Yield curve strategies primed to perform

In March the US Federal Reserve kept interest rates on hold and announced a slowdown in the pace at which it would reduce its Treasury holdings. The median forecast from the central bank's voting members was unchanged, pointing to a total of 50 basis points in rate cuts in 2025. Trade and fiscal policy uncertainties stemming from the Trump administration have skewed inflation risks to the upside and growth risks to the downside. Upcoming US inflation data for February may help to ease concerns of stagflation – in which high inflation coincides with stagnating economic growth – though it could also add to these worries.

We believe the best way to navigate the current environment is through exposure to US and German yield curve steepening. This is because we expect sell-off pressure to continue to shift from better-anchored short-term rates to longer-term yields, impacted by the prospect of greater government borrowing and fiscal deficits. A long interest-rate duration stance looks better suited to the UK and Australia, where there is more room for bond yields to fall further on the back of potential future rate cuts.

In contrast, we expect Japan's yield curve to flatten. In March the Bank of Japan held its policy rate at 0.5% despite continued signs of domestic reflation. The key rationale for holding steady, according to the central bank, was concern about tariff-related risks. In our view, ongoing pressure to normalise monetary policy, more stable front-end US rates, and attractive yen (JPY) valuations favour a long JPY position. In currency markets, we have implemented two cross-market strategies to reflect global policy divergence – a long JPY position versus the Thai baht, and a long Australian dollar position versus the US dollar.

In Asia, policymakers went ahead in February with more monetary policy easing, for instance in India, Korea and Thailand. The Philippines and Indonesia bucked that trend by keeping policy rates unchanged – a slight surprise to markets that had anticipated some degree of easing from both countries. Nevertheless, we expect the general trend of central bank easing across Asia to continue unabated, and in view of that, we're trimming duration risk in select markets, including China. Having said that, we remain constructive on Chinese government bonds and await better market conditions to reengage.

Elsewhere in emerging markets, Turkish asset prices weakened significantly after the opposition party's presidential candidate-in-waiting was arrested, alongside other party officials and opposition figures, on a set of corruption, fraud and terrorism charges. The Central Bank of Turkey responded with a significant currency intervention worth over USD 14 billion, as well as an overnight rate hike of 200 basis points to 46%. If popular protests and dollarisation stay contained, we believe economic policy measures may prove sufficient to restore confidence in Turkey's economy and markets.

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In high yield corporate credit, Asian and emerging market spreads have outperformed both US and European markets of late, reflecting fears of slowing US growth and complicated economic prospects for the euro area. Our overweight exposure to B and BB-rated bonds – at the better quality end of the high yield category – has performed well following significant "risk-off" sentiment among the lowest-rated and distressed credits. In future, we expect greater dispersion of performance by name and sector. We continue to de-risk at the margin by allowing cash balances to rise while remaining on the lookout for dislocations where we believe we can profit.

In investment grade, valuations remain fair to expensive. We nevertheless retain a modest overweight position because we think these bonds still offer an attractive carry. Bank bonds remain in favour both in Europe and the US, as they have historically outperformed the broader market during periods of yield-curve steepening. In March, EUR corporates continued to outperform their USD counterparts at a market index level, marking the first time since January 2022 that EUR spreads traded tighter than USD spreads. The EUR primary market has been very active, with large volumes and limited premiums met by ample demand.

Global convertible bonds now lead other bond markets year-to-date on a total return basis. The underperformance of US issuers was more than offset by strong returns in Europe, where the removal of EU-imposed limits on government defence spending has shored up sentiment in euro convertibles.

Fixed income market performance

Indicative market indices **Data as at 20 March 2025**	**Total return YTD 2025 (%)**	**Total return Feb 2025 (%)**	**Yield-to-worst* (%)**	**Effective duration (years)**
Global convertible bonds	3.51	0.51	-0.6	1.7
Asian high yield	3.46	2.53	9.9	2.7
Global emerging-market sovereign bonds	3.12	1.57	7.6	6.5
US aggregate	2.71	2.20	4.6	6.2
US investment grade	2.49	2.04	5.1	7.1
Asian investment grade	2.31	1.60	5.1	4.8
US high yield	1.59	0.65	7.4	3.1
US Treasury bonds 1-3 years	1.41	0.71	4.0	1.6
US floating-rate notes	1.11	0.43	4.9	0.0
Euro high yield	1.02	1.04	5.7	2.7
Global aggregate	0.96	1.20	3.6	6.6
Euro government bonds 1-3 years	0.37	0.37	2.3	2.0
Euro investment grade	-0.08	0.61	3.3	4.4
Global government bonds AAA-AA	-0.48	1.00	3.2	7.5
Euro aggregate	-1.22	0.68	3.0	6.4

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 20 March 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 inflation

Federal Reserve Chair Jerome Powell referred to tariffs as a key source of inflation worries, but reiterated that the US central bank was not in a rush to cut interest rates. He noted that while new tariffs may delay disinflation, the base case was that any impact ought to be transitory. Markets will search for confirmation of this narrative in the much-anticipated US personal consumption expenditures (PCE) price index for February, which is scheduled for release on 28 March.

