APRIL 2025

Allianz Global Investors

Fixed Income Forward

Case for bonds intact despite higher volatility

Volatility in bond and equity markets has been high since the US announced its reciprocal tariff policy on 2 April. Sentiment deteriorated further after China announced retaliatory tariffs, while other countries have been more cautious in their response to US trade policy. Sharp drawdowns in risk assets have seen similarly sharp reversals, partly on the back of a 90-day pause on a portion of US tariffs, and more recently on hopes of progress in bilateral trade deal negotiations.

Despite heightened market volatility and policy uncertainty, fixed income assets have mostly delivered positive total returns so far this year. We believe investors can still profit from yield-curve steepening through the appropriate portfolio positioning in core rates, though we are now looking to trade more tactically around this previously more strategic allocation. The same goes for duration versus benchmark indices, where we also favour tactical positions and profit-taking until yield volatility comes down further.

We have taken profit on some positions that have gained from global policy divergence, for example the Japanese yen outperforming the Chinese yuan. But we maintain exposure to cross-market themes, such as anticipating that the yield spread will tighten between five-year US Treasuries and five-year Bunds. At the same time, we are long 10-year US Treasury Inflation-Protected Securities (TIPS) and have added some US duration risk by closing our short position in 30-year US Treasuries.

Hard economic data from the US remains relatively solid, but the gap with softer data is growing as surveys report plunging business and consumer confidence. A key annual inflation measure, the US core personal consumption expenditures price index, came in at 2.8% for February and did little to soothe fears of stagflation. Meanwhile, the US dollar reached a three-year low on a trade-weighted basis. We exited a position that favoured the Australian dollar over the US dollar and added long euro exposure instead.

In Europe, markets continue to price downside growth risks amid little progress in EU-US trade talks. As expected, the European Central Bank cut rates by 25 basis points to 2.25%. In the UK, a 2.6% annual headline inflation print reinforced expectations that the Bank of England will cut rates at the next Monetary Policy Committee meeting in May. Even in the case of a bilateral trade deal with the US, the UK economy remains vulnerable to contagion effects. We suspect 10-year Gilts will outperform their German and Canadian equivalents and are positioned to gain from this outcome.

Corporate credit has rallied following the widest credit spreads seen so far this year, in mid-April. Elevated all-in yields still are a supportive technical factor, and we take comfort in strong company fundamentals and expected interest rate cuts ahead of any serious recession. We are slightly overweight investment-grade credit risk and remain conservatively positioned with

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a bias towards quality issuers. Our participation in primary markets has been highly selective, as activity is relatively muted with the corporate earnings season in full swing.

In high yield credit, we are taking slightly less risk than benchmarks. Our global strategies favour euro over US dollar debt. We are staying away from the CCC-rated segment of the market, exiting names with a potentially deteriorating outlook, and continue to deploy cash from matured or called bonds into high-conviction credits with good liquidity. With the market yielding around 7.5% in US dollar terms, we want to be well invested to maintain carry and guard against overnight rallies.

Among hard-currency spread assets, Asian investment-grade corporate credit and emerging-market sovereign bonds have outperformed comparable assets on a total-return basis. Some local currencies have held their ground or strengthened amid the escalating trade conflict with the US. We think Asian and emerging markets are likely to continue to do well – especially those with less dependence on US exports and where issuers are more biased towards domestic consumption and liquidity.

In the current environment, we see some of these higher yielding spread assets as a good place of refuge for many investors, especially given their improving credit metrics. At the same time, there is a strong case for maintaining quality exposure, mostly at the shorter end of core government and corporate bond curves. This could prove a defensive strategy if the global growth outlook were to deteriorate sharply.

