Fixed Income Views

June 2024

Fixed Income Allocation

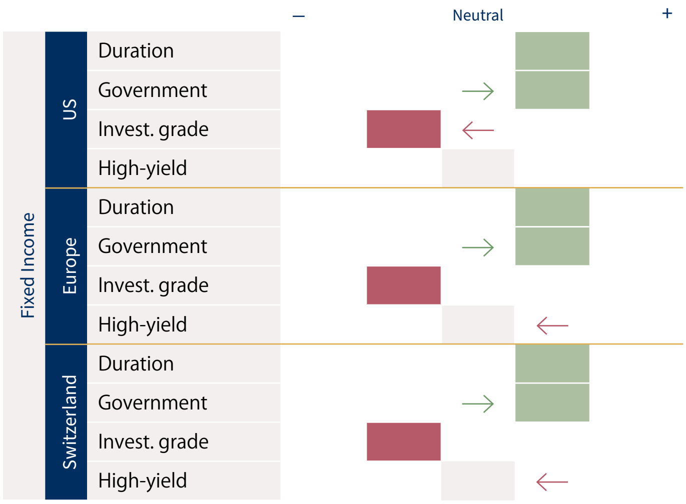
The business cycle is often more important for portfolios than geopolitical events, and markets' relative stability seems to have been encouraged by the continuation of the relatively favourable macro mix of ongoing disinflation with improving economic activity. Notably, for the first time in 2024, a US inflation release was in line with – rather than above – expectations, while inflation trends in Europe remained relatively benign.

Inflation generally is still looking "sticky", with a lasting return to target unlikely in our view, but not alarmingly so, given that this is likely the "last mile" of the disinflation journey. Importantly, this gradual disinflation is continuing even as business surveys stabilise, and unemployment rates remain close to historic lows.

This economic resilience has been the main reason for interest rate expectations backing up as they have done in 2024. At the start of the year, money markets were expecting around seven 25bp US rate cuts this year: in recent weeks this has fallen to just one or two. We were always in the "higher for longer" camp: we did not see expectations backing up this far, but the US economy has been even more resilient than we'd thought it might be.

While it seems unlikely that the Fed will lower key interest rates before the fall, the ECB has already cut rates. Switzerland has also started to do so, but then it did not have much inflation to begin with.

Within bond markets, we continue to favour longer-duration exposure across all currency bases, despite bonds' weakness in 2024. We still see the risk-return balance as skewed positively: with yields now back at "old normal" levels, we can see many growth bears ready to pounce on any signs of economic weakness to drive yields lower, but fewer inflation "vigilantes". If yields were to spike higher on firmer inflation data, or another rethink on longer-term policy settings, we doubt that they would stay elevated for long, and can imagine a more pronounced rally unfolding in due course as renewed recession fears took hold.



Our positioning

EUR: Our long-duration view for European bonds has yet to materialise. In view of the ECB's first interest rate cut, we now expect the outlook for the bond market to improve. We are gradually adjusting our stance on credit quality in EUR bond portfolios. Credit spreads have narrowed further, with some indices nearing post-GFC lows. So far, this has been a "good" cycle, and defaults may be peaking; however, this outcome appears to be fully priced into these segments. Consequently, we reduced a long-standing overweight position in high-yield bonds in our European portfolios and went overweight government bonds. This adjustment aligns our fixed income positioning in US and European portfolios.

USD: Last month, we changed our positioning for US bonds. We are now overweight in government bonds and moved underweight in investment-grade credit. While neutral in overall bond allocation, we maintain an overweight stance on US duration. We remain open to increasing exposure based on growth and policy developments. Our US portfolios are neutral across the credit quality curve.

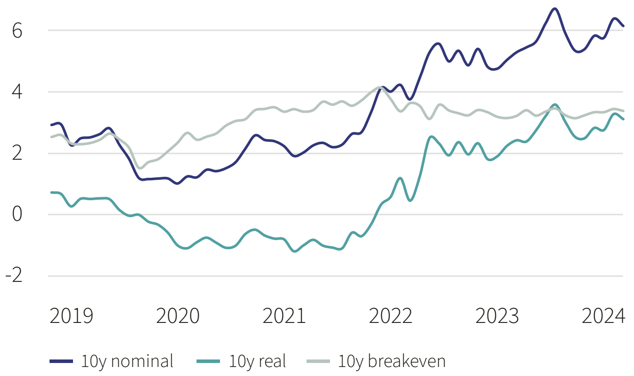
CHF: In contrast to the US and Europe, our single overweight position in long duration Swiss bonds has already paid off. Mirroring our EUR bond positioning, we moved CHF speculative-grade bonds from overweight to neutral and government bonds from neutral to overweight.

