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Fixed Income newsletter

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Editorial

Is the prospect of steeper long term rates a cause for concern?

The prevailing paradox as we head into 2018 is that market confidence appears to be evenly matched with growing doubts among investors regarding valuations across all asset classes, which many consider stretched. The most frequently expressed fears, such as the recent flattening of the US yield curve and steeper outlook on long-term rates, appear to be major preoccupations among investors. Is there really cause for concern however?

In the US, a flatter yield curve tends to herald a significant economic slowdown. The past five recessions have been preceded by the spread between short and long-term rates narrowing sharply. Is this factor therefore a reliable precursor indicating a downturn in US economic fortunes over the next few months? Let us focus on the causes and identify the trends among Treasury yields which have taken shape essentially since the end of the summer.

The short-end of the yield curve has recently corrected sharply as markets have begun pricing-in a shift in outlook regarding the Federal Reserve (Fed) rate hike cycle. Despite appearing to have been broadly impervious to Fed Funds rate hikes, even amid steady steepening in forward-guidance from the US central bank over several months, the markets seem finally to have integrated the potential increase in US short-term rates. Let us rejoice in the fact that the Fed deftly managed three rate hikes during 2017, while investors simply did not believe any steepening likely at the beginning of the year, without destabilising the markets, particularly equities which have hit a series of new all-time highs. However, it is always preferable, for the sake of financial stability, for forward guidance issued by central banks to be fully understood by the markets and also reflect outlook, which is now increasingly the case.

While short-term rates have steepened, long-term rates have also edged higher, but to a lesser extent. Although sluggish inflation outlook, despite upward revisions in growth forecasts, undoubtedly accounts for the relatively muted rise in US long-term rates, the global liquidity context is also preventing any rapid steepening. With central bank liquidity yet to peak and long-term rates in Japan and the eurozone remaining at historically low levels, Treasuries remain compelling.

As the US yield curve is being shaped by two highly divergent dynamics, particularly against a backdrop of stronger growth forecasts, we cannot conclude that this trend foreshadows a recession within the next twelve months.

With liquidity remaining extremely abundant, it would be unreasonable to predict any significant steepening among long-term rates. We should bear in mind that bonds have already begun correcting sharply in the US, with 10-year yields doubling since their mid-2016 lows, while in the eurozone, the European Central Bank (ECB) is expected to maintain its rates unchanged at all-time lows until 2019.

Despite the current market jitters, it would nonetheless be judicious to adjust our investment strategies to include the strong support factors which continue to underpin fixed-income markets. Any further correction among long-term rates would provide an opportunity to increase portfolio duration.

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Key macro trends & investment strategy

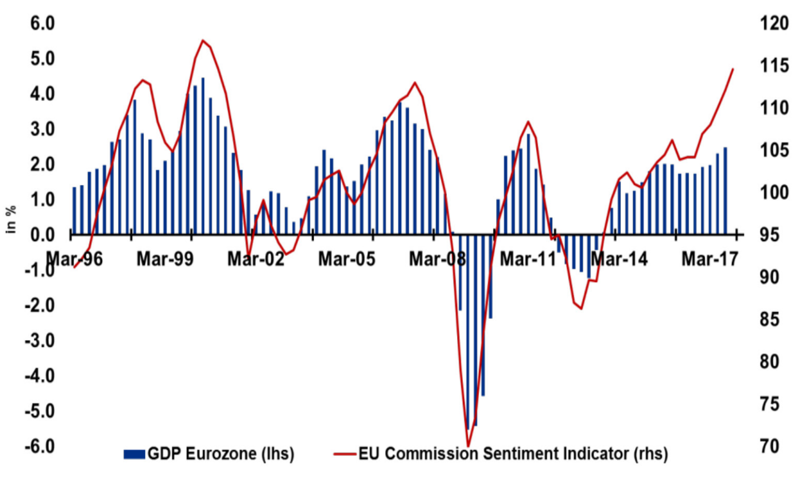
Europe

Euro-zone bonds traded in a narrow range over the fourth quarter, with the yield on the 10-year German Bund oscillating between 0.3% and 0.5%, before ending the quarter just above 0.4%. In general, peripheral euro-zone bonds outperformed German Bunds, again with Portuguese performing strongly: yields on Portuguese debt fell to their lowest levels in two years after credit rating agency Fitch upgraded the country's credit rating by two notches to BBB. In mid-September, S&P had already upgraded Portugal back into investment grade territory. Fitch's upgrade paves the way for Portugal to re-enter common fixed income indices. In contrast, Italian bonds underperformed as investors were unsettled by the news that the country's president had dissolved parliament, heralding a two-month election campaign ahead of elections in early March.

