Diverging paths ahead

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Diverging economic and monetary policy paths are feeding through to government bond markets, presenting risks and opportunities for investors. In the second of four articles exploring ways that investors can reset bond allocations, we discuss ideas for navigating the divergence in central bank policy, inflation, currency risks and economic performance.

Key takeaways:

– Economies and policies are shifting from broadly in-sync to deeply out-of-sync

– Investors should watch out for divergent recession risks, a possible blowout in riskier bond yields in the euro area, and the chance of stagflation in the UK

– Fear of inflation becoming entrenched is motivating some central banks to frontload rate hikes

– Investors could consider flexible bond strategies and adding incrementally to core rates markets likely to benefit from flight to safety

From Germany to Brazil and the UK to China, economies are moving at different speeds as monetary policy and growth begin to diverge in the wake of the turmoil created by the Covid-19 pandemic. This contrasts with the Covid-19 pandemic era when central banks across advanced and emerging-market economies converged in their willingness to over-loosen policy and let inflation overshoot for a while to bring down unemployment.

But we are now seeing a divergence in banks' resolve to over-tighten, to bring down inflation at the expense of economic growth and jobs. The division is creating risks, but also opportunities for those investors prepared to be flexible, as well as seek out potential safe havens.

There's now a stark contrast in after-inflation (real) yields across many government bond markets. Consider the more than 3% yield for Brazil's local currency bonds at the end of August, compared to the -9% for Spain's equivalent after relatively little yield difference during the pandemic's onset (see Exhibit 1).[1] This mixed picture suggests that economies and policies are becoming deeply out-of-sync regarding how and when they might exit the current inflation-led regime.

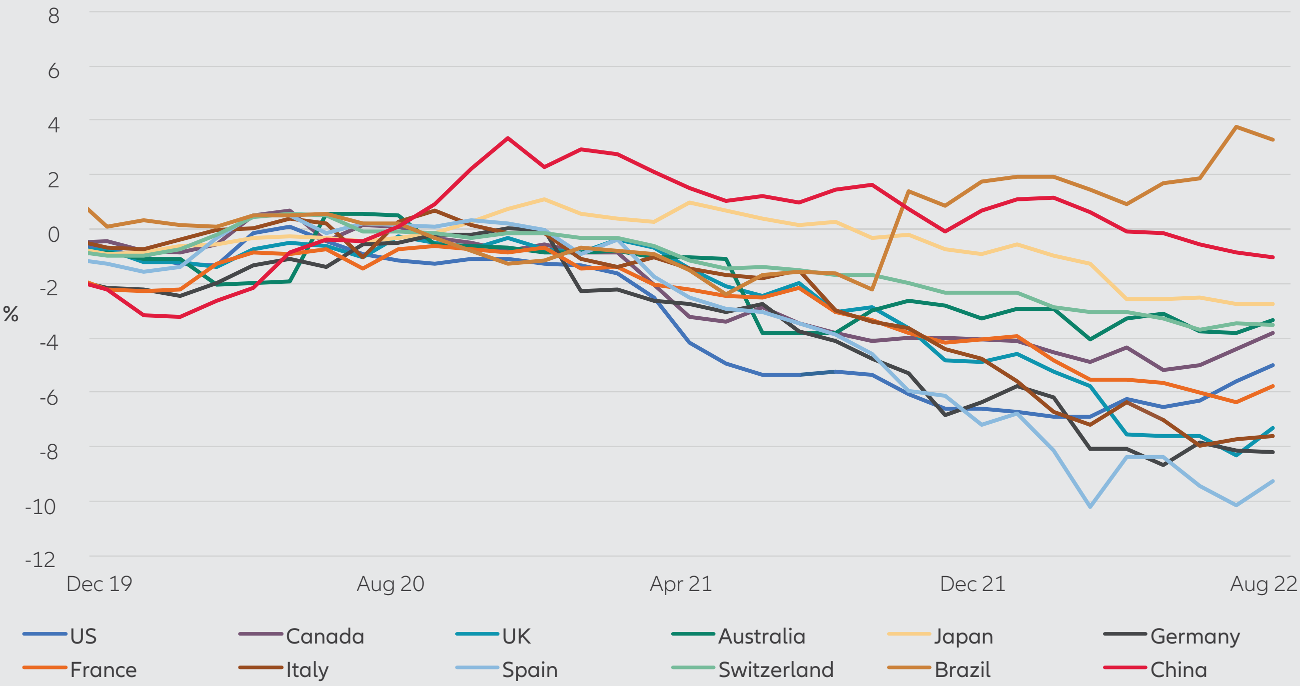
One reason for this divergence is that the range of economic outcomes differs materially across borders.

1. Source: Bloomberg. Allianz Global Investors. Yield data as at 31 August 2022. Latest available official inflation data for the month of July 2022.

Navigating Rates

Allianz Global Investors

Exhibit 1: month-end 1-year government bond yields (local currency). adjusted for monthly headline consumer price inflation (year-on-year, not seasonally adjusted)



Source: Bloomberg. Allianz Global Investors. Yield data as at 31 August 2022. Latest available official inflation data for the month of July 2022

Euro area vs North America

A deeper recession in the euro area looks greater in likelihood and magnitude than in energy-rich economies like the US and Canada, where the chances of reining in inflation without a hard landing may look better. The difference is largely because of Europe's outsized dependency on natural gas supply from Russia – which could be unilaterally turned off for a prolonged period due to the geopolitical tensions surrounding the war in Ukraine. Euro-area real rates remain deeply negative as the European Central Bank (ECB) has been slower to raise rates than the Federal Reserve, even as the region's annual inflation figures surpassed those in the US. This also explains why we see more yield curve steepness in the euro area. In contrast, 2/10-year curves for the US and Canada have inverted due to the frontloading of rate hikes pushing up yields much more at the front-end.

