Fixed Income Views

July 2023

OUR VIEW AT A GLANCE

Key takeaways

- **The charts**: Last month was driven by yield curve flattening, where UK bond yields (2 years vs 10 years) flattened more than 60 basis points. Credit spreads have tightened further with low-quality bonds (high yield) tightening the most. Inflation expectations in the US and the Eurozone are unchanged, and have risen by 20 basis points in the UK.
- **Our view**: Strong economic data and sticky inflation pushed central banks all over the world to tighten monetary policy more than expected. This pushed up short-dated bond yields more than yields on the long end.
- **Our positioning**: After upgrading US duration last month, we changed our view for EUR and CHF duration from under-weight to neutral this month. At current levels and with weaker economic data, duration is more attractive than before.

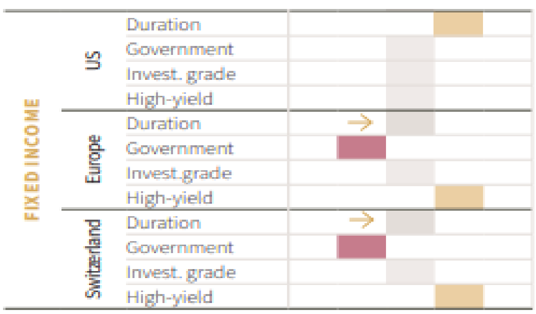
OUR MARKET VIEW

Banking worries have receded, but there are ongoing concerns about both profitability and interest rates, in particular. Business surveys suggest that growth will slow further in the second half of 2023, while stubbornly sticky core inflation is keeping central banks on their toes, and policy rates have yet to peak.

That said, a more dramatic economic setback still feels neither necessary nor likely. Developed economies' terms of trade have rebounded sharply as energy costs have fallen, while China's reopened economy has little inflation, and so can benefit from resumed policy stimulus should it be required. Supply-side resilience suggests that the growth in prospect need does not prevent Western inflation from eventually falling back more decisively. However, a sustained return to 2% targets seems unlikely, and resumed cuts in interest rates seem a long way off. Central banks have to rebuild their monetary credibility first.

Higher interest rates have restored some value to bond markets. But it has been patchy and in European portfolios we remain underweight, in favour of liquidity. That said, we now see more value emerging in longer-dated bonds, and are moving up to benchmark duration in European and Swiss portfolios.

FIXED INCOME ALLOCATION

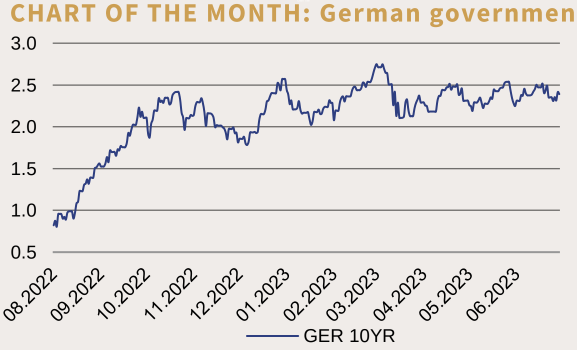


US: Last month we switched our view on USD duration to overweight due to more attractive valuations.

EU: In European portfolios we changed our view on duration from underweight to neutral but we remain underweight the asset class. In credit we have a continuing preference for the speculative grade segment.

CH: We upgraded our view on CHF duration to neutral but remain underweight the asset class. We prefer credit over government bonds due to the attractive spread pick-up.

CHART OF THE MONTH: German government bond yield



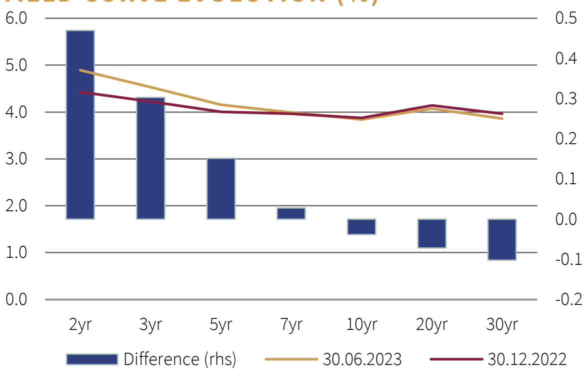
- **The charts**: The yield for a 10-year German government bond is back to the upper end of its 2,2% to 2,5% range.
- **Our view**: Given the recent hawkishness of the ECB, which is unlikely to get even more hawkish, Bund yields at 2,5% offer a better opportunity than before. With two more rate hikes expected before year end, markets are now much more realistic than back in May. Additionally weaker economic data in the eurozone supports our view to change our positioning for EUR duration from underweight to neutral.

