Fixed Income asset class overview

May 2025

Markets continued their recovery in May, driven by encouraging economic data and easing trade tensions resulting from a temporary tariff delay, prompting investors to price out the likelihood of a global recession. However, US Treasuries had a more challenging time amidst growing concerns over the US fiscal situation, with questions raised about the sustainability of government borrowing, exacerbated by a sovereign rating downgrade by Moody's.

Month in review

Despite the tariff concerns, US inflation continued to surprise to the downside. The US consumer price inflation (CPI) was 2.3% YoY in April, down by 10 basis points (bps) from the prior month, its [1]lowest rate since February 2021. Core inflation also surprised to the downside, printing at 2.8%, its slowest rate since March 2021. As US inflation continues to trend in the right direction, there may be some upward pressure from tariffs, but this is unlikely to alter the overall landscape.

In May, investment grade (IG) spreads tightened notably, having now fully offset the US tariff 'Liberation Day'-driven widening. Global spreads tightened by 16 bps, led by USD spreads with an 18 bps tightening. Similarly, EUR and GBP spreads were 14 bps and 10 bps tighter respectively.

High yield (HY) had a strong month given the improvement in economic data and the easing in trade tensions. The Global HY Index returned 1.5% (USD-H) in May and year-to-date (YTD) performance is at 2.6%. Government bond yields were volatile during the month, so gains were driven by tighter spreads, particularly the US. Global HY floating rate notes (FRNs) also posted strong returns of 1.4% (USD-H), exceeding leveraged loans -- a sub-asset class with which they are often compared by investors -- thanks to tighter spreads.

Emerging markets (EM) also delivered positive returns during the month, with spread compression the main driver of returns in the hard currency (HC) sovereign and corporate space. Local currency (LC) bonds were once again the standout performer, delivering 1.4% during May, bringing YTD returns to 9.2%, making it one of the best-performing asset classes in the fixed income space. During May, and indeed the year, the returns from LC sovereign bonds have been broadly split by currency and carry, with the former benefitting from a dollar that continues to weaken, and the latter benefiting from growing expectations for rate cuts.

Inflation

Delving into the inflation report, there were a few encouraging developments worth highlighting. Conversely, there is also something less encouraging that bears watching.

Starting with the positives, both "inflation ex-rents" and "supercore inflation" have declined further. Excluding rents offers a more timely insight into current inflationary dynamics because rents are a significantly lagging indicator due to the method by which they are calculated. Inflation excluding rents has been at or below normal levels for over two years now, indicating that inflationary pressures have eased considerably.

Turning to supercore inflation, this is the Federal Reserve's (Fed) most closely watched gauge, as it includes categories predominantly influenced by wages, thereby posing a potential risk for a price-wage spiral. Recently, supercore inflation has declined sharply and it continued its downward trend in April. This is encouraging news for the Fed, in our view strengthening the case for future rate cuts.

On the less encouraging front, the median CPI has not seen substantial declines in recent months and remains above its historical average. We like to monitor median inflation because it excludes outliers, focusing on the core of the inflation distribution, thus providing a clearer picture of underlying inflation dynamics. The fact that the median CPI has not decreased significantly is not necessarily indicative of an inflation problem, but it does suggest that inflation may remain sticky around current levels. This is something worth monitoring moving forward.

In summary, US inflation continues to trend in the right direction despite concerns surrounding tariffs. In the upcoming months, we may see upward pressure from tariffs; however, it is unlikely that this will significantly alter the overall inflation landscape. The inflationary pressure from tariff-impacted goods will likely be counterbalanced by continued normalisation in the service sectors of the

[1] https://www.bls.gov/news.release/cpi.nr0.htm

economy. Inflationary pressures will likely continue to diminish, albeit at a relatively slow pace.

Developed market sovereigns

May proved to be a robust month for most financial assets, driven by encouraging economic data and reduced US-China trade tariffs, which prompted investors to dial back expectations of a global economic slowdown. However, US Treasuries faced significant challenges amid rising concerns over the fiscal outlook, exacerbated by a credit rating downgrade from Moody's. Additionally, attention centred on a tax bill progressing through Congress, contributing to a tough environment for Treasuries. As a result, Treasuries declined, with the 30-year yield reaching an intraday high of 5.15%, reflecting a wider global sell-off in longer-dated bonds.

