FIXED INCOME QUARTERLY | APRIL 2023

Fixed income in flux as opportunities emerge

Shifting paths of inflation, interest rates and economic growth are creating a complex market environment. As central banks balance taming inflation with containing financial risks volatility in markets is likely to persist – but we see select openings arising across government and corporate bonds.

Bond markets are in flux after a historic reset. Market volatility remains elevated, in line with shifting economic data (principally inflation) and uncertainty about the future path of interest rate-setting.

In our view, the first quarter of 2023 has reinforced a major dilemma facing central banks. They will likely have to keep fighting stronger-than-expected core inflation, while containing financial stability risks arising partly from the abrupt rise in interest rates. Some recent cases of market distress stand out: in the UK government bond market in September and October 2022, and in the US regional and European banking sectors in the first quarter of 2023.[1]

1. Questions arose about the health of US regional banks after the collapse in March of Silicon Valley Bank and Signature Bank. In Europe, the same month UBS agreed to buy rival Credit Suisse in a state-brokered rescue.

KEY TAKEAWAYS

- We believe fixed income's versatility can help investors plot a path through tepid global growth and higher interest rates in the months ahead.
- At a time of higher volatility and lack of direction in rates, sovereign yields may trade within certain ranges – and investors can position to capture opportunities.
- We see scope for interest rate curves to begin steepening over the course of 2023 as central banks approach the end of their rate hiking cycles.
- At a company-level, we think prospects remain manageable for many investment-grade issuers; and we view the high-yield credit market as reverting to fair value.

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Navigating Rates

In response, one possibility is higher-for-longer interest rates combined with a continuation of intermittent market liquidity injections from central banks.

The good news is that higher yields have boosted the bond market's appeal, and the asset class's versatility can help investors plot potential paths through a complicated market outlook. For now, resilient job markets are helping allay global recession fears. And economic and policy divergence from country to country can offer bond investors a broad opportunity set. We believe one starting point may be considering shorter-maturity core government bonds with more advanced rate hiking cycles and higher inflation-adjusted yields.

Fixed-income asset allocation views in summary

Core rates	
Country	Focus on cross-market relative value positions; favour higher real yielders eg, US over Germany, Japan
Duration	Tactical trades in more rangebound markets, eg, US; go longer duration as increasingly contrarian strategy
Yield curve	Scope for steepening in the US where hiking cycle closer to ending; too early for steepening in euro zone
Inflation	Small overweight on euro zone, reduce exposure as inflationary pressures ease or become better priced in
Currency	More constructive signals for USD weakness as cyclical US growth outperformance vs. rest of world wanes
Corporate credit	
Investment grade (IG)	Historical analysis suggests 3 months into a recession provides more favourable entry points to add risk
High yield (HY)	Neutral to slightly underweight beta; ready to add risk on sell-off in BB/B due to higher spread cushion
Hybrids	Selective on convertibles despite steep discounts, floating-rate preferred securities to help dampen rates risk
Securitised	Spread over corporates less attractive now, prefer higher-rated tranches where banks retain some of the risk
Region	Modest preference for US over euro HY, vice versa for IG; greater scope to reduce underweight to Asian HY
Sector	Overweight systemically important EU and US banks with ample capital and diversified funding and revenue
Emerging market debt	
Hard currency sovereign	Headwinds fading, eg, US rates, China, Russia/Ukraine; fund flows turning more supportive; attractive carry
Local currency sovereign	Some compelling duration opportunities as inflation peaks; USD weakness can add to return expectations
Hard currency corporate	Generally attractive corporate fundamentals and carry with relatively low duration; China headwinds easing

These views are updated regularly to reflect changing market conditions and are independent of portfolio construction considerations.
Past performance is not a reliable indicator of future results.

Tepid global growth and watch out for recession risk

We see global growth continuing to run below its trend rate over the coming months. Weak global growth remains our base case – as well as the consensus forecast of global economists (see Exhibit 1). In our view, the US economy's outperformance of the rest of the world is narrowing, partly thanks to reduced pessimism about the outlook for the euro zone and China.

But we expect recent interest rate hikes by central banks to weigh on activity in the months ahead. The impact of tighter monetary policy is evident in recent US labour data and surveys showing that banks are tightening their lending standards. A global recession still cannot be discounted given the risk of further interest rate rises.

The earlier-than-expected reopening of the Chinese economy has helped to partially offset weak activity in other major developed economies. However, compared with the reopening of the US and European economies after their Covid-induced lockdowns, we expect a less pronounced effect on Chinese demand.

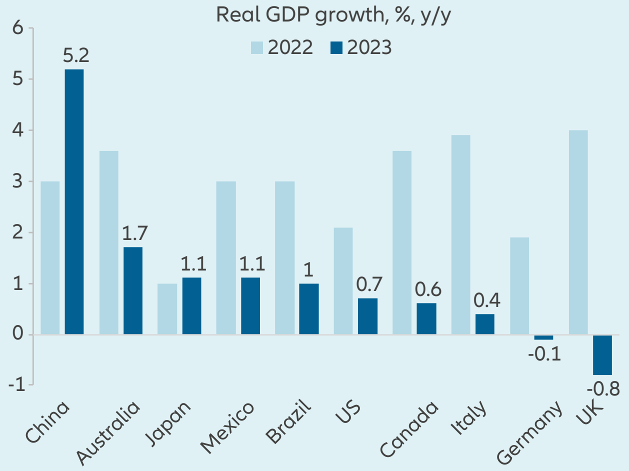
In emerging markets, expectations about growth prospects for 2023 have been falling.[2] But China's recent reopening and stronger-than-expected economic activity in Europe should provide a lift to global growth, supporting emerging markets.

