in November is likely to lead to stagnating economic growth in the euro area during the final quarter of this year. This scenario has raised the chances of a larger rate cut of 50 basis points at the next policy meeting of the European Central Bank (ECB) scheduled for 12 December. Pricing in interest-rate swap markets puts the odds for such a rate cut in the region of 50%.

### 2 UK services inflation

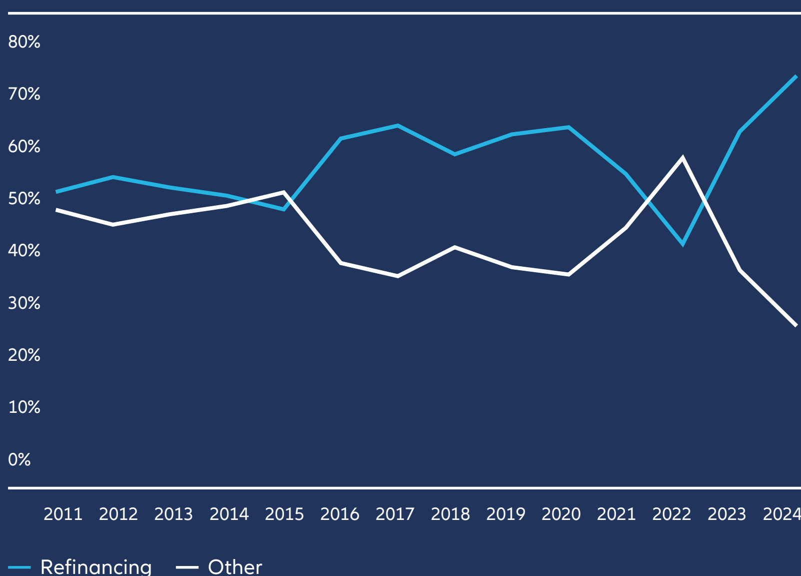
Inflation in the services sector of around 5% continues to pose a headache for the Bank of England. However, weak factory and retail sales data may be a precursor to softening in consumer demand, which could dampen inflation. UK Gilts look attractive on a relative value basis as they're currently priced for shallow rate cuts – market expectations may have turned more hawkish than warranted.

### 3 German Bund spread

Amid the collapse of Germany's governing coalition and the prospect of federal elections in February, the yield on German 10-year government bonds has traded above the equivalent rate on euro interest-rate swaps. While this "spread" is also driven by the run-off in ECB bond holdings, there are concerns that Germany may have to borrow and spend more in the event of major tariff-led disruptions to international trade.

## CHART OF THE MONTH

### Use of bond proceeds by high-yield issuers




Sources: Allianz Global Investors, Leveraged Commentary & Data (LCD) Pitchbook, data as at 30 September 2024. Past performance does not predict future returns.

Investors who aren't sure whether to allocate to high-yield credit often say that one of their biggest concerns is the potential for defaults. A measure we follow that helps gauge the creditworthiness of the high yield market is use of proceeds – in other words, what money raised by high-yield bonds is used for. It can be used for two main purposes. The first is refinancing, which extends the maturity wall – the period when a significant amount of debt is due – and reduces the risk of a company defaulting. The second is general business operations, mergers & acquisitions, and paying dividends. Refinancing falling below 50% of total new issuance is a sign that leverage is increasing in the market and that default rates could rise. But the proportion of proceeds being used for refinancing has hit a record high in 2024 (see Chart of the Month), which should bode well for default rates.

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