USD Fixed Income Market

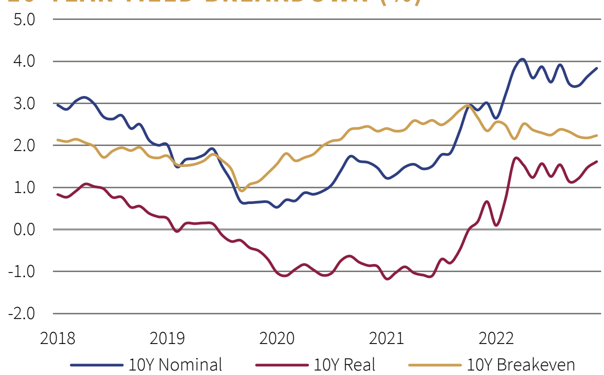
Key takeaways

- **The charts:** The USD yield curve flattened by 30 basis points in June and is now most inverted since 1981. Breakevens are unchanged compared to last month. Credit spreads, particularly for high yield bonds, tightened further in June.
- **Our view:** The uplift in yield was driven by a more hawkish Federal Reserve where the focus switched from inflation to stronger economic data. After a hawkish pause by the Fed in June, another rate hike in July is on the table and more likely than not.
- **Our positioning:** We moved our duration view from neutral to overweight in June and are still convinced the hiking cycle by the Fed is almost finished. We still prefer government bonds and higher-quality credit over low-quality credit.

YIELD CURVE EVOLUTION (%)

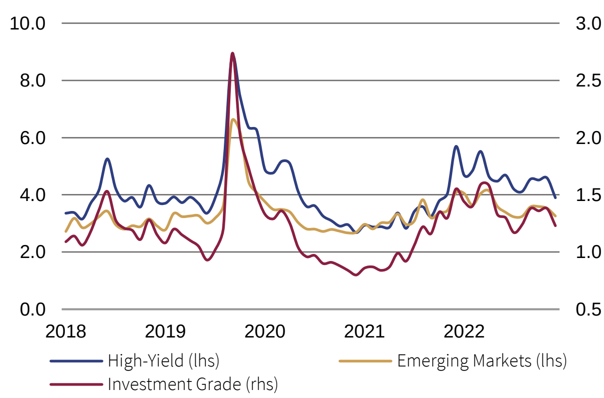


10-YEAR YIELD BREAKDOWN (%)

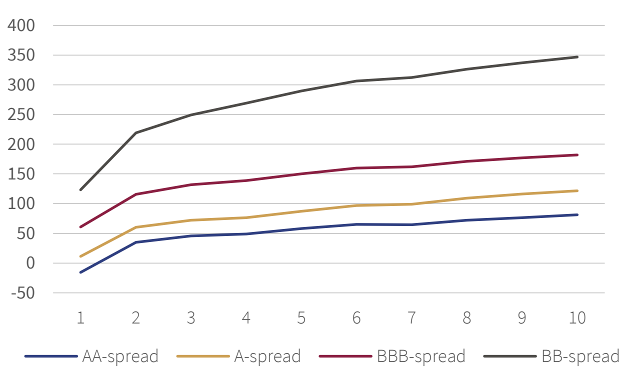


YIELD CURVE STEEPNESS 10-2 YEARS (BPS.)

