Fixed Income asset class overview

February 2025

February began with the threat of imminent US tariffs on Canada (25%), Mexico (25%) and China (10%), to be implemented from 4 February, leading to a strong risk-off move as markets opened at the start of the month. The US consumer price index (CPI) release for January showed the strongest monthly print since August 2023, running at 0.47%. Later in the month, the Federal Reserve's (Fed) preferred inflation measure, the personal consumption expenditure index (PCE), increased 0.33% month-on-month, leaving inflation lingering above the 2% target, at 2.5%.

Month in review

Besides inflation uncertainty, February also saw a drop in consumer confidence, with the US Conference Board reporting a seven point fall in consumer confidence to 98.3, its largest monthly decline since August 2021. Notably, the expectations portion of the index (which gauges consumers' short-term outlook for income, business and labour market conditions) dropped below 80 for the first time since June 2024 (readings below 80 can be indicative of a recession ahead). These factors have raised concerns about economic growth and the Trump administration's policies. The 10-year Treasury yield dropped 33 basis points (bps) to 4.21% in the month, on increased growth anxieties. Markets now anticipate two 25 bps Fed interest rate cuts by September.

Against this backdrop, global investment grade (IG) credit spreads moved wider for only the third month out of the previous 16. European spreads continued to outperform, finishing the month unchanged, while spreads in the US and the UK widened slightly. The convergence in spreads across geographies over recent months means that ranges are much tighter. Despite spreads widening, returns across all markets were positive due to a move lower in government bond yields.

Over the month, global high yield (HY) markets saw a positive return of 0.9%, with emerging market (EM) HY leading the way at 1.4% due to rallying USD rates and stable spreads. European HY followed at 1.1%, with US HY at 0.7%. In February, US HY spreads widened by approximately 20 bps to 287 bps due to tariff concerns and weakening growth, while European HY spreads tightened by 10-15 bps, driven by the prospect of European Central Bank (ECB) monetary policy easing and a potential resolution in Ukraine.

In EM, local currency (LC) sovereign bonds returned 0.7% over the month (2.7% year-to-date (YTD)), with hard currency (HC) sovereigns at 1.6% (3.0% YTD), and HC corporate bonds returning 1.5% (2.4% YTD). While total returns for HC sovereign and corporate indices were broadly similar, the underlying drivers differed due to market characteristics. US Treasury returns were positive for both, with HC sovereigns benefiting more from longer duration. Spread returns were positive for corporate bonds but negative for sovereigns, reflecting lower average credit quality in the sovereign index.

Inflation

After a few boring reports, we finally got some excitement back. This time, it's on the hot side. US inflation for January exceeded economists' expectations, coming in at 3.0% year-on-year (YoY), compared to the anticipated 2.9%. Core CPI also surpassed expectations with a 3.3% increase versus the 3.1% forecast. At the end of 2024, we noted that inflation had become somewhat predictable and suggested that this trend was going to change in 2025 -- and so it did. January is always a tricky month for predicting inflation due to a combination of seasonal factors and changes in the weights used to construct the inflation index (these changes, applied once per year, reflect evolving consumption patterns).

There are a couple of things worth highlighting from this report:

1. Tariffs Impact: there are no clear signs of tariffs affecting the report yet, but this is something to monitor going forward. One of the most obvious areas where tariffs might have an impact is apparel, as hardly any is produced in the US. Currently, apparel inflation stands at -1.4% month-over-month and 0.5% YoY.

2. Median versus headline CPI: while the monthly CPI pace has increased significantly in recent months, the median increase has been much more modest. This suggests that the recent inflation spike is mostly due to one-off factors rather than a broadening of inflationary pressures. Given that January is often a volatile month for US inflation, it might be prudent to focus more on median inflation to get a clearer picture of current trends.

Zooming out, we like to focus on the key components of inflation and what drives them to get a better sense of what lies ahead.

The first and arguably most important category in the inflation basket is rent. We have discussed this extensively previously. In summary, rent inflation, which represents a significant portion of the inflation basket, is likely to continue decelerating, preventing overall inflation from rising much further.

The second category, often referred to as super-core inflation, consists of core services excluding rent. This category is heavily influenced by wages, as labour costs are a key input for these sectors. The Fed is very focused on this indicator because it is where a wage-price spiral would first materialise. For now, there seems to be no reason for significant concern. While super-core inflation remains elevated, it is slowly moving in the right direction and will likely continue to do so as the labour market softens and wage growth slows.

The last item is core goods. Among the three key categories, this is by far the most volatile. After posting a 12.5% annual increase in 2022, this category fell back into deflation in 2023 and is now almost flat. Given that the US economy largely relies on imported goods, the key driver here is the US dollar. A weaker dollar will make imports more expensive, pushing core goods inflation higher. Conversely, a stronger dollar will likely exert downward pressure on core goods prices. There might be further volatility ahead in this category, particularly if tariffs are implemented, but as long as the USD remains strong, we are unlikely to see significant inflation from core goods.

