

Markets stay the course for a soft landing

With the disinflation trend intact in the euro area, markets had widely expected the European Central Bank (ECB) to cut rates by 25 bp to 3.25% in October. The ECB did just that, accompanied by more “dovish” communication, which for some market participants now makes a 50 bp cut in December plausible. That may look like a stretch at this juncture, but we wouldn’t exclude more frontloading in the form of consecutive cuts. That could lend support to further yield curve steepening, primarily coming from the more policy-anchored front end.

The longer end of EUR yield curves is susceptible to more complicated dynamics at play, both in national fiscal policies and in the global economy. We favour portfolio exposure to yield curve steepening not just in Germany but also in the US. Moreover, with the recent backup

in yields, duration risk and fixed income generally look increasingly attractive from a strategic asset allocation perspective. UK Gilts in particular stand out favourably on a relative value basis, compared to, for example, German Bunds.

When it comes to outright duration risk, we prefer to stay more tactical on US Treasuries as they should trade in a wider range – as long as US economic data continue to hold up and reflationary risks stemming from greater trade protectionism under a Trump administration remain a possibility. The next US Federal Reserve (Fed) policy meeting is scheduled two days after the US presidential election on 5 November. In the meantime, we’ll be getting two crucial data prints: the US Personal Consumption Expenditures (PCE) Price Index for September and Nonfarm Payrolls for October.

Turning to credit, companies have started to announce Q3 earnings. In investment grade credit, utilities was the outperformer in the third quarter, followed by financials and then industrials. Real estate continued its resurgence helped by more muted asset value declines. Meanwhile, consumer cyclicals underperformed with notable weakness in Europe, where several names within autos and retail (especially luxury goods) have cut guidance or released profit warnings.

We consider investment grade credit to be trading at fair value, as the market is pricing in strong fundamentals across the majority of sectors, but also discounting future growth concerns, with better value now derived in EUR debt. We continue to favour financials given the benefits associated with the elevated interest rate environment and better valuations relative to industrials. Additionally, we still like the defensive nature of US-regulated utilities.

In high yield, USD outperformed EUR in the third quarter whilst CCC-rated and distressed credit led returns across the ratings spectrum. The primary market remained buoyant and we see a healthy pipeline up ahead. While we’re keeping overall risk exposure relatively close to benchmark, we expect sectors such as telecoms, leisure and banking to outperform energy (driven by falling oil prices), autos and media. Spreads are tight even relative to rather benign default-rate forecasts, while the absolute level of yield remains attractive.

Asian high yield USD credit continues to lead other credit markets year-to-date by a wide margin, with 16.05% total return based on the JP Morgan Asian Credit Index (JACI) Non-Investment Grade (see fixed income market performance chart). More stimulus measures in China have certainly helped. Still, compared to



Michael Krautzberger
Global CIO
Fixed Income



Georgios Georgiou
Global Head
Product Specialists
Fixed Income

a few years ago the Asian high yield market is now more diversified. China accounts for 25% of the JACI's market capitalisation, compared to about 50% back in 2021, and China property makes up less than 10% versus 35% before. Consumer, financial and utility sectors now account for half the index.

In other spread assets, we remain constructive on emerging market external sovereign debt as flows are returning to the asset class. Some

countries have grossly outperformed year-to-date, including several which we had overweighted such as Ecuador, Egypt, Pakistan, Lebanon and Ukraine. This year has seen the completion of many debt restructurings, some of which were pending since Covid-19. We do not see major credit events in 2025 as large maturities are concentrated mostly in issuers supported by IMF programmes.

Fixed income market performance

Indicative market indices Data as of 21 October 2024	Total return YTD 2024 (%)	Total return Sep 2024 (%)	Yield-to-worst* (%)	Effective duration (years)
Asian high yield	16.05	1.85	10.5	2.5
Global convertible bonds	9.30	2.09	-0.2	1.8
US high yield	7.73	1.64	7.1	3.1
Euro high yield	7.37	1.04	5.7	2.7
Global emerging-market sovereign bonds	7.23	1.85	7.6	6.7
US floating-rate notes	5.29	0.50	5.4	0.0
Asian investment grade	5.01	1.10	5.0	4.7
Euro investment grade	3.99	1.23	3.2	4.5
US Treasury bonds 1-3 years	3.60	0.82	4.1	1.6
Global aggregate	3.34	1.16	3.5	6.6
US investment grade	3.20	1.77	5.1	7.1
Euro government bonds 1-3 years	2.47	0.79	2.3	2.0
US aggregate	2.32	1.34	4.6	6.2
Euro aggregate	2.15	1.23	2.8	6.5
Global government bonds AAA-AA	1.74	1.06	3.0	7.7

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 21 October 2024. 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 does not predict future returns.



