Navigating the Fixed Income Landscape in 2025

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Key points

- The Fed remains cautious about further rate cuts due to persistent inflation, leading to a higher-for-longer rate environment.
- Tight historical Investment Grade (IG) spreads suggest limited room for further spread compression, reducing the potential for price appreciation.
- With 'coupon-minus' returns expected this year, diversifying into sub-classes like agency mortgage-backed securities (MBS), senior loans and CoCos, while keeping duration low, is a cautious approach.
- Our projections have prompted us to take a more cautious view on fixed income and have led us to adjust our tactical view to 2/5 (from 3/5 previously).
- In terms of duration strategy, we have opted for a relatively short stance, with our bond portfolios averaging around three years.
- By focusing on carry, diversifying spread sources, and carefully managing duration, we aim to construct portfolios that can weather the anticipated economic shifts while still capturing value where it exists.

The year has started on a volatile note for fixed income investors, marked by fluctuations in 10-year Treasury yields. This instability reflects inflation concerns and uncertainty on trade policy and on the Federal Reserve's interest rate trajectory, as the Fed maintains a cautious stance on rate cuts in response to persistent price pressures, reinforcing the higher-for-longer rate environment.

For the months ahead, what can investors expect for rates and spreads? And what are the anticipated returns for key fixed income sub-classes, along with the most suitable positioning? Our assumption of 'coupon-minus'-type returns for the year is the catalyst to diversify into sub-classes like agency MBS or senior loans while keeping duration relatively low.

Rates: higher for longer

US growth should remain robust. We expect a growth rate of between 2.5% and 2.9%, exceeding the current consensus outlook of 2.1%. Inflation is likely to persist in mini waves, potentially reaching 2.5%-3.0% in the second half of the year, meaning the Fed should proceed cautiously in easing rate at around 4%.

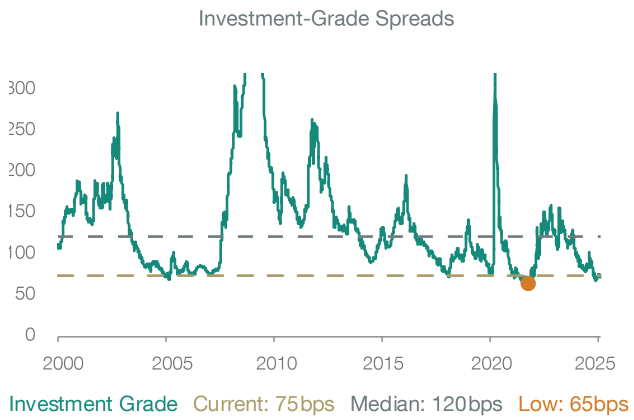
Our year-end target for US 10-year Treasury yields is 5%, explained by a shift in Treasury issuance from short-dated bills to longer-dated notes, the inflationary impact of tariffs and immigration policies, and the expectation of a continued normalisation of term premia across the yield curve that will lead to a steeper curve. We peg the fair value of 2-year, 5-year and 10-year paper at 4%, 4.5% and 5%, respectively.

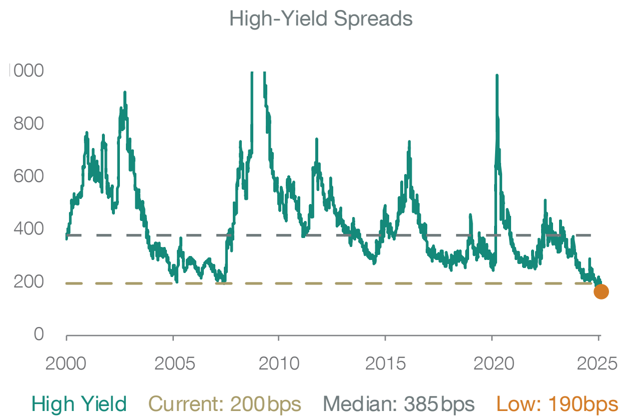
We also see a tangible risk of rates overshooting our targets on the upside driven by upside risks to inflation and debt sustainability concerns.

Spreads at multi-decade lows

Credit spreads are essentially the yield difference between corporate bonds and equivalent government securities, serving as compensation for the additional credit risk. For investment-grade (IG) bonds, the median spread sits at 120 basis points (100 basis points (bps) is equal to 1%), with spreads falling below the 100-bps mark about one third of the time. Currently, IG spreads are at 75 bps, which puts us in the fifth percentile of historical data, meaning we have rarely seen tighter spreads. This level naturally suggests there is limited room for further spread compression.

High-yield (HY) bonds, which are naturally more volatile due to their riskier nature, are currently trading at spreads of close to 200 bps, placing them in the first percentile of historical data. This indicates that HY bonds are sitting at multi-decade lows, where even a slight increase in perceived risk could lead to significant spread widening, as the median level is considerably higher (380 bps). While the argument that the composition of the HY market has seen an increase in less risky BB-rated bonds over the years, suggesting some structural shift to lower spreads, the current spreads still look rich by historical standards.





