

Carry stands out with rate cuts still on hold

Higher-yielding spread assets continued to outperform year-to-date (YTD) after gaining more in February and March, with Asian high yield a highlight. Credit opportunities are reemerging in Asia, and we see attractive EUR valuations relative to USD in lower-rated issuers. At the same time, there is more scope to extend spread duration risk in US high yield due to the steeper spread curve. We continue to like global investment grade corporates for the carry but maintain an underweight on cyclical sectors.

By contrast, core government bond returns stayed negative YTD as rate cuts keep being pushed back. Central banks are awaiting more evidence of sustained disinflation. We believe the European Central Bank (ECB) could cut rates mid-year when more data on negotiated wages becomes available, and as the risks to growth and inflation become more balanced.

Euro area periphery holds up

While overall the euro area economy (and most notably Germany) has stagnated, several periphery countries are outperforming the core. Indicatively, the spread between 10-year Italian

and German government bonds has tightened to 130bp (from 250bp back in September 2022).¹ A favourable backdrop, as reflected in depressed risk premia, should support periphery sovereign spreads in the short term.

Meanwhile, the UK slid into recession in 2023² but not yet to an extent that offsets policymakers' preoccupation with inflation. Japan narrowly avoided a GDP contraction as Q4 growth was revised from negative to slightly positive.³ We expect the Bank of Japan (BOJ) to exit negative rates soon, putting upward pressure on the yen. We think

there may be more room for active cross-currency positioning in portfolios as economic data and monetary policies begin to diverge, possibly driving up exchange rate volatility.

The US is the notable outperformer among advanced economies. Robust February readings for non-farm payroll employment and the consumer price index⁴ complicate the path to the first rate cut by the US Federal Reserve. Statements from the Fed still imply rate cuts later this year, barring any major hiccups in inflation data. US real yields are attractive at current levels

Fixed income market performance

Indicative market indices Data as at 8 March 2024	Total return YTD 2024 (%)	Total return Feb 2024 (%)	Yield-to- worst (%)	Effective duration (years)
Asian high yield	5.57	2.21	13.6	2.5
Global convertible bonds	2.63	2.49	0.2	1.9
Euro high yield	1.68	0.35	6.3	2.8
US floating-rate notes	1.40	0.59	5.9	0.0
Global emerging-market sovereign bonds	1.32	0.98	7.9	6.6
US high yield	1.08	0.30	7.7	3.3
Asian investment grade	0.55	-0.25	5.2	4.7
US Treasury bonds 1-3 years	0.29	-0.45	4.5	1.7
Euro investment grade	0.07	-0.89	3.7	4.5
Global aggregate	0.04	-0.69	3.7	6.8
Euro government bonds 1-3 years	-0.15	-0.54	2.9	2.0
Euro aggregate	-0.28	-1.08	3.1	6.7
US investment grade	-0.42	-1.50	5.2	7.3
US aggregate	-0.50	-1.41	4.7	6.3
Global government bonds AAA-AA	-0.72	-1.10	3.1	7.8

Source: Bloomberg, ICE BofA and JP Morgan indices; AllianzGI, data as at 8 March 2024. Index returns 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.



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compared to nominal yields, favouring an allocation to Treasury Inflation-Protected Securities.

Generally, we maintain a long bias to interest rate duration. But given that a possible US recession continues to be pushed further out into the future, we prefer to add rates risk through yield curve and cross-country spread trades. We have high conviction in curve steepening globally due to insufficient term premia in ultra-long maturity bonds amid deteriorating fiscal dynamics. Core rates have moved in lockstep in recent years, but we see decorrelation ahead with diverging growth outlooks, creating relative value opportunities.

China rates in focus

China remains the outlier at the opposite end of the spectrum. China government and policy bank bonds⁵ are up YTD (1.42% in CNY, 2.10% in USD-hedged terms), having benefited from looser policy in response to anaemic activity and deflation.⁶ In our view, China sovereign debt is in the midst of a structural bull market since lower interest rates are the obvious answer to structurally slower growth. We are not too concerned about RMB weakness as China is likely to maintain a strong current account surplus, moving up the value chain in exports and diversifying its trading partners.

We also see downward pressure on prices in several Southeast Asian and Latin American economies, some of which have already embarked on their rate-cutting cycles, making emerging-market local currency real yields potentially compelling. In hard currency sovereign debt, valuations are becoming increasingly expensive (especially for investment grade issuers), but we think carry is high enough to offset near-term spread widening.



WHAT TO WATCH

1 US job market normalisation

US employment growth was strong in February, with 275,000 jobs added.⁷ Unemployment ticked up from 3.7% to 3.9%, which is a step toward job market normalisation. But with nearly 9 million job openings in January, it's still hard to make the base case for a sharp and rapid deterioration in employment.

2 European wages and profits

The ECB remains worried about price pressures staying elevated, partly due to higher wage growth and falling labour productivity. While looking for moderation in negotiated wages, the ECB will also be watching closely the extent to which corporate profits will absorb rising labour costs, which should help ameliorate the potential inflationary impact of wage increases.⁸

3 Japanese interest rates

The BOJ's policy rate has been in negative territory since 2006. A first hike to zero or to a slightly positive rate is widely expected as early as March or April. The bigger question is how gradual the pace of hikes will turn out to be, and the implications for money market rates. Investors will also watch for any signs the central bank may eventually start to shrink its massive bond portfolio.



CHART OF THE MONTH

Increasing pressure on the ECB to ease

ECB policy indicator and deposit rate



While the risks for the ECB of cutting rates too early outweigh the risks of cutting them too late, pressure to lower rates is likely to increase especially after the sharp downward revision to Germany's expected GDP growth for 2024 (down to 0.2% from 1.3% previously). Our proprietary "ECB policy indicator" suggests there is still more pressure on the ECB to prepare for a first rate cut than to revert to tightening. This indicator represents an equally weighted average of the following three components*: (1) our proprietary euro area leading economic and spare capacity indicators, (2) survey-based manufacturing pipeline inflation pressures, and (3) loan growth to euro area households.

* We convert the values of these metrics to a common scale (standardisation or "z-score normalisation") which measures standard deviations below or above the average.

1. Bloomberg benchmark government bond indices, data at 12 March 2024.
2. UK Office for National Statistics, 15 February 2024.
3. Japan Cabinet Office, 11 March 2024.
4. US Bureau of Labor Statistics, 12 March 2024.
5. Bloomberg benchmark government bond indices, data at 8 March 2024.
6. China National Bureau of Statistics, 11 March 2024.
7. US Bureau of Labor Statistics, 12 March 2024.
8. ECB Monetary Policy Statement and Press Conference Transcript, 7 March 2024.

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