Aggressive start to Fed rate cuts

A highly anticipated rate cut by the US Federal Reserve (Fed) finally arrived this month, the first Fed cut in more than four years. The Fed opted to front-load policy easing, cutting rates by 50 bps, taking the target range for the Fed funds rate to 4.75–5.0%. The rationale is that with the recent easing in inflationary pressures and softening in the labour market, current rates are unnecessarily restrictive and there is quite some distance to a neutral policy rate. Therefore, a bigger first step makes sense. Initial market reaction interpreted the Fed move purely as front-loading and pricing puts the Fed funds rate at around 3% by mid-2025.

During previous rate-cutting cycles, bonds have typically outperformed other assets. To some degree, that outperformance was driven by a more dramatic "risk-off" sentiment taking hold and central banks having no choice but to cut rates in reaction to a major economic downturn or external shock. While that is not the case today, the current more proactive rate-cutting cycle still looks very favourable for bond investors. Faster or bigger rate cuts will push bond prices higher due to their sensitivity to declining rates but may shorten the window of opportunity to lock in higher yields.

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The European Central Bank (ECB) cut rates for the second time this year, cutting the deposit rate by 25 bps to 3.5% in a move that was well priced by markets. Euro area growth has disappointed expectations so far this year, while the disinflation process in the region remains broadly intact. Wage growth has slowed down and forward inflation expectations have also fallen back to the ECB inflation target. We think that interest rates at current levels are clearly very restrictive, and the current data mix requires rates to move towards a neutral stance sooner rather than later.

The Bank of England (BOE), meanwhile, held rates steady at 5% this month, having cut rates by 25 bps in August. Relative to the Fed and ECB, the BOE has signalled a more conservative easing cycle. This is not surprising: UK economic growth has confounded the gloomiest expectations at the start of this year and core inflation has also been stickier than in other G10 markets. Looking beyond September, however, we think there is a good chance that BOE rate cuts will intensify as the UK labour market continues to loosen and wage growth slows. This is underpinned by a UK government that is likely to maintain a tight fiscal stance at the upcoming Autumn Budget in October.

What does this mean for core government bond markets? Following some disappointing US activity data over the summer, especially from the labour market, short-term interest rate markets began to price a front-loaded Fed's rate cutting cycle, helping to support yield curve steepening positions. We think the macro and policy backdrop still favours yield-curve steepeners, especially given that risk assets could be overpricing a soft landing and underpricing a hard landing.

At the same time, a lot is now priced into forward markets for the current policy easing cycle. This presents an opportunity to tactically take profit on the recent sharp steepening of yield curves. With markets now set to turn their attention to the US election, bond volatility may well remain elevated, so we think it's also a good idea to tactically trade duration along the way, with a bias to add some inflation protection in portfolios. Within G4 markets, taking duration exposure in UK Gilts on a relative value, cross-market basis against German Bunds make sense from

both a fundamental and valuation perspective.

In spread assets, emerging market debt and especially local sovereign rates stand out as a longer duration asset class that can gain from emerging-market central banks cutting rates further. Inflation across many emerging-market economies has been on a softening trend for some time, which has kept real (after-inflation) rates relatively high compared to core markets. With the easing cycle in advanced economies now underway, we are likely to see a recovery in both issuance and flows into the asset class.[1]

In corporate credit, spreads are rather tight for high yield and, to a lesser extent, for investment grade. As rates come down, we do not think tight spreads will stop investors from reallocating some of their money-market funds into credit. In high yield, we see a stronger case for shorter-dated credit, since extending spread duration risk does not offer a sufficient yield premium at the moment. In investment grade, we like high-quality, liquid debt typically maturing in less than 10 years. Moreover, floating-rate notes issued mostly by highly-rated companies continue to provide an attractive yield-spread and hedge against any unexpected repricing of expectations towards higher-for-longer inflation and rates.

Fixed income market performance

Indicative market indices Data as at 30 June 2023	**Total return YTD 2024** (%)	**Total return Aug 2024** (%)	**Yield-to-worst** (%)	**Effective duration** (years)
Asian high yield	11.89	0.48	11.4	2.4
Global emerging-market sovereign bonds	7.76	2.32	7.6	6.8
US high yield	7.03	1.59	7.3	3.1
Global convertible bonds	6.65	1.42	0.3	2.0
Euro high yield	5.82	1.15	6.1	2.7
Asian investment grade	5.81	1.82	4.7	4.8
US investment grade	5.45	1.57	4.7	7.3
US aggregate	4.93	1.44	4.1	6.2
US floating-rate notes	4.62	0.45	5.9	0.0
Global aggregate	4.57	1.10	3.3	6.7
US Treasury bonds 1-3 years	4.10	0.92	3.6	1.7
Euro investment grade	3.19	0.29	3.3	4.5
Global government bonds AAA-AA	2.88	0.74	2.8	7.8
Euro aggregate	2.17	0.44	2.8	6.6
Euro government bonds 1-3 years	2.14	0.49	2.4	1.9

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 13 September 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.