In the US, a robust April jobs report marked one of the first significant data points following 'Liberation Day'. The report[2] revealed nonfarm payrolls rose by 177k, with the unemployment rate holding steady at 4.2%, signalling to investors that the US economy was not facing an abrupt decline. This positive sentiment was further bolstered when the ISM services index unexpectedly climbed to 51.6, solidifying a picture of sustained economic resilience.

The US and the UK announced a trade deal on 8 May, raising hopes that it could be the first of many. On 12 May, markets received a positive jolt when the US and China announced a 90-day tariff reduction, with the US lowering its rate on Chinese goods from 145% to 30%. This unexpected development uplifted investor sentiment, particularly as it contrasted with President Trump's recent statement advocating for an "80% tariff on China".

Mid-month, a growing unease about the US fiscal outlook took hold. The tipping point came with a Moody's downgrade, amplifying existing worries about persistent US deficits exceeding 6% of GDP in 2023 and 2024. This sparked a rise in long-end bond yields, with the 30-year Treasury yield surpassing 5% by 21 May. Although it eased slightly by month-end to close at 4.93%, this still reflected a 25 bps increase for May overall.

In the eurozone, aggregate inflation held steady at 2.2% in April[3] but core CPI rebounded from 2.5% year-on-year (YoY) to 2.7%.

EU GDP growth[4] for Q1 came in at 0.3% quarter-on-quarter versus 0.4% expected. Meanwhile, the euro area unemployment rate held steady at its historical low of 6.2%.

In the UK, the Monetary Policy Committee (MPC) voted by a majority of 5–4 to reduce the Bank Rate by a quarter of a percentage point from 4.5% to 4.25%. The decision was driven by concerns over lacklustre economic growth and the expected impact of US trade tariffs, despite inflation remaining above the BoE's 2% target at 2.6% in March 2025. CPI numbers for April surprised to the upside, proving to be stickier than surveys expected.

In Japan, following fiscal concerns Japan's 30-year bond yield surged to its highest point since the maturity's introduction in 1999, reflecting heightened market dynamics, before retreating toward the end of May.

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	4.4	-1.1	2.5
Bunds	2.5	-0.4	-0.2
Gilts	4.6	-1.2	1.0

Source: Bloomberg, 31 May 2025

Investment grade credit

Risk assets performed well through May, largely due to the rollback of tariff threats, which resulted in a continued reversal of the spread widening that followed 'Liberation Day'. An announcement of a deal between the US and the UK set the tone for positive news early in the month, which was followed by the temporary alleviation in trade tensions between the US and China. A significant reduction in tariffs for a duration of 90 days, aimed at providing the necessary leeway to negotiate a more enduring trade agreement, helped sentiment despite the increase in uncertainty. However, the positive narrative on global trade took a downturn towards the end of the month, with Trump threatening a 50% tariff on goods from the European Union, initially slated for implementation from 1 June and subsequently extended until 9 July. Amid these escalating tensions, the US Court of International Trade intervened by rejecting the authority claimed by the Trump administration to actually impose the bulk of their proposed tariffs, adding another layer of complexity and uncertainty to the evolving landscape.

[2] https://www.bls.gov/news.release/empsit.nr0.htm
[3] https://ec.europa.eu/eurostat/databrowser/view/prc_hicp_manr/default/table?lang=en
[4] https://ec.europa.eu/eurostat/en/web/products-euro-indicators/w/2-15052025-ap

Elsewhere, fiscal concerns continued to fester, resulting in a steepening of government bond curves, and specifically so in Japan and the US. On the latter, markets were focused on the implications of the US administration's newly proposed tax bill for overall debt sustainability. The proposition aims to extend the tax cuts that were enacted in Trump's first term, which were originally set to expire later this year.

Economic indicators painted a somewhat positive picture. In particular, labour market data in the US was resilient, while inflation figures were lower than the market had forecasted. Against this backdrop, global IG corporate spreads tightened notably, having now fully offset the widening in response to the original tariffs announced on 'Liberation Day.'

