Insights
Fixed Income

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Fixed Income 2025: Return of the Sovereigns

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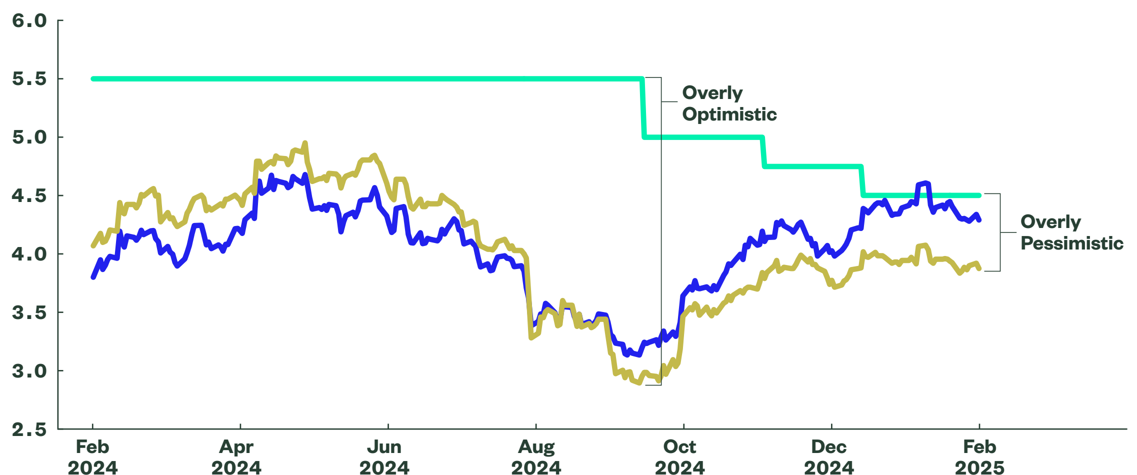
- **We have a positive outlook for fixed income assets in 2025. With economic output generally below trend and inflation quite tame central banks can cut policy rates further.**
- **Some countries are experiencing a pronounced softening in growth and inflation, their central banks can move faster while others may take longer to get to a more neutral or accommodative policy setting.**
- **That most likely means higher volatility in sovereign debt markets in the coming quarters, but that uncertainty may offer investors tactical opportunities to build or expand their duration positioning through divergent easing cycles.**

From One Extreme to the Other

In setting out our views for the coming year we are keenly aware of short-term market gyrations and the inherent risks in presenting a near-term, or somewhat tactical, outlook in the midst of such large moves. The final few months of 2024 provide a great illustration of how markets sometimes swing from optimism to despondency in short order.

A moderating labour market and softer inflation data led investors to price Fed Funds futures for settlement 1-year ahead just below 3.0% in mid-September (Figure 1), three months later Fed Funds futures for 1-year settlement were priced at 4.0%! Clearly much has changed after the US election — some of it potentially enduring and some of it more transient. The former may yet change our views, while the latter can provide tactical opportunities.

Figure 1
From Optimisim to Pessimism



Source: Bloomberg Finance L.P., data to 4 February 2025.

Sovereign Bonds

We expect government bonds across most advanced economies to provide attractive returns as central banks can now focus more on aligning policy rates with weakening domestic demand and international trade and worry less about inflation. Trying to understand how central banks will respond to incoming noisy data — which is subject to significant revisions — will be a big challenge however. Add to that the potentially inflationary policies of the new Trump administration, uncertainties around which tariffs may ultimately be implemented and what countermeasures they may illicit from trading partners and the scene is set for a volatile 2025.