1 IMF Blog, Fed Rate Cuts May Help Revive Bond Flows to Emerging, Developing Economies, 5 September 2024.

WHAT TO WATCH

1 UK government bonds

Despite the BOE leaving its policy rate unchanged this month at 5%, markets may be underpricing the extent of cuts to come over the next two to three quarters – in light of cooler UK wage growth and services inflation, as well as tighter fiscal policy. In this regard, Gilt valuations look increasingly attractive when compared to heftier ECB and Fed cuts already reflected in futures markets and bond yields.

2 US Dollar

While the USD has previously benefitted from the relative outperformance of the US economy versus other major markets, head-winds are emerging for the USD as US growth expectations are pared back and as markets price front-loaded Fed rate cuts. On the flip side, if growth in the euro area and China continues to disappoint, this may help to reverse some of the recent USD weakness.

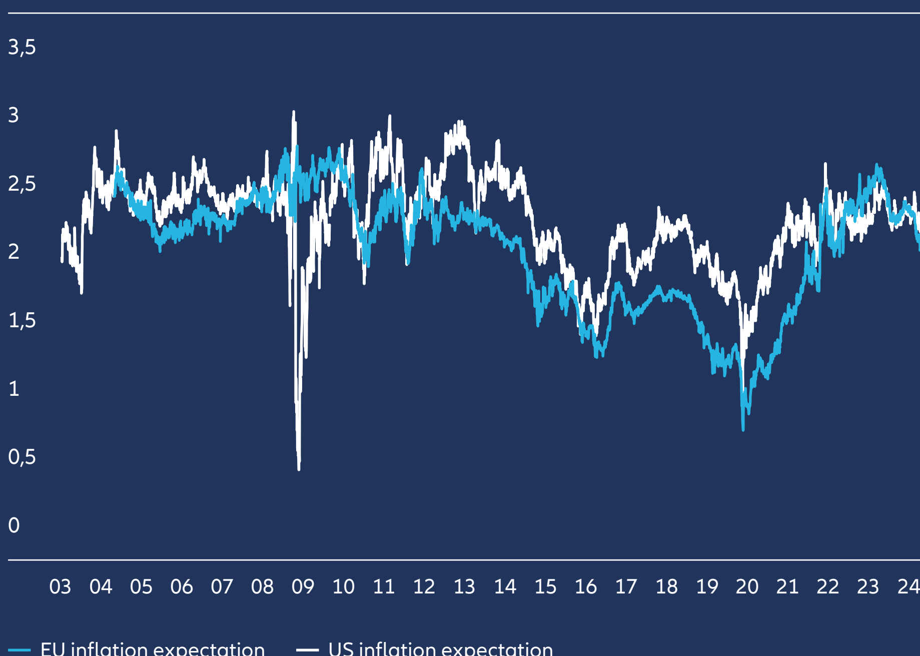
3 US elections

Markets are set to begin focusing on the US elections in November. Uncertainty on the outcome of the Presidential election and the make-up of the next Congress may have important implications for fiscal, trade and immigration policy, driving expectations to some degree when it comes to US and global growth, inflation, as well as the future trajectory of monetary policy.

8 US Census Bureau, Advance Monthly Sales for Retail and Food Services, Manufacturing and Trade Inventories and Sales, 17 September 2024.

CHART OF THE MONTH

5-year, 5-year forward inflation expectation rates



Sources: Bloomberg, Allianz Global Investors; the indices in the chart are calculated using inflation swaps (for the euro area, data 27 April 2004–16 September 2024) and inflation-adjusted Treasury securities (for the US, data 2 January 2003–16 September 2024). Past performance does not predict future returns.

Long-term inflation expectations in the US and the euro area have fallen close to the 2% central bank target. The indices in the chart represent a measure of expected inflation (on average) over the five-year period that begins five years from now. For one, the downward trend in "inflation forwards" may be a signal that the Fed and the ECB have reasserted their inflation-fighting credibility, and consequently long-run inflation rates have re-anchored to central bank mandates. Moreover, markets seem to have moved away from "stagflation" fears and turned their attention to a demand-driven slowdown, led by China and Europe at the moment. However, long-run expectations should in principle reflect factors that are more structural than cyclical. Some of these structural factors, such as a shrinking workforce in Europe, could prove inflationary. In this respect, forward inflation rates may have overshot to the downside, perhaps providing an opportunity for fixed income investors to position for a repricing.

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