WHAT TO WATCH

1 US data

The Fed's preferred inflation gauge, the PCE price index, will be next released on 31 October and should provide a better idea on whether the disinflation trend remains intact or has stalled. For August, annual headline inflation was at 2.2%, and 2.7% when excluding food and energy. We'll be looking out for any signs of deterioration in the October jobs report which is scheduled for 1 November.

2 Public finances

Concerns about the sustainability of European public finances are coming into focus. The French government has already proposed a budget for 2025 with about EUR 60 billion in tax increases and spending cuts. On 30 October, it will be the UK government's turn, which has recently softened its messaging, with the risk that borrowing in the near term may need to be higher than projected.

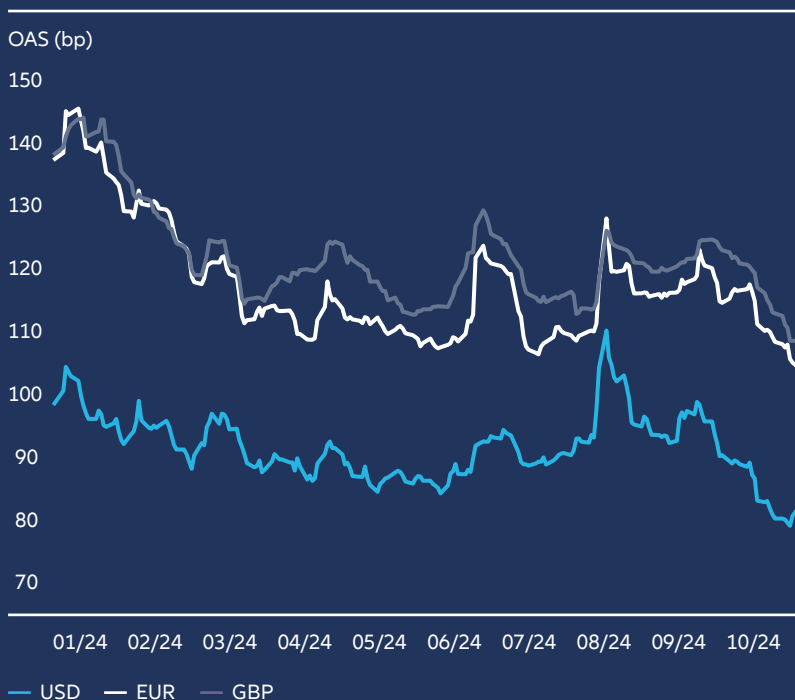
3 Corporate earnings

We've seen a rather good start to the Q3 earnings season. From the companies in the S&P 500 which have reported so far, about three-quarters of those beat earnings estimates. Among those were several banks which reported results consistent with a "soft landing", providing a sanguine snapshot of the economy, with consumer spending and loan portfolios generally holding up.



CHART OF THE MONTH

Option-adjusted spread (OAS) for global investment-grade credit, by region



Credit spreads for investment grade issuers globally have continued to tighten unabated this year, following a similar trajectory in 2023. US investment grade spreads lead the way since they are now trading at their tightest levels since 2005. Amongst sectors, spreads for industrials stand out as they hover at narrower levels (below 90 bps) than financials and utilities. Whilst these levels suggest that investment grade credit may no longer be "cheap", corporate fundamentals for high-quality issuers remain robust and higher yields provide a healthy carry cushion. Technical fundamentals remain good too as heavy supply of new issuance (including a lot of subordinated paper) has been met with strong demand, also in the form of fund flows. With diminishing spread compression up ahead, we think that strengthens the case for actively managed credit portfolios – focused first and foremost on issuer selection aimed at capturing higher income, while avoiding more vulnerable credits where spread widening could eat up yields.

Sources: Bloomberg Corporate Statistics Indices, Allianz Global Investors, data as at 21 October 2024. Past performance does not predict future returns.

* 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.

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