The euro area also faces the additional challenge of having one currency and one policy rate, yet still plenty of economic divergence between euro-area countries. The official flash estimate for euro-area annual inflation in August came in at 9.1%, up from 8.9% in July[2], and showed the biggest dispersion between member states since the euro's introduction. Estonia's inflation came in at 25.2%, compared to 6.5% in France.[3] The ECB has been trying to partially offset its "one-size-fits-all" policy rate by reinvesting proceeds from its maturing debt holdings issued by euro-core countries to buy euro-periphery debt. Without such support, the spread between 10-year German and Italian bond yields would probably have widened further past the 235-basis-point level seen at the end of August[4]. It remains to be seen whether the ECB's new "anti-fragmentation" bond-buying programme will be officially activated and can succeed in preventing a blowout in riskier euro-area yields.

UK stagflation risks

We haven't seen a major shift in longer-term inflation expectations that would lend support to a stagflation scenario. Anchoring longer-term expectations is probably the most crucial factor that has kept a lid on inflation pre-pandemic. It is the fear of "de-anchoring" that is motivating some central banks to frontload rate hikes, both in size and speed. But if there is any chance

2. Source: eurostat, 31 August 2022
3. Source: eurostat, 31 August 2022
4. Bloomberg, 31 August 2022
5. Source: Bank of England, August, 2022

of a stagflation scenario taking hold in an advanced economy, the UK looks like a good candidate. Annual inflation has crossed 10%.[5] The Bank of England expects it will peak above 13% in the autumn and is hiking rates rapidly, notwithstanding its forecast that the UK economy will enter recession by the end of this year. Inflation could move even higher if gas prices remain at current levels. The yield on two-year UK debt has spiked from 1.7% at the start of August to cross 3.2% in September[6], the biggest such jump since the early 1990s. A chronically large current account deficit does not bode well for UK debt, and neither would a growing budget shortfall if the new Prime Minister Liz Truss went ahead with bold tax cuts.

Asia asymmetry

The theme of global policy divergence also extends east. The Bank of Japan has maintained its benchmark rate at -0.1% and stuck to its bond-buying programme, which aims to cap 10-year yields at 0.25%. Annual inflation is around 2.5%,[7] but the economy remains vulnerable – it only recovered to its pre-pandemic size in the second quarter this year thanks to stronger exports and consumer spending. China's annual inflation is slightly higher, but the country is also bucking the global tightening trend. Authorities there have loosened their monetary and fiscal stance to grapple with repeated Covid-19 shutdowns taking a toll on economic activity and a highly distressed property sector. Chinese real estate bonds were a positive outlier in August, retracing some of their year-to-date losses, which remain deeply negative.

Emerging markets are ahead in the tightening cycle

Some of the earlier and most aggressive hikes in 2022 have come from emerging market economies, many of which have had to contend with a brewing cost-of-living crisis – as food and energy prices typically account for a higher share of consumer price indices. As their tightening cycle has led that of advanced economies, many emerging markets such as Brazil and Mexico feature positive real yields and inverted yield curves. Higher commodity prices have, to some degree, shielded net commodity exporters. Yet, inflation and rate expectations tend to be harder to anchor than in advanced economies, as the damage to local currencies and fiscal positions from global shocks is usually more pronounced.

Currency casualties

Currency market fluctuations in 2022 offer perhaps the most extreme reflection of the global policy divergence theme. For example, since the start of the year to the end of August, the Japanese yen shed more than 17% against the US dollar. The currency has lost over 45% of its value against the USD from its 2011 peak[8]. Another casualty has been the euro, which has fallen below parity with the USD for the first time since its inception. And outside of frontier markets which are in distress or default, the picture is mixed, ranging from the Indonesian rupiah's rather modest -4.5% fall against the USD to a more pronounced -23% for the Hungarian forint.[9]

Flexibility and flight to safety may help investors

So, where to invest in this divergent world? The opportunity set for flexible bond strategies has been greatly enriched by this inflation-led regime – especially for those that can profit from cross-country relative value positions across the full duration and yield-curve spectrum, as well as from select exposures to inflation, credit and currency markets. As many investors are heavily underweight duration by now, we believe it makes sense to start allocating incrementally to those rates markets which are most likely to benefit from flight to safety – because they have already priced in worst-case scenarios. Few seem to believe that stagflation is the endgame. But the range of plausible outcomes is not quite narrow enough yet to exclude that possibility, nor to secure only shallow recessions as opposed to harder landings. Reading the divergent signs across countries is a good way to anticipate what happens next.

6. Bloomberg, 31 August 2022
7. Source: Japan Ministry of Internal Affairs and Communications
8. Bloomberg, 31 August 2022
9. Bloomberg, 31 August 2022

Allianz Global Investors is a leading active asset manager with over 600 investment professionals in over 20 offices worldwide and managing EUR 578 billion in assets. We invest for the long term and seek to generate value for clients every step of the way. We do this by being active – in how we partner with clients and anticipate their changing needs, and build solutions based on capabilities across public and private markets. Our focus on protecting and enhancing our clients' assets leads naturally to a commitment to sustainability to drive positive change. Our goal is to elevate the investment experience for clients, whatever their location or objectives.

Active is: Allianz Global Investors

Data as at 30 June 2022. On 25 July 2022, AllianzGI completed the transfer of investment teams (including 87 Investment Professionals) and USD 101bn of assets they manage to Voya Investment Management as part of a strategic partnership. Two thirds of the assets continue to be managed on behalf of AllianzGI clients outside of the US.