Chart Flash

US and Eurozone

US 10-year yield breakdown (%)

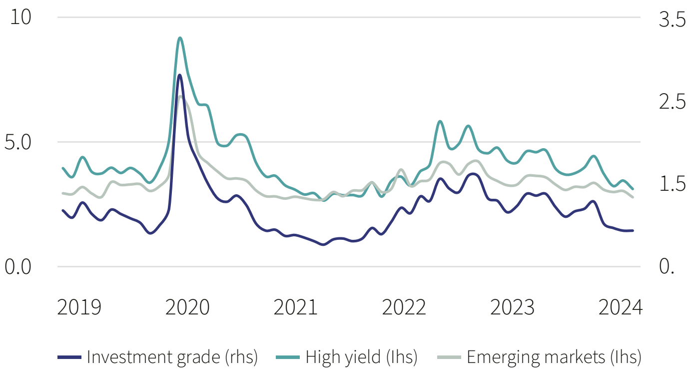
Round-trip May but finally slightly lower



All data source: Bloomberg, 31.03.2019 - 31.05.2024. Past performance is not indicative of future performance and investments and the income from them can fall as well as rise.

US credit spreads evolution (%)

IG Spreads slightly lower, HY spreads higher



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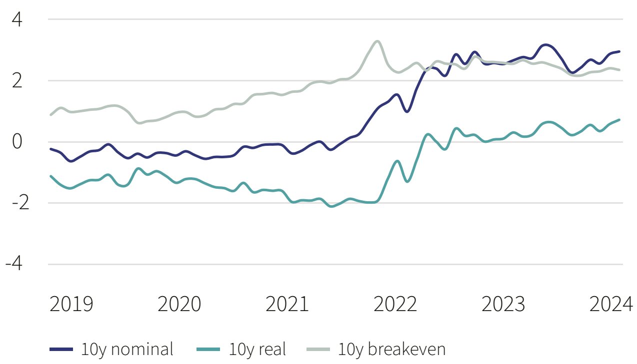
US Treasuries outperformed other core markets in May. Yields for US Treasury bonds fell in the first half of the month, driven by a weaker labour market report and the first in-line CPI print since the beginning of the year. However, weaker US Treasury auctions and hawkish remarks from Fed officials caused yields to rise in the second half of the month. Overall, yields have fallen slightly compared to the previous month. By the end of May, forwards were pricing in fewer than two cuts by year-end, which is less than the Fed's dot plot projection of three cuts for 2024.

EU 10-year yield breakdown (%)

Yields in long-dated German bonds marching higher



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EU credit spreads evolution (%)

Credit spreads tighter

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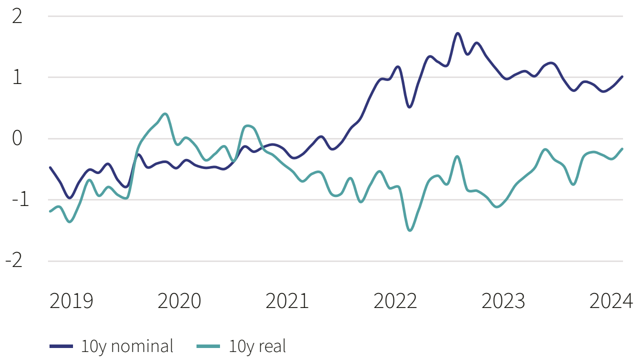
After breaking out of their sideways range maintained since mid-January in March, 10-year German government yields rose again in May. With the ECB set to start cutting rates in June and the Fed expected to wait until at least autumn, an interesting divergence has emerged between German (yields up) and US yields (yields down) in recent weeks. This yield divergence is driven by improving economic data in Europe and slightly higher-than-expected inflation data for May.

Chart Flash

Switzerland

CH 10-year yield breakdown (%)

Yields were higher in May



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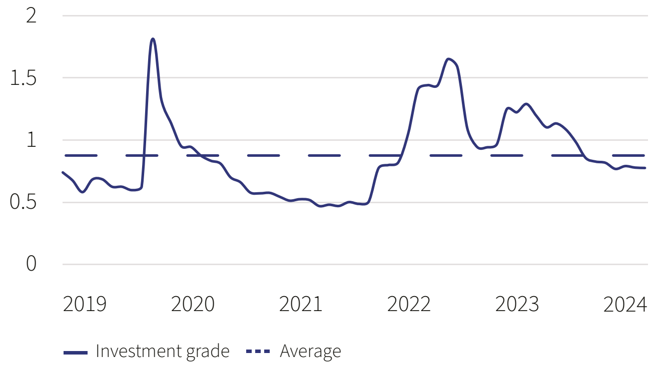
CH credit spreads evolution (%)

Credit spreads were unchanged



All data source: Bloomberg, 31.03.2019 - 31.05.2024. Past performance is not indicative of future performance and investments and the income from them can fall as well as rise.

Swiss yields moved in tandem with German government bond yields upwards. The SNB surprisingly cut rates from 1.75% to 1.50% in March, marking the first cut among G10 central banks. Market expectations for a second rate cut shifted from June to December 2024. This rethink was driven by an unexpected inflation increase in April, published at the beginning of May, with inflation rising by 1.4% YoY compared to the expected 1.1%. Despite this, inflation remains significantly lower than in the Eurozone and the US.

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