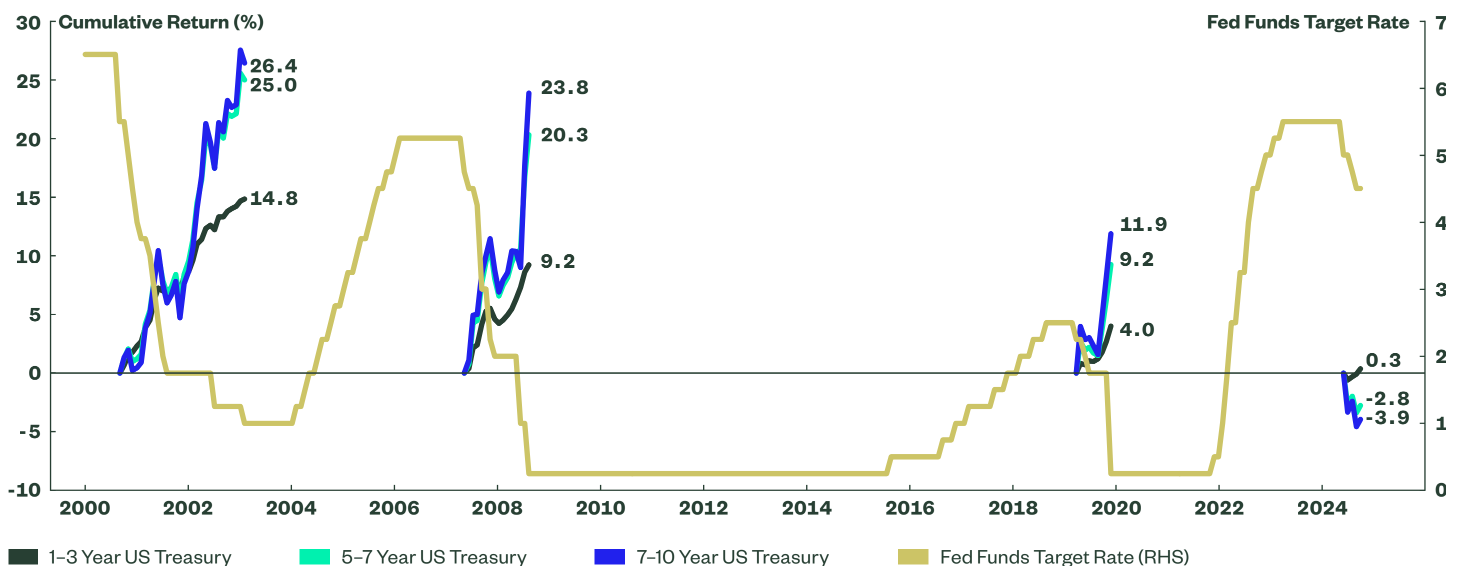
A US Perspective

In recent months US interest rate markets moved from pricing a soft landing to a much firmer landing and more recently to almost no landing (where the economy remains solid and there are few, if any, rate cuts). Market participants and even the Federal Reserve seem to be focusing excessively on month-by-month inflation, labour market and other data, extrapolating the latest print into the future and then reversing course on the next data release or revision! A more stable reference point will serve us better. Our estimate of the long-run neutral Fed Funds rate currently stands at 3.25%. In a soft-landing scenario — which is still our base case for the US economy — we believe the Fed will move towards that level. Of course there are a number of factors that could push back the timing of that: a more pro-growth policy leaning of the new Trump administration increases the possibility of a no-landing outcome for the US economy which might make a neutral rate setting less appropriate in the near term. On balance, it looks like it may take a little longer to get towards neutral but current market pricing suggests significant weight is being placed on the no-landing outcome. That seems premature and may present opportunities for investors as markets reprice the prospect of more rate cuts.

As further rate cuts materialise, yield curves will be pulled lower, led by the short end in the classic bull-steepening trade. Duration exposure is important however: history shows us that rewards are typically much greater further out the curve as the cutting cycle gets under way (Figure 2).

History also tells us that the journey is rarely smooth — we've already noted above some of the potential risks that could arise. The direction of travel is pretty clear though, and repricing like we saw in the closing months of 2024 could present opportunities for investors to get to their desired duration positioning at relatively attractive prices.

Figure 2
Duration Rewarded as Rates are Cut



Source: Bloomberg Finance L.P., data to 31 January 2025.

Ex-US/European Perspective

The widely anticipated pro-growth policy shift under the Trump administration underlines the upside risks to US economic prospects and stands in sharp contrast to the outlook for several of its advanced world peers which offer a clear, if downbeat, picture. Having experienced a more powerful transmission of monetary policy as rates rose sharply a number of major economies in Europe (for example) are now seeing a significant slowdown in growth with limited capacity to offset the malaise with fiscal policy — the fiscal constraints in France, Germany and the UK come to mind.

To compound the challenge, a number of these countries are relatively open economies with significant exposure to a more volatile international trade backdrop. That combination makes the direction of travel for policy rates clearer across many European and Asia Pacific markets. We see further interest rate cuts from most major central banks in 2025.

In Europe, we see the European Central Bank and the Bank of England delivering 100 and 125 basis points (bps) of cuts respectively this year. We believe the Bank of Canada will cut rates by 100 bps by mid-year while the Reserve Bank of Australia will likely cut by 75 bps over the year. Those rate cuts combined with deteriorating macroeconomic positions translate into a favourable outlook for their sovereign debt markets.