Economic news flow was positive in Q4 2017: the euro-zone economy expanded by 0.6% in the third quarter of the year, taking its year-on-year growth rate to 2.6%, and the unemployment rate slipped below 9% for the first time since the start of 2009, further narrowing the gap to the non-accelerating inflation rate of unemployment (NAIRU). Purchasing managers' indices indicated that the strong momentum was continuing into the fourth quarter, with November's Ifo index of German business sentiment setting a record high for the fifth time this year, while the European Commission's economic sentiment index rose to the highest level since October 2000.

Despite the buoyant economic development, inflation has remained subdued. Against this backdrop, the European Central Bank kept interest rates on hold. It committed to maintaining its monthly asset purchases until September 2018, although it did half the size of its purchases, reducing them to EUR 30 billion a month starting in January 2018. In contrast, outside of the single currency region, there were indications that central banks in Norway, Sweden and Switzerland were considering starting the process of normalizing monetary policy due to higher inflation forecasts.

Eurozone GDP vs EU Commission Sentiment Index



Source: Bloomberg, Datastream, January 2018

USA

On balance, US bonds rose slightly over the quarter. The yield on the 10-year Treasury bond touched a nine-month peak of 2.5% in late December amid expectations that tax reforms could provide a short-term boost to the US economy, before closing the year just above 2.4%. However, it was at the short end of the curve where yields rose the most, with the yield on the two-year note rising to a nine-year peak of 1.90%. Treasury Inflation Protected Securities (TIPS) outperformed nominal US Treasuries as break-even inflation rates rose.

Data showed that the US economy had rebounded from the temporary shocks caused by hurricanes Harvey and Irma. More than 200,000 jobs were added in each of October and November, and the unemployment rate held steady at 4.1%. Inflation remained subdued, however. While headline consumer prices rose 2.2% year-on-year in November, up from 2.0% in October, the Federal Reserve's preferred measure of inflation, the core Personal Consumption Expenditure Index, inched only slightly higher to 1.5%, compared to 1.4% in the previous month.

As widely expected, the US Federal Reserve (Fed) raised interest rates by 25 basis points to a range of 1.25%-1.50%, and maintained its forecasts for three further rises in 2018 followed by two in 2019. The US central bank also raised its growth projections for both 2017 and 2018 to 2.5%, citing the impact of tax cuts, but indicated it expected inflation to stay below its target. Janet Yellen's term as Fed chair ends in early 2018, with Jay Powell chosen as her successor. Mr Powell is expected to continue with the current policy of slowly normalizing rates.

Japan

Market sentiment was boosted by Prime Minister Shinzo Abe's decisive victory in October's snap election in which he won over two-thirds of available seats. The victory was seen to reinforce his mandate to continue with his "Abenomics" policies.

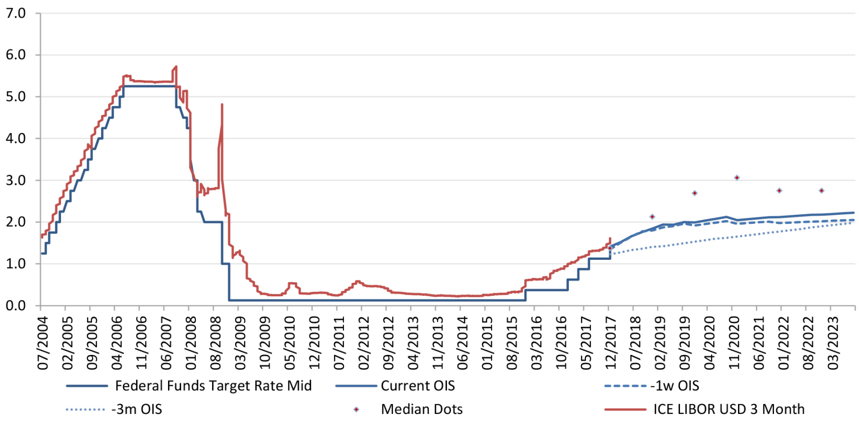
Japan's economy expanded by an upwardly revised annualized rate of 2.5% in the third quarter. This was the seventh consecutive quarter of growth, and the Bank of Japan's Tankan survey showed that business sentiment at larger manufacturers was at its strongest level in 11 years.

The unemployment rate dropped to a 24-year low of 2.7% in November, but wage growth remained sluggish and inflation remained well below the Bank of Japan's official target of 2%. As a result, the Bank of Japan maintained its monetary stimulus measures.