In summary, despite a hotter-than-expected report, the overall inflation narrative hasn't significantly changed. While inflation is still above target, it appears to be under control for now.

The January report was likely influenced by one-off factors and some technical adjustments. We believe the February report will likely paint a more benign picture.

Developed market sovereigns

Despite the fears over US tariffs, in February there was a last-minute extension of the deadline on Canada and Mexico, with tariffs postponed by a month. However, the 10% tariffs on China did come into force. The threat of higher tariffs added to rising fears of inflation in February, with CPI coming in stronger than anticipated. This saw investors move to price in meaningfully higher inflation for the coming year, with the one- year inflation swap up 27 bps on the month to 2.92%.

Alongside weaker consumer confidence, these factors have raised concerns about economic growth and the Trump administration's policies.

In the euro area, German election results were broadly in line with opinion polls, and boosted the eurozone's growth outlook, with expectations of increased defence spending and looser fiscal policy. The increased confidence in a ceasefire between Russia and Ukraine also supported economic growth expectations in the region. This saw European sovereign yields fall less than in the US, with higher-yielding Italian bonds (+0.7%) outperforming German bunds (+0.6%).

In the UK, January headline CPI stepped up 3.0% YoY from 2.5%, driven by an unwinding of airfare weakness, VAT on private sector school fees, and core goods and food price increases. However, there were some encouraging signs on underlying services. Gilt yields dropped very slightly over the month to 4.48%.

Past performance is not a guide to future performance.

Government bond total returns (in local currency)

	10-year yield %	Total return % (1m)	Total return % (ytd)
Treasuries	4.2	2.2	2.8
Bunds	2.4	0.6	0.2
Gilts	4.5	0.8	1.6

Source: Bloomberg, 28 February 2025

Investment grade credit

Going into February, expectations were for trade policy decisions to dominate news headlines, and while that was certainly the case, broader geopolitical developments also played a part. Original plans to put 25% tariffs on both Canada and Mexico were temporarily shelved until early March, after discussions among the respective governments, while a 10% tariff on China went ahead. Later in the month, the US announced reciprocal tariffs, due to become effective from April, where the US would charge other countries the same tariffs they imposed on the US. While there are several mitigating factors on whether the implementation of tariffs will necessarily feed through to meaningful inflationary pressures, an escalating trade war is very likely to be damaging for global economic growth and consumer and business confidence. Indeed, the Conference Board’s consumer confidence indicator fell to an eight-month low, and riskier assets had a challenging second half of the month.

Also in February, the US administration began negotiations with Russia over ending the war in Ukraine. Those negotiations did not, importantly, include Ukraine or European representatives; however, French President Emmanuel Macron, UK Prime Minister Keir Starmer, and Ukraine’s President Volodymyr Zelenskyy subsequently visited the Oval Office, where Russia’s aggression was discussed at length. Unfortunately, Zelenskyy was ambushed by the US administration and discussions were halted, making onward negotiations trickier.

Finally, the German election resulted in the CDU/CSU bloc initiating exploratory talks with the centre-left SPD to form a new government. While the two parties would hold a majority, questions remain about their ability to secure enough support from other parties to achieve a two-thirds majority necessary for constitutional changes, which, importantly for financial markets, includes any adjustments to the debt brake.

Against this backdrop, global IG credit spreads moved wider for only the third month out of the previous 16. European spreads continued to outperform, finishing the month unchanged, while spreads in the US and the UK widened. The convergence in spreads across geographies over recent months means that ranges are much tighter. Despite spreads widening, returns across all markets were positive due to a move lower in government bond yields

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	88	2.0	2.6
Euro IG	90	0.6	1.1
UK IG	97	0.5	1.7

Source: Bloomberg, 28 February 2025

High yield credit

February was a positive month for global HY markets returning 0.9% with mixed regional performance. EM HY was the best performing market (1.4%) supported by rallying USD rates and flat spreads, followed by European HY (1.1%) and US HY (0.7%). YTD the global HY market is up 2.1%.

US HY spreads widened in the second half of February, driven by concerns around tariffs and weakening growth to end at 287 bps (approx. +20 bps). On the other hand, European HY spreads behaved strongly during the month, tightening a further 10-15 bps on the prospect of ECB rate cuts and a potential Ukraine resolution.

HY fundamentals have been solid and market technicals remain very strong. Importantly, the HY market continues to shrink as issuers seek capital elsewhere (private markets, loans market), which further reduces supply against ongoing robust demand backdrop.

Going forward

February has seen a clear change to market sentiment, particularly in the US. As some flags have been raised over a cooling economy, it is worth remembering that only a month ago riskier assets' prices were hitting record highs. Markets have grown used to good news and, when anything less than good comes along, they sell off. We are likely going to see more corrections ahead as macroeconomic and market expectations readjust and find some balance.

