Allianz Global Investors

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Fixed Income Forward

Spreads lead rates as markets look past geopolitics

Global bond markets have stayed sanguine despite the US bombardment of Iran's nuclear sites and Iran's retaliatory strike at US military bases in Qatar. The spike in oil prices and the US dollar has since dissipated and given way to a rally in risk assets, as Iran's retaliation was generally viewed as symbolic and a ceasefire appeared to take hold. Meanwhile, the US Treasury market remains largely unfazed by geopolitics. There has not been a material "flight to safety" and markets seem mainly influenced by the direction of US monetary and fiscal policy.

Investors in credit markets are also seeing past the international trade and Middle East conflicts – credit assets have outperformed core rates markets this year. Two major contributors have been persistently robust credit metrics reported in the latest corporate earnings season (fundamentals) and investor demand outpacing supply (technicals). While companies are seeing higher costs from new US tariffs (some of which have now been watered down), many businesses affirmed or raised their guidance. They highlighted mitigating factors such as pricing power and alternative supply chains – the automotive sector being a notable exception.

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Valuations are less appealing, however. They look fair to somewhat expensive, as corporate spreads have been compressed again after recovering from their sell-off in April. We favour staying invested in credit for the income, but with a higher quality bias, because we think lower-rated and subordinated debt, across investment grade and high yield, doesn't offer a sufficient risk premium at the moment. We prefer senior debt issued by financials and utilities over cyclical industrials, though we have reduced our financials overweight as the sector has turned more expensive relative to others.

Among spread assets, emerging market debt continues to shine, and we see little geopolitical contagion impacting the asset class. Solid economic fundamentals, comfortable real (after-inflation) yield cushions, and proactive central bankers are helping to sustain the outperformance of local currency sovereign debt. The diversity of the asset class allows investors to take positions in regions, such as Latin America, that have been spared of the brunt of new US tariffs. Moreover, reform efforts in several countries are still on track and supportive of hard currency debt dynamics too – for example, Argentina's lifting of capital controls, and widely anticipated fiscal reforms in Nigeria.

In core rates markets, our US yield-curve steepening exposure has paid off. Short-term yields remain well bid on monetary easing expectations, whereas investors continue to shun very long-dated Treasuries amid a deteriorating fiscal outlook. The US Federal Reserve left rates unchanged in June and flagged a mixed economic outlook, in which inflation expectations have gone up but growth and employment are expected to soften.

Since then, comments from several US central bank voting members lent further support to the scenario of one to two rate cuts later this year. That could help the 10-year US Treasury yield settle at around 4%. In global aggregate portfolios, we're expressing our expectation of this outcome through a modest longer duration position relative to benchmarks.

In cross-market investment ideas, we still have a short US dollar bias. We are positioned to gain from ultra-long yields in Spain and the UK outperforming those in the US – a view based on improving debt dynamics in Spain and a return to fiscal conservatism in the UK. We expect investors will continue to demand a higher term premium for 30-year US Treasuries on account of a precarious US fiscal outlook. In Japan, the 30-year premium has become more attractive after yields crossed a two-decade high of 3%, though we expect volatility to stay high as large buyers, such as Japan's life insurers, are now sellers due to asset-liability gaps.

Global policy divergence continues to be a key investment theme in our portfolios. In contrast to monetary authorities in the US, UK and Japan, which stayed on hold in June, the European Central Bank cut its benchmark rate by 25 basis points to 2%. In announcing the eighth cut in 12 months, the bank hinted at a pause ahead. Euro area official headline inflation for May came in at an annual rate of 1.9%, with a stronger euro and the drop in oil prices helping to slow the pace of inflation. While inflation looks well-contained, business activity in the euro area remains subdued as industrial output has increased only moderately and the services sector shows persistent signs of stagnation alongside stickier inflation.

Fixed income market performance

Indicative market indices Data as at 20 June 2025	Total return YTD 2025 (%)	Total return May 2025 (%)	Yield-to-worst* (%)	Effective duration (years)
Global convertible bonds	8.26	3.37	-1.0	1.6
Global emerging-market sovereign bonds	4.22	1.12	7.7	6.4
US high yield	3.44	1.68	7.3	2.9
Asian high yield	3.21	1.92	9.7	2.5
Asian investment grade	3.03	0.11	5.2	4.6
US investment grade	2.99	-0.01	5.2	6.9
US aggregate	2.95	-0.72	4.7	6.1
Euro high yield	2.60	1.33	5.5	2.8
US Treasury bonds 1-3 years	2.46	-0.22	3.9	1.6
Global aggregate	2.27	-0.33	3.6	6.5
US floating-rare notes	2.26	0.55	4.9	0.0
Euro investment grade	1.75	0.52	3.1	4.5
Global government bonds AAA-AA	1.55	-0.24	3.0	7.5
Euro government bonds 1-3 years	1.47	0.08	2.0	2.0
Euro aggregate	0.89	0.17	2.8	6.4

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 20 June 2025. 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, or any prediction, projection or forecast, is not indicative of future performance.