While a number of these government bond markets — particularly in the Euro Area — offer significantly lower yields than US Treasuries, much lower absolute growth and inflation prospects make them our preferred choice for non-US based sovereign debt investors in the coming quarters. As the year progresses and the US exceptionalism narrative wanes US Treasuries come into the mix also.

The notable exception among advanced markets is Japan. Despite the recent surprisingly dovish comments from the Bank of Japan we still expect it will continue to raise its policy rate this year. Much of this is already priced in to Japanese government bonds but against such a clearly divergent policy stance we remain somewhat cautious.

Inflation & Inflation Expectations

Our base case is that inflation edges lower in the coming quarters helping underpin our favourable duration view. While market pricing of near-term (next 12 months) inflation has nudged upwards it is not expected to become engrained medium term — indeed market pricing of 5-year inflation 5-years forward has remained close to or below pre-election levels in US dollar, British pound and Euro swaps. That said, some surveys have very recently pointed to a modest lift in consumers' inflation expectations. We keep a watchful eye.

Slow-Moving Factors

In addition to the cyclical forces which clearly impact bond pricing on a near-term horizon there are slow-moving determinants of long-term real return which investors need to incorporate into their calculations. One such factor — demographics — is supportive for bonds while the other — fiscal fragility — is potentially hazardous. Let's get the unpleasant one out of the way first!

Aside from a brief four-year spell around the turn of the millennium, the US has run a budget deficit since 1970. If this remains unaddressed, at some point bond vigilantes may be resurrected and exact a sobering price for sustained fiscal largesse without a credible turnaround plan. The US is in the enviable position of having the world's reserve currency of choice but even the US cannot rely indefinitely on the kindness of strangers or the inert investment policy of domestic investors. At some point painful political decisions will need to be made or borrowing cost will rise significantly.

The problem is not unique to the US. Most of the advanced world went on an understandable spending spree to insulate their domestic economies during the covid pandemic (average gross government debt jumped from 103% to 122% of GDP in 2020 alone). According to the IMF this is expected to drop to 109% at end 2024 but starts rising slowly but surely again this year. Behind that average lie some conspicuous culprits — running significant budget deficits with already high levels of debt-to-national income. The US and France have captured much attention but others could do with getting their house in order sooner rather than later. The UK is by no means alone in seeing its long-term borrowing costs rise in recent months but it is the only major advanced economy to see its 30-year yield hit the highest level since 1998. It's difficult to attribute the exact drivers of this move but a less-than-business-friendly budget is not entirely helpful when trying to place a nation's debt sustainability on a more credible footing.

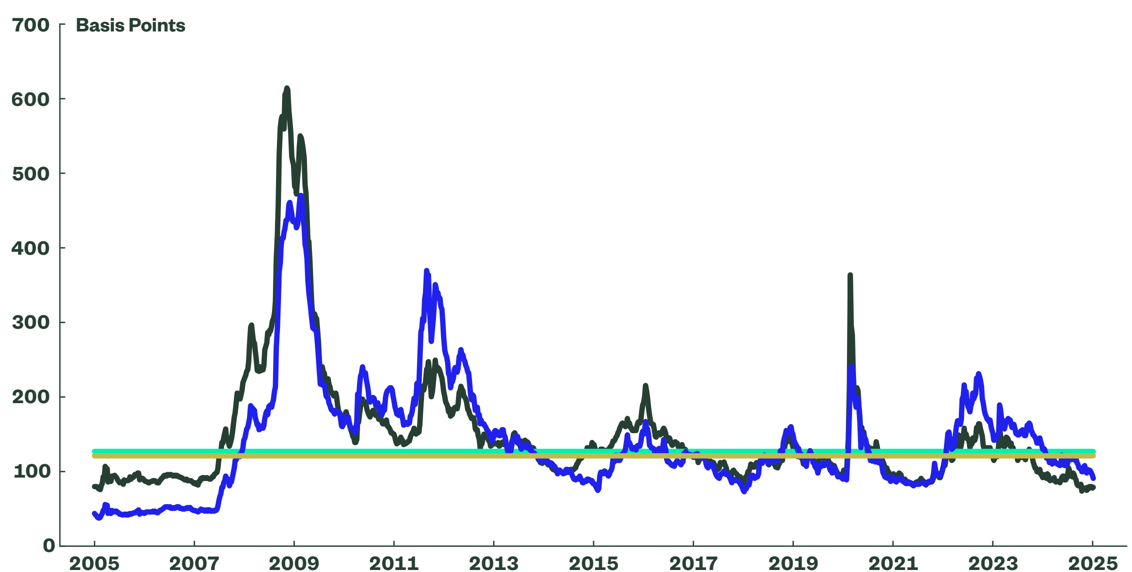
The other (favourable) slowing-moving factor relates to the level of potential GDP growth across many advanced economies. Modest labour force expansion and waning productivity growth point to a future state where the safe operating speed or trend growth of several economies will be lower than today. In the medium term this structural aspect will act as an anchor for long-dated sovereign yields across many advanced economies. Indeed, despite the near-term headwind of the Bank of Japan's policy direction — Japan will also experience the same gravitational pull of an aging population on it sovereign yields.