Emerging markets

Emerging markets put in a strong showing in the fourth quarter of 2017, with the JP Morgan sovereign EMBIG-D index returning +1.16%, bringing total returns through year-end 2018 to 10.26%. Sovereign spreads were relatively stable over the reporting compressing by a mere -2bp from September's close to end the year at a spread of +285bp vs UST. Emerging market corporates, likewise, saw positive performance, with the JP Morgan CEMBI-BD index returning +0.68%, as spreads tightened by -8bp, to close the quarter at a spread to worst of

Fed Funds Rate, FOMC Guidance & Market Pricing



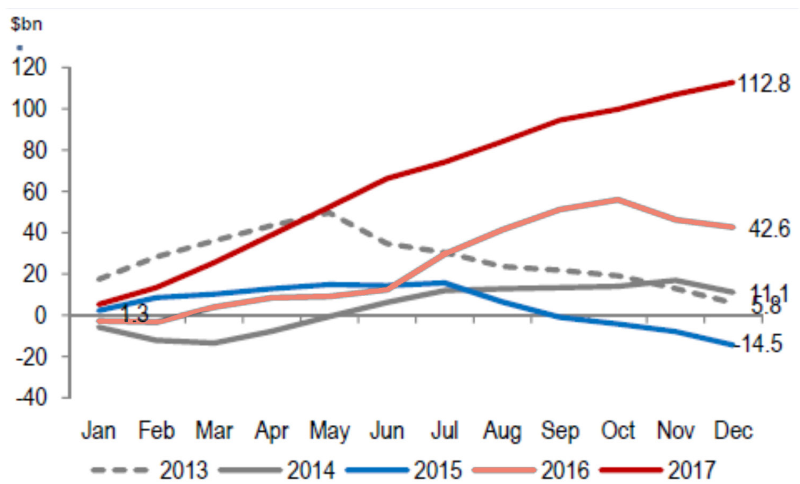
Source: Bloomberg, AllianzGI, January 2018
Past performance is not a reliable indicator of future results.
The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve Board that determines the direction of monetary policy.

+223bp vs UST, touching tights last seen in 2007. The EM local debt markets put in a solid performance in the quarter, returning +0.82% in USD terms, bringing full year returns to 15.21% through December's close.

The US treasury component detracted from EM returns, in the front end, as the UST 2yr widened by +40bp, the 5yr widened by +27bp, and the 10yr UST widened by +7bp. However, in the long end, the 30yr UST tightened by -12bp during the quarter. The hard currency JP Morgan, with its longer duration, benefited from its longer duration profile in this curve flattening environment. The USD continued to see softness during the 4Q, adding further ballast to EM assets and enhancing local currency and foreign exchange returns.

As with Q3 inflows EM fixed income markets continued to be a primary driver performance. Flows to hard currency EM totalled $21.1bn in Q3, whereas the local currency market saw $15.7bn of inflows during the quarter. For the full year, EM fixed income inflows totalled +$112.8bn, split $73.3bn hard currency and $39.5bn local currency.

EM fixed income inflows reached a record+ $113bn in 2017



Source: JP Morgan, 4 Jan. 2018

Fundamentals in EM continue to improve in many sovereigns, and EM growth projections were again revised upward by the IMF in October. Growth in EM economies is now projected to be 5.0% versus Advanced Economies, whose growth is projected at 2.3% in 2018, less than half that of the emerging world. (Source: JPM 12/01/18)

Emerging markets were also supported by improved commodity pricing during the third quarter, with Brent Oil rising by 16.2% to end December at $66.87/bbl., having touched a low of $44.82/bbl. this year, in June. Iron ore (IOE1) gained +2.9%% during the quarter, copper rallied an additional +11.7% and zinc (LX1) rose by 4.7% during the period. Such moves benefited commodity producers within the asset class, more broadly supporting CEEMEA and Latin American assets. As many commodity producing countries, such as those in the Sub-Saharan Africa tend to be lower rated, this had a positive impact on the single-B part of the ratings curve which returned 2.8% during the quarter. Double-B's returned 1.2% in the hard currency sovereign Index and triple-B's 1.1%. Venezuela could not be saved by rising oil prices and dragged down the C rated basket, which returned -9.9% during Q3. Delayed coupon payments yielded moves to selective default on specific securities in the Venezuelan complex and the Venezuelan component of the index returned a negative -28% during the quarter.