2 US tariffs

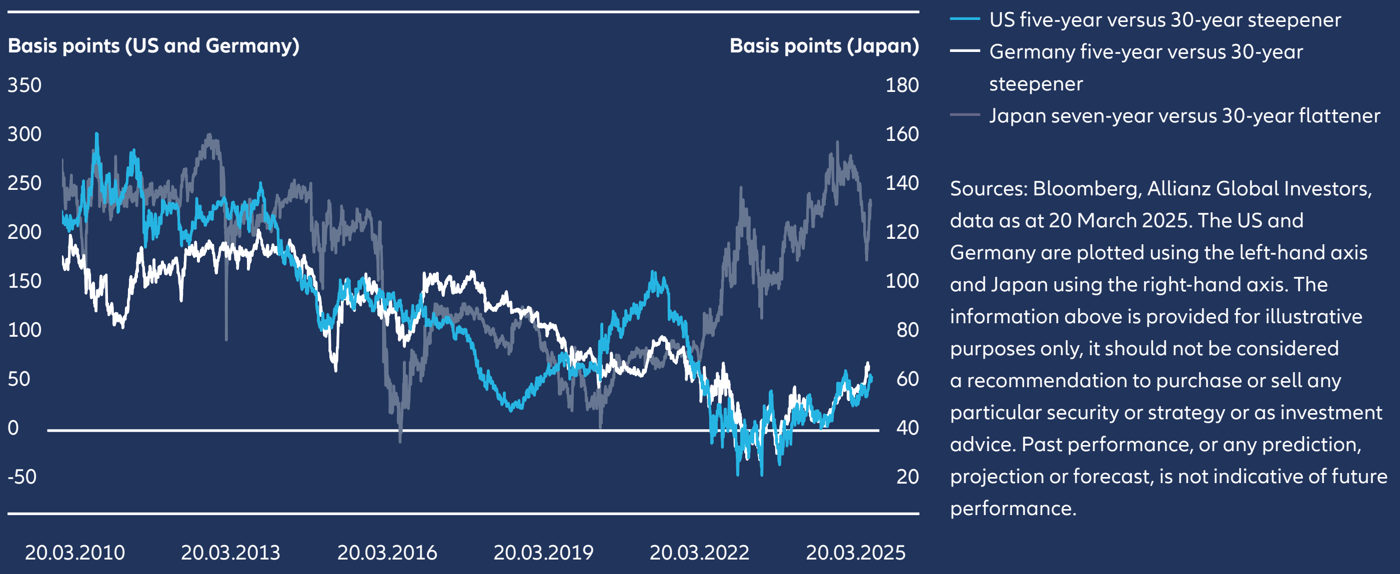
Another upcoming milestone is 2 April, when the US administration is expected to announce the next batch of tariffs, including reciprocal measures. Bond yield volatility may rise as the date draws near. More targeted measures that allow some countries and sectors to escape unscathed could provide a boost for risk assets. On the other hand, indiscriminate tariffs may help re-flatten yield curves in near term; however, we think steeper curves could develop beyond any pullbacks.

3 Credit spreads

While corporate spreads – the yield pick-up over core government bonds – in the US and Europe remain historically tight, demand for corporate bonds is still strong and supply has moderated recently amid heightened yield volatility. A turn to expansionary fiscal policy has helped euro spreads outperform this year. At the same time, US spread widening is not all that bad and can help global credit strategies profit from cheaper entry points in select sectors and names.

CHART OF THE MONTH

Yield-curve strategies stay in favour



Sources: Bloomberg, Allianz Global Investors, data as at 20 March 2025. The US and Germany are plotted using the left-hand axis and Japan using the right-hand axis. 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.

We think the current market environment favours portfolio positions that can profit from yield-curve steepening both in the US and Germany. We recently increased our US yield-curve steepening exposure, adding a five-year versus 30-year steepener in addition to an existing seven-year versus 30-year position. We also added back a German five-year versus 30-year steepener given the prospect of increased fiscal spending in Europe. It is true that fiscal worries relating to rising long yields might begin to wear off somewhat – because their impact may be too far out into the future to be felt today; however, we think the financial tightening effects of rising long yields will nevertheless add pressure onto the European Central Bank to cut rates again in April, which in itself may contribute to the German yield curve maintaining or extending its steepening. To balance the steepening exposure, we favour a Japanese seven-year versus 30-year flattener. The Bank of Japan remains on a path towards policy normalisation given that inflationary pressures continue to build.

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