Looking forward, there are still valid reasons to consider investing in HY, albeit with some caution and much focus on selectivity. First, economic data is not recessionary, and recent weakness has been more in surveys, rather than hard data. Second, even if growth does weaken, central banks now have a lot of room to cut rates and support the economy. And third, markets have already proven highly resilient to several risks this year, including tariffs and geopolitics, suggesting it would take a much bigger shock to cause a large sell-off.

• **All-in yields are historically attractive:** while spreads are at relatively low levels, yields on HY bonds remain historically elevated. With today's yield-to-worst (YTW) of c. 6.9%, we believe there is arguably potential for the asset class to generate reasonable returns.

• **Greater confidence in the economy:** recent economic performance is fine, in our view, (not great but also not recessionary), with corporate profits and consumer spending remaining largely resilient in the face of high interest rates. This environment suggests a benign default cycle going forward, also evidenced by diminishing levels of market distress.

• **HY fundamentals look resilient despite macroeconomic uncertainty:** improved growth expectations are likely to further support fundamental metrics. It's worth noting that the interest coverage ratio (which measures a company's ability to pay off its debt) while dropping as companies have refinanced at higher rates, remains well above levels at which analysts would typically become concerned about companies' ability to pay.

• **The possibility of a carry-driven year:** given the power of carry and expected low defaults, mid-to-high single digit returns are plausible over 12 months.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	287	0.7	2.0
Euro HY	297	1.1	1.7

Source: Bloomberg, 28 February 2025

Emerging market bonds

While there wasn't much to separate the HC sovereign and corporate indices in terms of total returns, there was disparity between the drivers reflecting the differing characteristics of the markets. US Treasury returns were positive for both but the HC sovereign index benefited more by virtue of having much more duration. Returns from spreads were positive in the corporate space but negative in the sovereign space which reflects the lower average credit quality within the sovereign index. With rates performing well, but spreads widening, the IG portions of the benchmark outperformed the HY segments. The local currency index performed well on the back of US dollar weakening although Asia underperformed from a currency point of view due to spillover effects from the tariffs imposed on China. Latin America, however, continues to be an outperformer in this regard.

February was marred by the continuation of uncertainty stemming from US policy, particularly tariffs, however markets are showing signs of beginning to ignore the noise and instead focusing on actions. Uncertainty continues to overshadow EM which, in isolation, look to be in a fairly good position but are continuously having to grapple with headwinds from the US. Trump also widened the potential scope of tariffs by mulling reciprocal tariffs being applied to other countries in line with what the US has to pay. He also suggested a 25% tariff on all aluminium and steel being imported into the US. This ultimately added to concerns that inflation would be negatively impacted as a result, which may hamper the Fed's ability to cut rates meaningfully.

The good news within EM is that inflation is broadly under control, although there are some outliers like Brazil and Chile, who were particularly quick to cut rates following the initial post-COVID inflationary pressures. Strong economic growth is also expected, with the EM versus DM premium continuing to widen, also driven by the modest growth levels expected in Europe. EM corporates are in good shape, with fundamentals appearing favourable in our view, with a relatively low level of defaults expected in the HY space. Equally, we believe sovereigns are in good shape, broadly speaking, with no defaults expected in the near term.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
LC government	n/a	0.7	2.7
HC government	331	1.6	3.0
HC corporate	253	1.5	2.4

Source: Bloomberg, 28 February 2025

Currencies

The US dollar swung in both directions during the month, as evidenced by the DXY index. Initially, the dollar index fell by as much as 1.8% mid-month but managed to recover some ground, ending the month down by only 0.7%. This recovery was largely driven by renewed and intensified discussions regarding tariffs, with the possibility of expanding their scope. Markets perceive tariffs as inflationary, and the potential implementation of these tariffs could significantly influence the Fed's policy. If inflation rises or remains stable, the Fed might find itself constrained in its ability to cut rates. However, the Fed might also consider the impact of tariffs as temporary, and choose to overlook it in policy considerations.

In response to the tariff discussions, the Canadian dollar and Mexican peso managed to recoup some of their January losses. This was initially due to President Trump delaying the imposition of tariffs on imports from these two countries, although later stating that the tariffs would likely be enforced in March. The Japanese yen continued to strengthen, as did several Latin American currencies, which had generally underperformed in 2024. Notably, the Russian ruble has emerged as the leading currency year-to-date. This can be attributed to President Trump's efforts to end the ongoing conflict, which, while not immediately resolving the situation, could eventually lead to the lifting of sanctions.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	1.5	0.5
GBP/EUR	1.4	0.3
EUR/USD	0.1	0.2

Source: Bloomberg, 28 February 2025

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

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