* 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.

WHAT TO WATCH

1. Middle East

Insurance premia for shipping in the region have already spiked. Our base case is that seaborne energy exports will continue as Iran needs the revenue from oil exports. We also think an Iranian attack on Saudi Arabian oil installations is unlikely given the rapprochement that has developed between the two countries in recent years. Assuming no closure of the Strait of Hormuz, further upside risks to oil prices should be contained, even in the event of reduced supply from Iran – because of the excess capacity available from Saudi Arabia and the UAE.

2. US rates

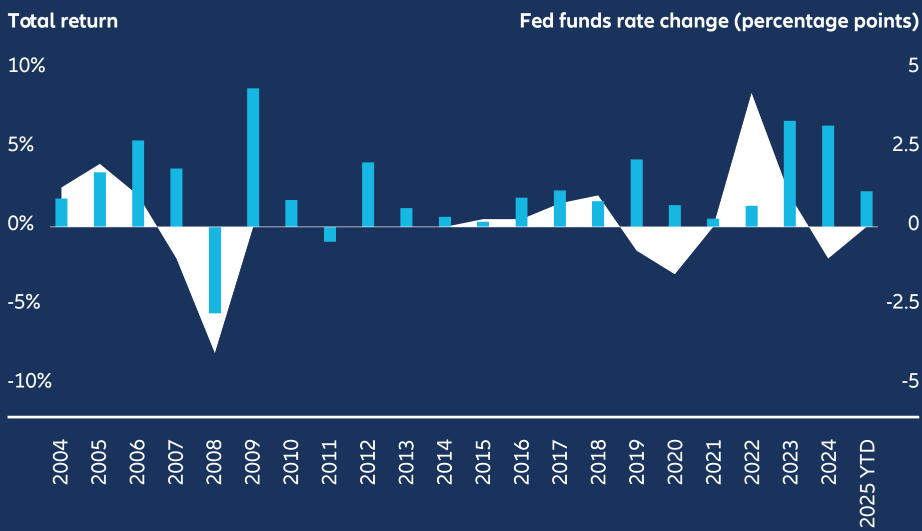
The next US rate cut is probably the most highly anticipated event in this year's economic calendar. The US central bank recently held rates unchanged for the fourth consecutive time amid trade and defence policy turmoil – issues that have complicated the economic outlook with hard-to-quantify risks on inflation and growth. There seems to be a growing contingent of US Federal Reserve voting members in favour of an imminent rate cut, though Chair Jerome Powell has signalled that he is in no hurry.

3. Credit spreads

Corporate debt dynamics can be a good leading economic indicator. Currently tight credit spreads are largely a product of healthy creditworthiness and excess demand for corporate bonds. In aggregate, we don't see immediate refinancing needs that could lead to a "credit crunch" scenario, since large maturities have been pushed back to 2026. At the same time, companies that can afford to do so are reducing their debt because of higher financing costs. We expect default rates to remain below long-term averages in the short term.

CHART OF THE MONTH

Floating-rate notes continue to perform amid rates uncertainty



— Bloomberg US Floating Rate Notes Index
— US Federal Reserve funds rate change

Sources: Bloomberg; Allianz Global Investors, data as at 20 June 2025. 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.

The rates outlook, especially in the US, remains uncertain, and we would expect rate-cut expectations to be frequently repriced. Market-implied forward US dollar cash rates are high. In this environment, we think an allocation to floating-rate notes, alongside fixed-rate corporate bonds, continues to make sense for credit investors looking for "pure" credit exposure – ie, the ability to generate income and total return from security selection and sector allocation without taking interest-rate duration risk. Floating-rate notes exhibit relatively low correlations to other fixed-income assets and can generate positive total returns even through rate-cutting cycles. In the chart, it is worth noting that the global financial crisis in 2008 is an outlier in that it was driven by a "credit crunch" that hit financial institutions, the largest issuers of floating-rate debt. Such conditions are absent in today's environment.

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