Investment Grade Credit

With investment grade (IG) spreads close to historic lows there is little prospect of further spread compression from here (Figure 3). Average credit fundamentals are still solid, but it seems reasonable to expect some deterioration in balance sheet strength and interest coverage as the credit cycle progresses. Indeed, there are already signs of this: although leverage among US non-financials has declined from its pandemic-era high it has risen once again from recent lows and remains above its historic average. Meanwhile, profit margins at those non-financials have recently reached an all-time high — unless that trend continues, it seems unlikely that interest coverage for this segment can improve and may weaken further.

Figure 3
Investment Grade Spreads Have Tightened

US IG Corporate Spread
US IG Median Spread
EUR IG Corporate Spread
EUR IG Median Spread



Source: Bloomberg Finance L.P., data to 31 January 2025.

Against that backdrop, earning the underlying sovereign return and capturing much of the current spread would be a good outcome for indexed credit investors. Of course behind those average metrics and fundamentals lies a spectrum of individual names with varying credentials and spreads. We believe that an active systematic approach to credit selection has a role to play in adding value as the credit and business cycle evolves.

High Yield Debt

We see high yield debt in a broadly similar position to its IG counterpart. With spreads at their tightest levels since 2007, returns will be driven more by declining underlying yields rather than further significant spread compression. Our favourable view on sovereign rates is therefore supportive in this higher risk segment as well.

Having previously faced legitimate concerns around an approaching maturity wall in the face of relatively high prevailing yields, many issuers have taken advantage of lower yields and tight spreads since then to refinance, thereby improving the technical outlook for high yield debt. This opportunistic refinancing has been more of a US dollar market phenomenon so far. That said, the fall in yields and tighter spreads are more widespread and those improved refinancing conditions could yet provide the same opportunity for euro (and other) issuers.

Emerging Market Debt

Although hard currency emerging market (EM) debt spreads have narrowed, most credit events have been priced in and a positive outlook for US Treasuries means that this debt segment has scope to add value for investors. Additionally, the turn in the US rate cycle should — in time — weaken another support for the external value of the dollar, which in turn would bolster sentiment towards emerging market assets.

That same US rate cycle dynamic can also support an easing in domestic policy rates across emerging markets, with generally positive implications for local currency (LC) EM debt as well. It is nuanced however, individual local currency issuers face very different inflation pressures and domestic conditions. It would therefore be unwise to assume that all the regions will be able to deliver policy accommodation in the coming quarters. That said, China — as a local currency heavyweight — is something of an exception and has the resources to boost domestic demand. The efficacy of current and potential future support is unclear though.

As noted above, the evolving policy stance of the incoming Trump administration will have a bearing on US Treasury yields and the US dollar, with implications for both EM debt segments. Depending on how targeted they are, protectionist US trade policies could have significant implications for sentiment towards individual countries.

How to Play It

In conclusion, we see a generally favourable environment for advanced economy sovereign debt. We witnessed a considerable change in pricing of US interest rate cuts in the closing months of 2024 with big implications for government bond yields worldwide.

Similar volatility can be expected in 2025: investors will face seemingly divergent economic and monetary cycles exacerbated by fiscal and trade policies under the new Trump administration. Such repricing — recent and prospective — may offer investors an opportunity to manage or extend duration if needed. While still susceptible to the same swings in sentiment the interest rate cycle across many other advanced markets is a lot clearer with favourable implications for investors.

With investment grade credit spreads close to historic lows there is little prospect of further spread compression from here. In such an environment capturing much of the current yield would be a good outcome for passive investors. An active systematic approach has merit for credit investors looking to add alpha in this environment. Similar to its IG counterpart high yield investors may want to manage expectations given current spread levels.

Emerging market debt offers an interesting risk-reward profile. The hard currency segment can clearly benefit from the favourable outlook for US Treasuries. The local currency segment should benefit from lower domestic rates although this will be more nuanced from here and may take some time. A weaker US dollar would be strong catalyst for outperformance.

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* Pensions & Investments Research Center, as of December 31, 2023.

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