JUNE 2024

Allianz Global Investors

Fixed Income Forward

New hierarchy emerges in bond risk premiums

Much has happened in fixed income since the start of the year. But the march toward greater differentiation in bond markets has been slow and arduous. Only now do we begin to see serious signs of a new hierarchy in risk premiums emerging. In particular, we're looking to see this new hierarchy expressed through an expansion in yield spreads (1) between core rates markets globally, (2) between different bond maturities along select yield curves, and (3) across the euro area's core and semi-core/periphery.

The European Central Bank (ECB) cut its key interest rates by a quarter of a point in June, while the US Federal Reserve (Fed) left its rates unchanged. Consumer inflation alone doesn't explain the divergence. The euro area's annual inflation rate for May rose, with the highest contribution coming from services.[1] In contrast, the annual rise in the US Consumer Price Index (CPI) for May slowed slightly compared to April.[2] The more closely watched US Personal Consumption Expenditures (PCE) Price Index will be released at the end of June.

We need to consider other economic activity indicators to make sense of why the ECB has beaten the Fed to the punch. Economic growth, job markets, as well as survey-based measures of business sentiment, remain stronger in the US than in Europe. The Fed's median projection is now showing only one rate cut (down from three) for 2024.[3] Futures markets are pricing in two.[4] We think the pendulum may have swung too far, and that the Fed risks having to play catch-up later down the line with faster and bigger cuts.

Just one day before the ECB, Canada became the first G7 economy in the last four years to cut rates (also by 25bp) as underlying inflationary pressure in the country eased further. Meanwhile, the Swiss central bank delivered a 25bp cut too, but that was the second time it did so this year. Policymakers in the UK kept rates unchanged but signalled the possibility of a rate cut later this summer. Norway also held back on its first rate cut, worried about stubborn inflation and wage growth, helping the krone rally in recent weeks.

We expect to see yield-spread widening between advanced economies as their trajectories begin to diverge through 2024 and into 2025 – given meaningful differences across markets in debt dynamics, the transmission of monetary policy, and fiscal support. We also favour

Fixed income market performance

Indicative market indices Data as of 18 June 2024	Total return YTD 2024 (%)	Total return May 2024 (%)	Yield-to-worst* (%)	Effective duration (years)
Asian high yield	10.00	2.75	12.2	2.5
Global convertible bonds	3.28	1.66	0.5	2.0
US floating-rate notes	3.21	0.57	5.9	0.0
Euro high yield	2.93	0.96	6.6	2.8
Global emerging-market sovereign bonds	2.80	1.80	8.3	6.5
US high yield	2.54	1.13	8.0	3.2
Asian investment grade	1.52	1.08	5.3	4.6
US Treasury bonds 1-3 years	1.11	0.73	4.7	1.6
Global aggregate	0.65	0.88	3.8	6.7
Euro investment grade	0.58	0.24	3.9	4.6
US investment grade	0.45	1.87	5.3	7.2
Euro government bonds 1-3 years	0.28	0.21	3.1	1.9
US aggregate	0.11	1.70	4.9	6.2
Global government bonds AAA-AA	-0.61	0.39	3.3	7.7
Euro aggregate	-0.69	0.04	3.2	6.6

Source: Bloomberg, ICE BofA and JP Morgan indices; AllianzGI, data as at 18 June 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 does not predict future returns.

Franck Dixmier
Global CIO
Fixed Income

Georgios Georgiou
Global Head
Product Specialists
Fixed Income

exposure to potential steepening of the US and German yield curves over time, given that ultra-long maturity bonds still offer an insufficient term premium – the extra yield investors demand for holding longer bonds over shorter ones.

In Japan, we anticipate curve flattening as the country has only recently begun to shift away from its zero interest-rate policy. Higher rate expectations have been brought forward, against the backdrop of JPY weakness. At its June policy meeting, the Bank of Japan kept rates unchanged but said that in July it would explain how it plans to go about cutting its long-standing bond-buying programme – the clearest sign yet that policy normalisation should also include a reduction in its massive balance sheet.