Fixed income market performance

Indicative market indices Data as at 23 April 2025	**Total return YTD 2025 (%)**	**Total return March 2025 (%)**	**Yield-to-worst* (%)**	**Effective duration (years)**
US Treasury bonds 1-3 years	1.90	0.47	3.9	1.6
US aggregate	1.80	0.04	4.7	6.1
Global convertible bonds	1.78	-1.18	0.2	1.8
Asian investment grade	1.54	0.04	5.3	4.7
Global emerging-market sovereign bonds	1.42	-0.76	8.0	6.4
Global aggregate	1.33	-0.42	3.6	6.6
Asian high yield	1.29	0.37	10.7	2.6
Euro government bonds 1-3 years	1.28	0.16	1.9	2.0
US floating-rate notes	1.24	0.37	5.1	0.0
Euro investment grade	1.04	-0.93	3.1	4.5
US investment grade	0.92	-0.29	5.4	6.9
Global government bonds AAA-AA	0.91	-1.23	3.0	7.5
Euro high yield	0.71	-0.99	5.8	2.8
US high yield	0.51	-1.07	7.9	3.2
Euro aggregate	0.45	-1.54	2.8	6.4

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 23 April 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 Yield volatility

When stock markets fall, Treasury yields usually fall too because of rising demand for safer assets. It may seem counterintuitive that Treasury yields recently rose in step with heightened equity volatility. One explanation may be investor concern that a sharp slowdown in US growth would make an already unsustainable fiscal outlook worse. Other explanations could be deleveraging by hedge funds or rebalancing among large institutional investors.

2 Corporate earnings

We have heard from more than a quarter of S&P 500 and Euro Stoxx 600 companies. First-quarter results are encouraging, though many companies are shying away from more guidance until there is clarity on tariffs. Analysts' 12-month forward earnings estimates have come down, though negative revisions are not yet extreme. The relative uniformity of analyst estimates could be read as a warning sign that analysts are overconfident in the resilience of future earnings.

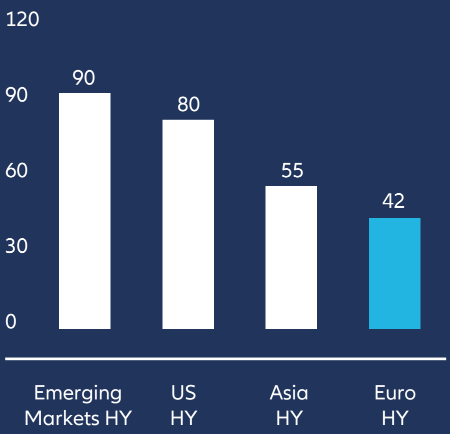
3 Emerging markets

The JP Morgan GBI-EM index, which tracks the performance of emerging-market local currency sovereign bonds in unhedged US dollar terms, was up more than 6% as at 23 April. About half the returns came from currency gains. We are following several positive fundamental and valuation stories in emerging economies, but we remain selective as recent gains in some growth-sensitive markets may not be sustainable.

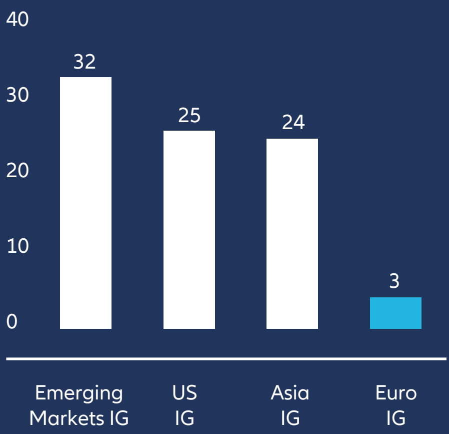
CHART OF THE MONTH

Euro credit spreads show resilience

Year to date spread change of major high yield (HY) fixed income indices (basis points)



Year to date spread change of major investment grade (IG) fixed income indices (basis points)



Sources: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 25 April 2025. 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.

A turn to German and European fiscal expansion, as well as European Central Bank policy easing, have helped euro credit outperform comparable assets, insofar as spreads have widened less in Europe than in other regions. In response to increased geopolitical uncertainty, the EU has proposed a major initiative that aims to mobilise up to EUR 800 billion to bolster defence capabilities. Alongside this development, the German Bundestag voted to reform the country's "debt brake", which should relax borrowing limits and allow new investments in defence, infrastructure and climate initiatives. Potential winners include sectors expected to benefit from increased government spending such as aerospace and defence, as well as building materials, construction and capital goods. On the other hand, the automotive, alcoholic beverages and luxury goods sectors could face challenges owing to US tariffs.

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