2. Source: Global Economic Prospects, World Bank Group, January 2023.

Market implications

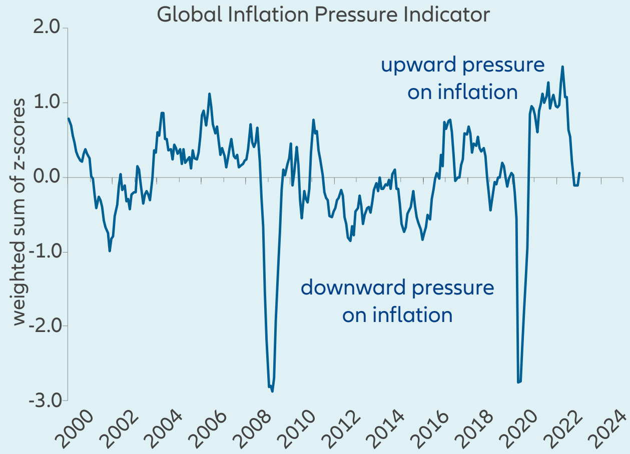
- **Consider euro zone periphery bonds:** we believe within sovereign credit markets, better-than-expected growth in Europe could present opportunities in euro zone periphery bonds where steeper yield curves can potentially offer additional yield over core government bonds.
- **Seek out beneficiaries of China's reopening:** we think China's emergence from lockdown and the rebound in Chinese demand – both in tourism and trade – is likely to be partially offset by a slowdown in the global economy. As such, investors looking for opportunities in Asia may consider countries that export more to China than the US and Europe, like Indonesia, Malaysia and Singapore.
- **Focus on earnings:** at a company-level, we think prospects remain manageable for many investment-grade issuers as fears of a long, deep recession fade. But we think investors should remain focused on company earnings in the coming quarters to gauge the scale of the impact on earnings from a squeeze on consumption and consumer confidence, as well as strong inflation.
- **Watch for B-rated issuers:** in our view, the high-yield credit market is reverting to what we see as fair value as a shallow recession is priced in. Prospects are deteriorating, but from a strong base. It may be prudent to be cautious as there is still uncertainty about terminal policy rates, growth and consumer spending. In an uncertain economic outlook, B-rated issues may provide a potential hedge in high-yield markets.

Exhibit 1: some markets are facing sharp slowdowns



Source: Thomson Reuters Datastream, Bloomberg, Consensus forecasts, Allianz Global Investors GmbH. Data as at February 2023.

Exhibit 2: there are signs inflation might be plateauing



Source: Bloomberg, Allianz Global Investors GmbH. Data as at February 2023.

High policy rates key risk for 2023 outlook even as inflation is set to ease

We expect global inflationary pressures to moderate in 2023 against a backdrop of weak demand and loosening labour markets (see Exhibit 2). But we think central banks will be reluctant to pivot away from tighter monetary policy as core inflation is still high (and well above central bank targets) and labour markets remain tight, despite recent signs of loosening.

The US Federal Reserve's latest Summary of Economic Projections implies one additional hike in 2023. Overall, we believe bond markets may be underestimating the Fed's willingness to maintain a "higher-for-longer" policy stance.[3] As such, we believe the key risk for 2023 is still central banks' willingness to keep policy rates high, even though core consumer price index (CPI) inflation measures are decelerating.

In the euro zone, we think investors may need to remain cautious about the path of interest rates. Despite recent aggressive rate hikes by the European Central Bank, we think real rates in the region are still too low to bring inflation back towards the 2% target by the end of the year.

In contrast, many emerging markets may be closer to the end of their tightening cycles. In our view, the Fed's policy stance raises questions about the ability of some emerging central banks to lower rates, even against a backdrop of weaker growth prospects and moderating inflation.

Market implications

- **Factor in trading ranges:** we believe at a time of higher volatility and lack of direction in rates in the coming months, sovereign yields may remain rangebound – where they trade between consistent highs and lows. We think that identifying and positioning within these trade ranges may help investors navigate the uncertain environment.
- **Seek out highly rated shorter-term bonds:** with many central banks approaching the end of their hiking cycles, we believe there is scope for interest rate curves to begin steepening over the course of 2023. Such a scenario may favour focusing on highly rated shorter to medium-term maturity bonds through a positive "carry and roll-down" exposure – gaining from both coupon payments and from the effect of the bond's price returning to its face value as the bond approaches maturity.
- **Look for real yields:** in an environment with uncertainty about the outlook for inflation, we think investors could focus on "real yields", returns from interest payments after taking account of inflation. That includes markets such as New Zealand, Mexico and the US where, in our view, central banks are at a more mature phase of their hiking cycles.
- **Examine European bank opportunities:** banking stress has hit the headlines in recent weeks, in part as the financial system is pressured by higher interest rates. But among European banks we think there may be opportunities in countries with a low sensitivity of deposit pricing to changes in interest rates (ie, where banks are not forced to pay regulated savings at close to market rates), combined with relatively fast repricing of loans due to a large share of floating-rate mortgages.

3. Source: Summary of Economic Projections, Federal Reserve, March 2023.

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