Back in Europe, the question of whether term premiums adequately price future monetary or fiscal risks came to the fore this month. French President Emmanuel Macron called a snap parliamentary election after his party performed poorly in the European elections. The yield spread between French and German 10-year bonds recorded its largest weekly spike since the euro debt crisis in 2011.[5] Markets seem unnerved by the prospect of a hung parliament or win by Marine Le Pen's far-right National Rally (RN) party, which could open the door to looser fiscal policy.

Year-to-date, emerging-market US dollar debt is outperforming developed markets. The largest issuers have addressed major imbalances whilst the weaker ones are turning to more orthodox policies or to IMF programmes. Overall, Asian high yield remains the top-performing fixed-income asset class, as China real estate bonds have rallied strongly on the back of more central government measures to revive the sector.

WHAT TO WATCH

1 French legislative elections

The outcome of the elections is made harder to predict by the electoral system's two-round voting process. The latest polls show President Macron's centrist alliance trailing its rivals on the right and the left, who have advocated for largely unfunded public spending programmes. The probability of political deadlock or limited action on urgent domestic issues looms large in the event of a no clear majority or solid alliance emerging.

2 US PCE deflator

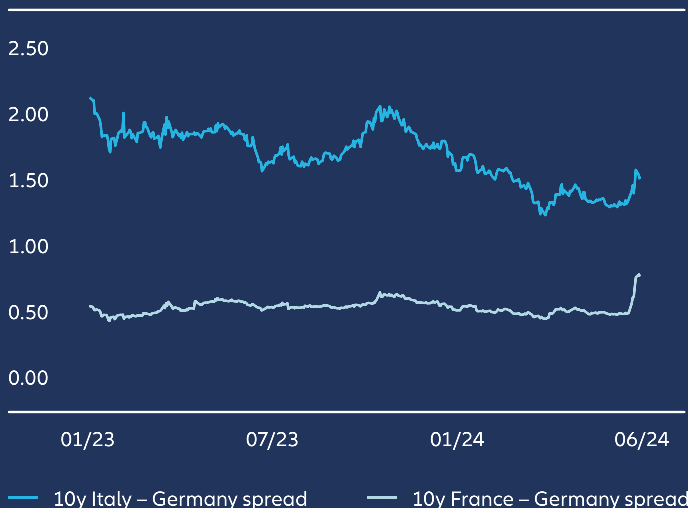
The Fed sees the PCE price index as including the broadest set of goods and services, out of all the official measures of consumer price inflation. For example, rent and gas have a much heavier weight in the CPI than in the PCE. Meanwhile, a slowdown in producer price growth[6] has raised market confidence that the PCE annual rate for May will come in softer, helping clear the path for the Fed's first rate cut.

3 Emerging market currencies

The pricing out of multiple US rate cuts for 2024 has helped strengthen the dollar against "higher carry" currencies of some emerging economies which now face uncertainty about future monetary and fiscal policies. For example, the MXN/USD suffered a double-digit drop after Mexico's ruling party swept the elections and sparked fears about possible constitutional reforms that could harm the economy long term.

CHART OF THE MONTH

France-Germany yield spread on watch



The difference between French and German 10-year yields, also known as the OAT-Bund spread, has eased from a recent peak of 0.82bp but remains just above 75bp, its highest level since 2017. France's credit outlook was on the back foot even before the latest political crisis. Markets look unsettled by the possibility of a hung parliament in France, where no party would have a majority. That could mean political deadlock for at least 12 months, since the French president is not allowed to dissolve parliament again until a year after the previous dissolution.

The OAT/Bund spread may very well rise to a full percentage point or more, if further polling were to show that the RN and its allies could command an absolute majority. In that scenario, we may also see a spillover of stress into periphery spreads, most notably Italy-Germany.

Source: Bloomberg benchmark government bond indices, yield data (bp) 1 January 2023 – 18 June 2024.
Past performance does not predict future returns.

* 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.

1. Eurostat, 18 June 2024.
2. US Bureau of Labor Statistics, 12 June 2024.
3. Federal Reserve Board, Summary of Economic Projections, 12 June 2024.
4. CME FedWatch Tool, 18 June 2024.
5. Bloomberg benchmark government bond indices, 18 June 2024.
6. US Bureau of Labor Statistics, 13 June 2024.

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