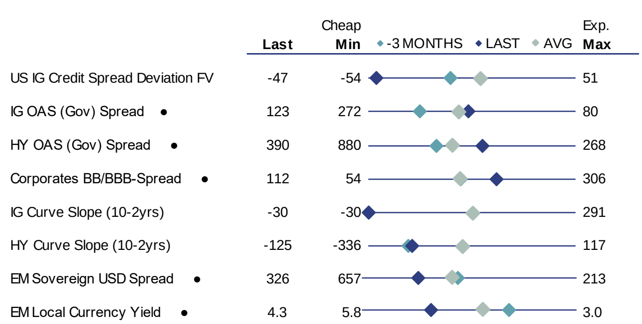
CREDIT SPREADS EVOLUTION (%)



CREDIT CURVE (Spread vs. government bonds in basis points)



CREDIT LONG-TERM VIEW



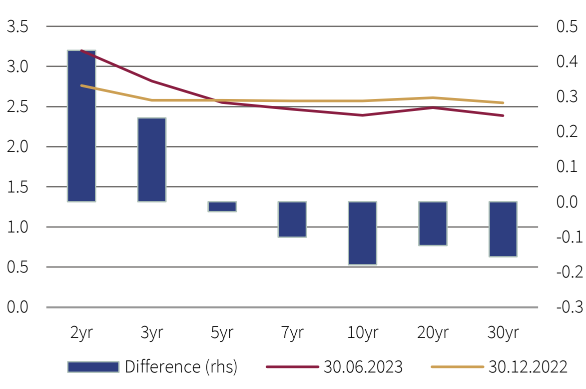
All data source: Bloomberg, as of 30.06.2023

EUR Fixed Income Market

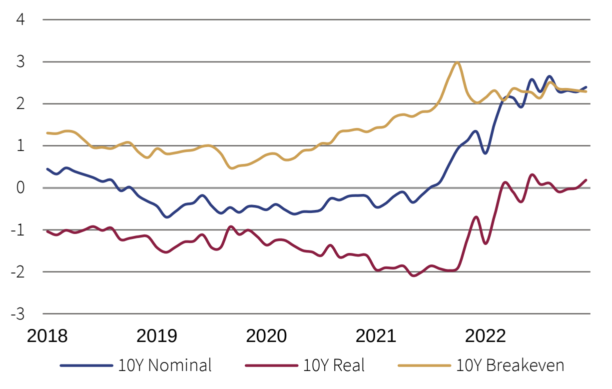
Key takeaways

- **The charts:** A hawkish ECB has driven yields at the short end of the curve up to 40 bps. With yields at the long end of the curve (10 years) more or less stable, the Bund yield curve flattened another 30 basis points. Credit spreads tightened further.
- **Our view:** The ECB seems to be the most consistent central bank with two more rate hikes until September likely and expected. This hawkish view is based on sticky core inflation and mixed economic data. But growth is weakening (Germany is in a technical recession), which should support yields at the long end of the curve.
- **Our positioning:** We upgraded our EUR duration view from underweight to neutral due to weaking economic data and the ECB not far from reaching the terminal rate. Different to the US, we remain tactically slightly bullish on high yield.

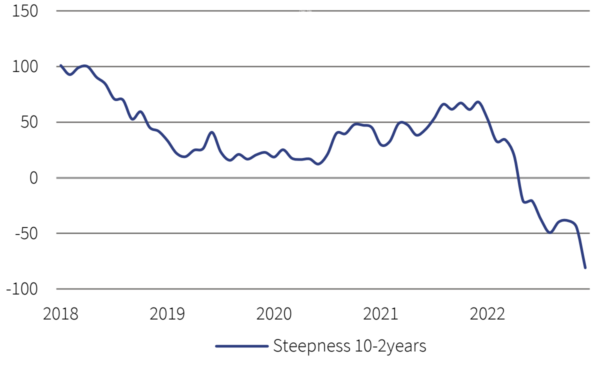
YIELD CURVE EVOLUTION (%)