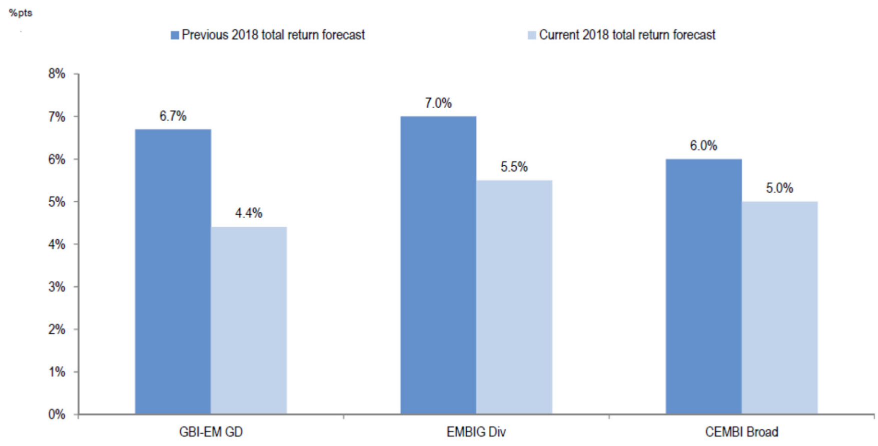
Pressure on Local Market debt continued to lessen as US Fed rate hikes were priced into the market. Dollar weakness continues to benefit returns in local currencies. These currencies remain undervalued by historical standards, and fundamentals in many EM geographies are improving. Investor appetite is on the rise, and renewed inflows are supporting this sub-asset class.

In the corporate space, record issuance was well absorbed, throughout the year. While there were minor and temporary digestion issues in Asia given the volume of supply, any pullbacks in spreads proved buying opportunities for investors as spreads on the JPM CEMBI-BD tightened further during Q4. Corporate fundamentals continue to improve in EM, with gross and net debt levels declining, and default rates (ex-quasi sovereigns) projected at sub-2.0% in 2017 and at 2.0% in 2018 (source: JP Morgan – 21 Nov. 2017).

Given current trading levels, spread tightening is likely to be far more limited than that seen in 2017 for all three EM sub asset classes: hard currency sovereigns, LCFX and corporates.

However, carry remains attractive, fundamentals are broadly improving, and technicals and inflows remain robust as 2018 begins.

We forecast lower 2018 full year total returns, following the strong EM rally towards the end of 2017



Source JPM: 12/01/18

Forecasts are inherently limited and should not be relied upon as an indicator of future results.

Trade-weighted G4 currencies

Source: Bloomberg, January 2018

Currencies

Despite the rate hike by the Fed in December and the US administration's tax cut plans, the USD weakened slightly in the fourth quarter of 2017. At this stage of the monetary policy cycle, further Fed rate hikes might not lead to further USD strength, with several central banks elsewhere catching up with the US Fed.

The strength of the European economic recovery and prospects for central bank normalization should benefit the undervalued EUR. Once the ECB lays down when to end the QE programme sometime next year, the market may start pricing a more convincing hiking cycle.

The Japanese Yen remains structurally supported by the current account surplus, political stability, and its undervaluation. However on a cyclical basis, the Bank of Japan might not stick to their yield curve control policy, which could mean monetary policy divergence. The most important event risk is the nomination of the new BoJ Governor, as Kuroda's term will expire on 8 April 2018. Nevertheless, the market currently sees Kuroda's reappointment as the most likely outcome.

Credit

2017 Q4 credit markets performance was positive for both Euro Investment Grade (IG) performing 0,62% and Euro High Yield (HY) performing 0.74%. This being said, October was the sole month in positive territory. 2017 annual performance was 2.4% for Euro Investment Grade and 6.7% for Euro High Yield.

Total flows to the end of Q4 2017 into the HY asset class were negative (-€ 6,2 bn or 7,9% of AuM according to JP Morgan) and were negative almost over the full quarter, whereas flows into IG European funds were steadily positive (+€ 19,1 bn or 12% of AuM). Such a significant amount seems to be mainly due to momentum-chasing behaviour with higher than expected full-year return of 2.4% and a lack of alternative of positive yielding fixed-income assets. The high level of demand on the IG side was met with net supply of € 164 bn of new issues on the Primary market over the course of 2017. Primary activity in IG markets were buoyant and spread tightened over the quarter (-10bp and -37bp over the year) but HY deals on the primary market were more muted as risk takers were less present (spreads widened +17bp over the quarter but tightened significantly by -100bp over the year). Dispersion among HY issuers increased however and bond selection remain essential.

Fundamentals of both IG and HY issuers remain healthy, Q3 earnings release were good, expected default rates on a 1-year horizon remain negligible and technical factors are supporting, although decreasing buying activity from central banks is expected over H2 2018.

Overall we keep a constructive but nonetheless prudent view applying a neutral to slightly underweight recommendation in our IG and HY flagship portfolios with Betas slightly under 1 given the current valuation which could be seen as slightly expensive. Spread tightening is now limited in our view but the carry play could be extended.