Sources: BofA ML Indices, 1-10 Year US Corporate and BB-B US High Yield US & Canadian Issuers Constrained
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Even though we are positive on the economy, to be conservative, we assume spreads will widen at least slightly from the current multi-decade lows.

Implications for fixed income returns

Having outlined our view on rates and spreads, we can now work out an expected return scenario. The table below is a simplification of what an investor can expect for 12-month returns of investment-grade bonds under different assumptions of rates and spreads. The red circle represents the status quo, where rates and spreads stay stable, and the investor earns the current carry, which is 5.1%. Naturally, as rates or spreads move down, returns increase, while the inverse is also true.

		US Rates: parallel curve shift						
		-0.75%	-0.50%	-0.25%	Now	0.25%	0.50%	0.75%
Spread Level	50	9.1%	8.1%	7.1%	6.1%	5.1%	4.1%	3.1%
	75	8.1%	7.1%	6.1%	**5.1%**	4.1%	3.1%	2.2%
	100	7.1%	6.1%	5.1%	4.1%	3.1%	2.2%	1.2%
	125	6.1%	5.1%	4.1%	3.1%	2.2%	1.2%	0.3%
	150	5.1%	4.1%	3.1%	2.2%	1.2%	0.3%	-0.6%

Sources: BofA ML Indices, 1-10 Year US Corporate and BB-B US High Yield US & Canadian Issuers Constrained
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In a scenario in which rates move up by 0.25% and spreads widen slightly (to 100 bps), the 12-month total return of IG is reduced from 5.1% to 3.1%, i.e. nothing to write home about and below the 12-month T-bill. A similar exercise in high yield (but with spreads widening 50 bps given the more volatile nature of the class) would reduce returns from 6.2% (current carry) to 3.9%.

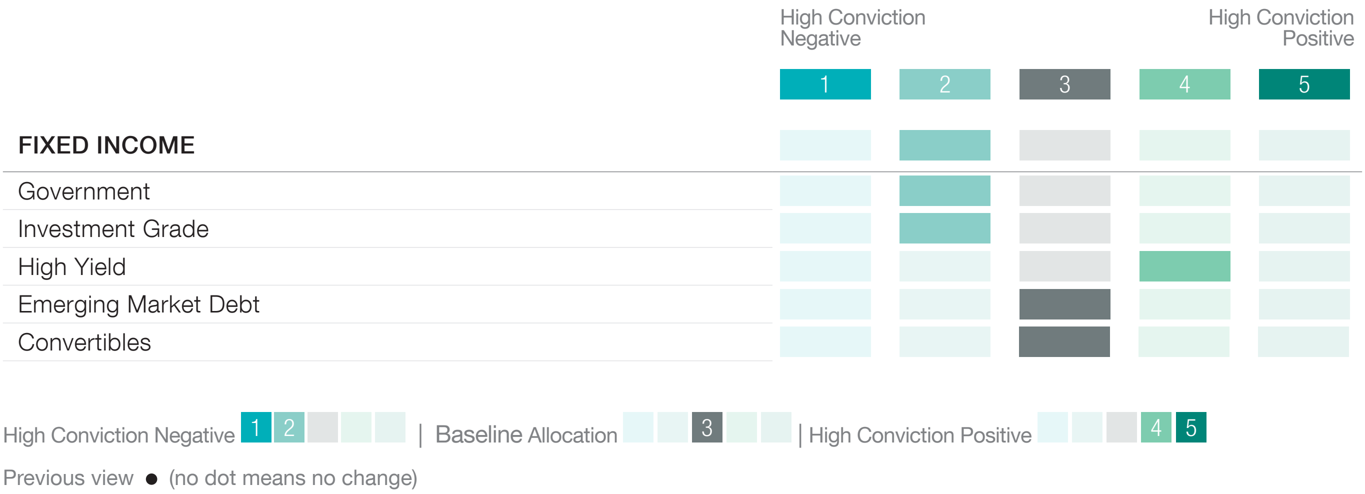
An interesting take from this exercise is to understand that a situation in which investment-grade bonds deliver negative returns is quite unlikely. This would only occur if rates moved up 0.75% and spreads simultaneously double. Importantly, in a situation where spreads double, it would be safe to assume that the economy is (at best) slowing, which is usually synonymous with rates moving down, cancelling out part of the spread-widening hit to returns.

These projections have prompted us to take a more cautious view on fixed income and have led us to adjust our tactical view to 2/5 (from 3/5 previously). This view also justifies why over the last few months we have continuously reduced the fixed income weighting in portfolios, mostly allocating the proceeds to hedge funds, as we expect the latter to offer more flexibility in navigating interest rate fluctuations and inflation risks.

In terms of duration strategy, we have opted for a relatively short stance, with our portfolios averaging around three years. We stand ready to extend this duration if yields move towards our revised targets. It is worth noting that European bond yields might hit their peak before US yields due to differing economic fundamentals, suggesting an earlier adjustment in Europe might be in play.

Asset allocation as at February 2025
Strategic views

Tactical views



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Where investors can find value

Despite the challenges, investors can capture value in several areas within the fixed income space.