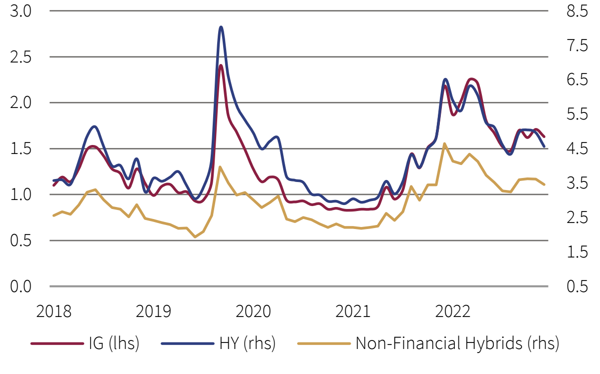
10-YEAR YIELD BREAKDOWN (%)



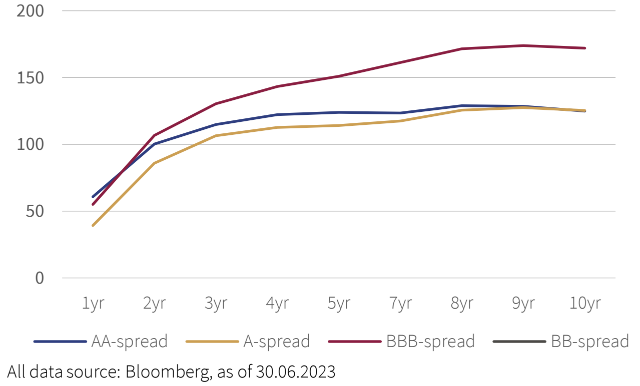
YIELD CURVE STEEPNESS 10-2 YEARS (BPS.)



CREDIT SPREADS EVOLUTION (%)



CREDIT CURVE (Spread vs. government bonds in basis points)



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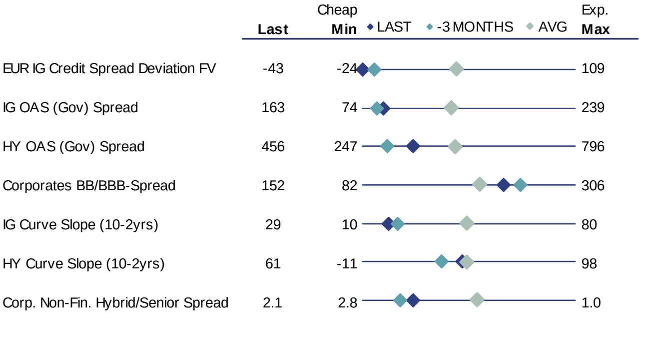
CREDIT LONG-TERM VIEW

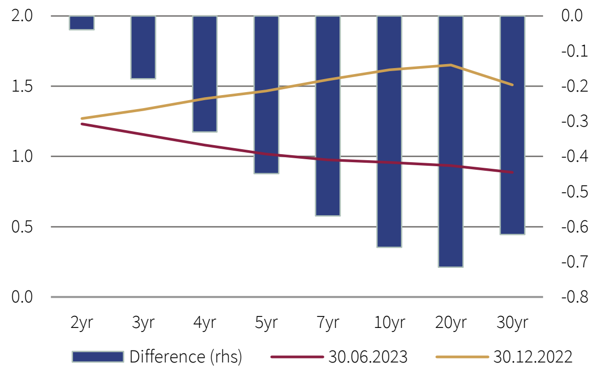


CHF & GBP Fixed Income Market

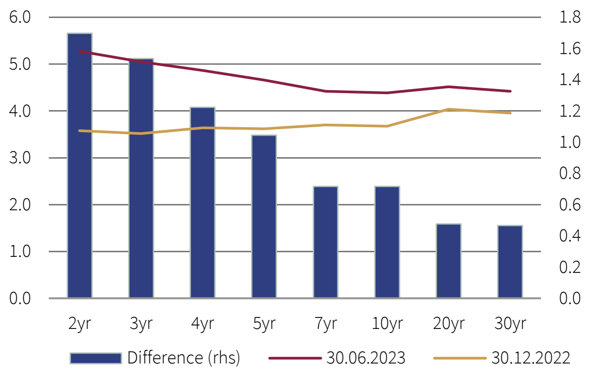
Key takeaways

- **Our view (CHF):** The CHF yield curve flattened last month and is now most inverted since the Global Financial Crisis. Spreads have tightened further but are still above average and therefore attractive. Due to the hawkish trajectory, two more hikes by the SNB before year end are possible. We upgraded our duration view from underweight to neutral.
- **Our view (GBP):** The UK saw a sharp increase in yields on short-dated government bonds over the month as strong labour and inflation data encouraged the market to price more hikes and steered the Bank of England to an unexpected 50 basis point increase at its June meeting. Credit was a relative outperformer and spreads remain around fair value. With real yields increasing sharply, we turned more positive on UK duration.

