Asset Management

BondTalk
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AEGON **INSIGHTS**

Fixed Income Outlook

Colin Finlayson, Euan McNeil and Thomas Hanson from Aegon Asset Management's fixed income team take a closer look at the prospects for Sovereign Bonds, Investment Grade Credit and High Yield Credit in 2024.

Colin Finlayson
Investment Manager, Fixed Income

Euan McNeil
Investment Manager, Fixed Income

Thomas Hanson
Head of Europe High Yield

Sovereign Bonds

After experiencing near relentless pressure for the last two years, the outlook for Government bonds has improved meaningfully. The key factors that drove the weakness within Government bonds, pushing yields to their highest levels in over 15 years are now abating and turning more positive.

With interest rates now in restrictive territory and meaningful progress being made to bring inflation lower, the major Central Banks (the Federal Reserve, the Bank of England and the ECB) all look to have reached the peak of their hiking cycles. Recent data indicates that economic growth is slowing and with risks skewed to the downside; the next move for Central Banks is expected to be towards lower interest rates.

Alongside this, the attractive valuations on offer present a strong support from investors in need of high-quality income or as an alternative to the soon-to-be declining cash rates on offer. The combination of these factors presents a strong foundation for Government bonds to perform well in 2024. This favours a long duration stance in anticipation of lower yields in the coming period. The flatness of the yield curve has increased the attractiveness of short-dated bonds, with steeper yield curves expected to be a feature as we move into the next phase of the economic cycle.

The macroeconomic backdrop offers support across core rates markets. Although the pace of decline in European inflation and the weakness in UK economic activity creates a strong case for the Bank of England and ECB easing policy first, the headwinds building in the US economy and the more elevated level of yields could see US Treasuries leading the way through 2024. The extent and pace of the economic slowdown will determine how far Government bond yields can fall but even with a more managed slowdown and easing cycle, we should still see compelling returns from Government Bonds.

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Investment Grade Credit

The prospects for the euro and sterling Investment Grade markets have for some months been inextricably linked to the outlook for global interest rates and the ongoing debate about how long interest rates will need to be restrictive.

We have been of the view for most of the second half of 2023 that the inflation threat, most notably in the US and Europe, is easing and that the threat of further rate hikes is thereby diminishing month by month. The final months of 2023 have seen tangible evidence of an ongoing downturn in mainland Europe, as well as tentative evidence of US economic activity starting to turn negative. It is our view that this will continue in the opening months of 2024 and that Central Banks will have to cut rates over the next 12 months, ultimately underpinning IG spreads in both euros and sterling.

As cash starts to become a less attractive option as an asset class in this environment, we would anticipate that the likely broad market re-allocation towards IG should prove to be a very supportive technical driver. Generic valuations (on a yield basis) are as attractive as they have been for several years and it is our contention that the potential for a growing disparity in returns between Cash and IG to emerge which should only serve to underline this point. Against this backdrop we expect that subordinated (and higher-yielding) financial paper would likely be the sweetspot.

We acknowledge the threats to this view, albeit ones we believe to be low probability outcomes; should the expected (mild) economic downturn we foresee prove to be more pronounced, then this would necessitate a reappraisal of our constructive outlook.

High Yield Credit

We believe the high yield market will provide compelling opportunities based on attractive yields and the solid fundamental starting point. However, caution is warranted as macro headwinds persist.

Although companies continue to face fundamental pressures, most high yield issuers have maintained solid fundamentals despite elevated inflation, have well-managed balance sheets and are well-positioned to navigate a downturn. Although leverage increased and interest coverage ratios deteriorated during the year, on average, most companies' credit metrics were coming off historically strong levels. In addition, many companies have been able to maintain margins regardless of elevated inflation.

As the cycle evolves and the economy slows, we expect to see increasing divergence across the high yield market. However, we believe many high yield companies are well-positioned to navigate a mild downturn. We expect defaults will rise but, given the solid fundamental starting point and higher-quality market, to remain lower than during prior recessions. However, bifurcation is increasing across the market and we expect the divide to widen in 2024. Weaker companies with lower margins and little room for error are most at risk. Although the maturity wall in 2024 looks manageable, challenged credits may have difficulty accessing capital markets and refinancing upcoming maturities. As a result, we remain cautious and focused on selection as idiosyncratic situations create more dispersion across the market.

From a valuation perspective, we continue to like high yield bonds at yields above 8%. While it is unlikely that spreads will tighten significantly in the near-term, the asset class continues to look attractive from a yield perspective. Historically, the starting yield to worst of the index has been a reasonable estimate of the forward five-year returns. Given current index yield to worst above 8%, high yield bonds look attractive for long-term investors, provided they can withstand some short-term volatility. Additionally, the structural case for high yield remains intact with equity-like returns and lower volatility over longer periods.

Given the macro uncertainty, we expect volatility will remain elevated in 2024. While credit spreads may be biased toward widening in the short-term, we think underlying yields will compensate for this. Additionally, market dislocations should expose attractive entry points. By balancing caution and optimism, active managers can uncover intriguing opportunities in the year ahead. More than ever, we think index agnostic security selection will be key to delivering performance in the high yield market.

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