Agency mortgage-backed securities (MBS) are pools of US home loans benefitting from an implicit government guarantee via entities like Fannie Mae or Freddie Mac, and they share the same rating as government bonds. Agency MBS offer a spread over Treasuries to compensate for prepayment risk, which has become particularly attractive due to market conditions like elevated rate volatility, the Fed's quantitative tightening, and reduced bank demand. Shifting part of our IG exposure to agency MBS allows us to improve both the rating and yield while diversifying sources of spread. Given our expectation of sustained high rates, we are comfortable with the prepayment risks, focusing on higher-coupon MBS for better spreads.

Senior loans are akin to high-yield floating-rate bonds, making them ideal in our high-rate scenario. They offer a way of gaining credit exposure with almost no interest rate duration risk, making them less volatile than traditional high-yield bonds. Spreads on senior loans are also at more reasonable levels than traditional high yield.

Additional tier 1 (AT1) or CoCos are deeply subordinated bonds issued mostly by European banks to satisfy capital rules. We have been positive on such securities for a long time, as they offer an attractive pick-up versus senior bonds, with the comfort of banks having been the target of intense regulation since the great financial crisis, thus boosting their capital base and reducing their willingness to take risks, as evidenced by all-time-low non-performing loans (1.9%) and all-time-high capital (CET1 at 16%).

Not all bad news

Despite our cautious outlook on fixed income, it is important to recognise that investment-grade bonds currently yield more than 5% – one of the highest levels in many years. This level offers a significant cushion against potential rate or spread shocks, making negative returns for the year quite unlikely. This yield environment is particularly attractive for buy-and-hold investors, encouraging a strategy of lengthening bond holdings to lock in current rates, which is why we maintain a strategic view of 3/5 on fixed income.

Navigating the fixed income landscape in 2025 requires a nuanced approach, balancing risk with opportunity. By focusing on carry, diversifying spread sources, and carefully managing duration, we aim to construct portfolios that can weather the anticipated economic shifts while still capturing value where it exists. This reflects our commitment to delivering returns while managing risks in an evolving global financial environment.

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Glossary of key investment terms

Agency MBS (mortgage-backed securities)
Mortgage-backed securities are issued or guaranteed by US government agencies such as Ginnie Mae, or government-sponsored enterprises like Fannie Mae and Freddie Mac. These securities are generally considered lower risk compared with non-agency MBS.

Additional tier-1 (AT1) capital
A category of regulatory capital for banks consisting of perpetual instruments that can absorb losses at times of financial stress. AT1 securities, often referred to as contingent convertible bonds (CoCos), can be written down or converted into equity under certain conditions.

Basis points (bps)
A unit of measurement used in finance to describe interest rate changes or yield differences. One basis point equals 0.01% (or 1/100th of a percentage point). For example, a 25-bps increase in interest rates means a 0.25% rise.

BB-rated bonds
A category of non-investment-grade (high-yield) bonds rated ‘BB’ by credit rating agencies such as S&P and Fitch, or ‘Ba’ by Moody’s. These bonds carry a higher risk than investment-grade bonds but offer higher yields in return.

Common equity tier-1 (CET1) capital
The highest quality of regulatory capital held by banks, consisting primarily of common shares and retained earnings. CET1 serves as a key measure of a bank’s financial strength and its ability to absorb losses.

Coupon-minus-type returns
The term refers to a scenario where the total return on a bond or fixed income investment is slightly lower than its coupon (interest) payment. This can happen when capital depreciation (a decline in bond prices) offsets part of the income earned from the coupon.

Duration
A measure of a bond’s sensitivity to interest rate changes. The longer the duration, the more a bond’s price is affected by rate fluctuations. Duration helps investors assess interest rate risk in fixed income portfolios.

High-yield bonds
These are bonds rated below investment grade (below ‘BBB-’ by S&P and Fitch, or ‘Baa3’ by Moody’s). These bonds offer higher yields to compensate for increased credit risk compared with investment-grade securities.

Investment-grade (IG) bonds
These are bonds with a credit rating of ‘BBB-’ or higher at S&P and Fitch, or ‘Baa3’ or higher at Moody’s. These securities are considered to have a lower default risk compared with high-yield bonds.

Senior loans
These are floating-rate loans issued by companies with below-investment-grade ratings. Senior loans are secured by collateral and rank higher in the capital structure than bonds or other unsecured debt, offering investors potential downside protection.

Term premia
This is the additional yield investors require for holding long-term bonds instead of rolling over a series of short-term bonds. Term premia reflect uncertainty about future interest rates, inflation, and economic conditions.

10-year Treasury yield
This is the yield on US government bonds maturing in 10 years, widely used as a benchmark for borrowing costs and risk-free rates in financial markets. Movements in the 10-year yield influence mortgage rates, corporate borrowing costs, and overall market sentiment.

Yield curve
This is a graphical representation of interest rates across different maturities of government bonds, typically US Treasuries. A normal yield curve slopes upwards (longer-term rates higher than short-term rates), while an inverted yield curve (short-term rates exceeding long-term rates) can signal economic downturns.

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