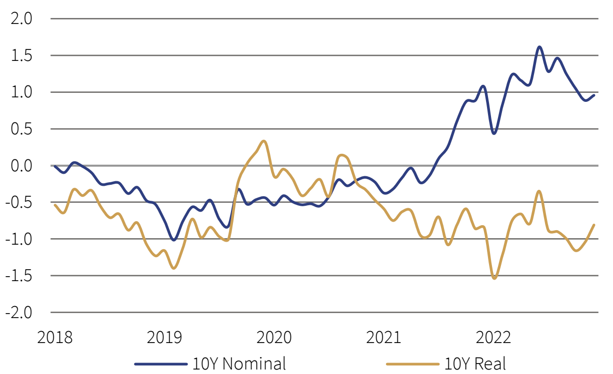
YIELD CURVE EVOLUTION (CHF, %)



YIELD CURVE EVOLUTION (GBP, %)

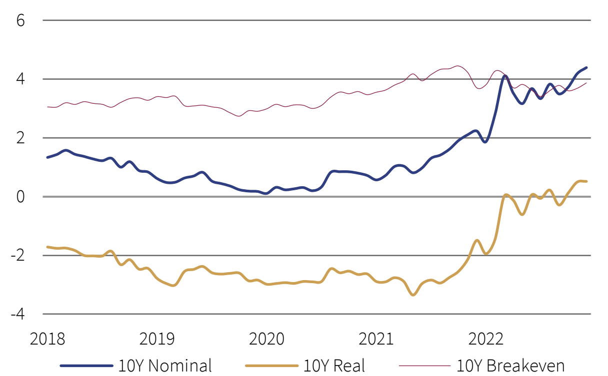


10-YEAR YIELD BREAKDOWN (CHF, RY* on core CPI)

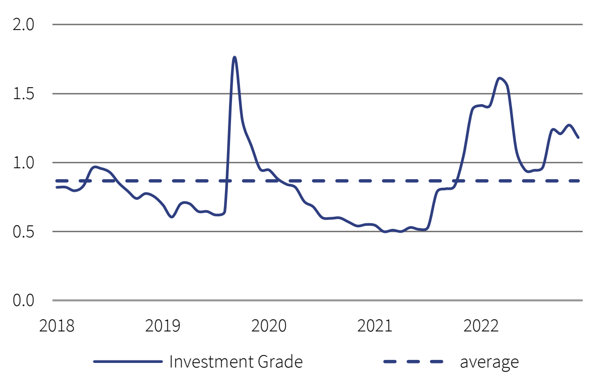


*RY = Real Yield

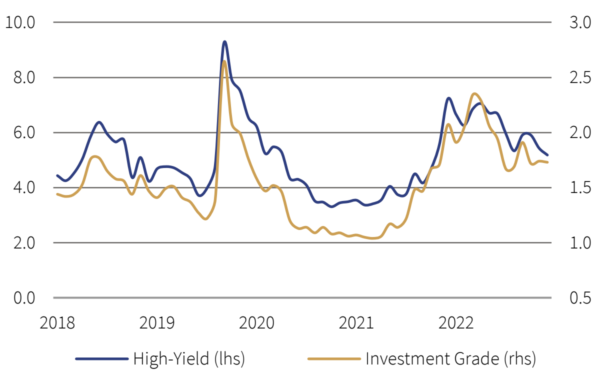
10-YEAR YIELD BREAKDOWN (GBP, %)



CREDIT SPREADS EVOLUTION (CHF, %)



CREDIT SPREADS EVOLUTION (GBP, %)



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