Despite favourable developments in May, uncertainty remains in vogue. Tariff-related newsflow, covering topics ranging from the legal foundations on which the US administration can actually enforce them, to the possibility of further trade deals being announced, could sway market sentiment in one direction or the other. Alongside geopolitical challenges, economic data is important: interest rates remain in restrictive territory and central banks are reluctant to ease monetary policy too quickly. However, the effects of monetary policy take time to play out and as such, the negative growth impetus will likely remain through this year and next. There is a lot to weigh up, and, as ever, it is important to have flexible, agile, active strategies which can endeavour to outperform through such times of volatility and opportunity.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	91	0.0	2.3
Euro IG	97	0.5	1.6
UK IG	110	-0.2	1.6

Source: Bloomberg, 31 May 2025

High yield credit

May was a strong month for HY markets with improving economic data and lower US/China tariffs supporting risk sentiment and investors pricing out the more extreme economic outcomes.

HY spreads tightened across the board in May, led by US HY, which benefitted from a rebound in risk appetite from the US/China de-escalation and generally recent positive economic surprises. Spreads tightened c. 50-75 bps during the month to close at 331 bps (US HY), 335 bps (EU HY) and 450 bps (HY FRN).

US HY has now erased most of its tariff-related losses, and spreads in other HY markets are now inside of 'Liberation Day' levels. However, absent a sudden escalation in trade tensions, we struggle to see spreads widening materially until the macroeconomic data starts to turn, which could take some time.

The market technical is still firm, with HY fund flows recovering from the early-April withdrawals. European HY has seen particularly positive inflows in recent weeks, maintaining a strong demand-side technical. On the supply front, there was a rebound in primary activity after a very quiet April. While May saw the most active primary market since September 2024, YTD 2025 net issuance volumes are still relatively light versus previous years. The combination of both demand/supply technical forces continues to be supportive for spreads.

May saw lower-quality bonds outperform. Best performing sectors include media, metals & mining, consumer and autos, partially re-tracing tariff-risk losses. On the other hand, food & beverages, banking and super retail underperformed during the month.

What we see going forward

Since 'Liberation Day', the HY market has been trying to stabilise and has finally found some grounding, with the global HY spread at mid 300 bps and all-in yields back in the 7.5%–8.0% range (USD terms), a level which is still fairly compelling from an income perspective, in our view.

At current spread levels, with the big rally behind us, there are arguably less obvious opportunities to pick up. However, as an active manager, we focus on alpha and remain confident in the skill of our global analyst team to identify sector and issuer dislocations that may arise from tariff headwinds/tailwinds and any further market volatility.

High yield – the opportunity

- **High single-digit yields:** yields of circa 7.8% (US HY) and 5.8% (EU HY) provide healthy coupon income and a comfortable cushion, in our opinion, to absorb a potential adverse move in spread.

- **Low duration:** HY markets have shorter durations compared to other fixed income instruments (IG or sovereigns). This reduces their sensitivity to swings in interest rates, helping mitigate capital loss in volatile markets.

- **Expectation of benign default cycle:** although interest rates remain historically elevated and economic growth is slowing, distress levels have been dampened by interest rates starting to trend lower and active refinancings taking place. Distress ratios are still consistent with a sub 3% default rate for the next 12-18 months, absent a major macroeconomic and/or tariff shock.

• **HY fundamentals** have come under some pressure, but generally remain robust, particularly when it comes to net leverage (which is not increasing, due to lack of M&A activity) and interest coverage ratios (still above levels at which analysts would typically become concerned).

• **An active approach** is always essential in HY investing, in our opinion, but especially so in times of elevated uncertainty and market volatility. Careful analysis prior to investing in HY credits is crucial to make sure credit spread appropriately compensates for the risks undertaken.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	331	1.7	2.6
Euro HY	335	1.3	2.4

Source: Bloomberg, 31 May 2025

Emerging market bonds

EM debt delivered positive returns in May with spread compression acting as the main driver of returns in the hard currency sovereign and corporate space. LC bonds were once again the standout performer, making it one of the best performing asset classes in the fixed income space. Following the very broad negative performance in April in the wake of 'Liberation Day', May was a much more positive month with the majority of countries delivering positive returns.

We expect a lot of uncertainty stemming from US policy, with the added complexity of countries clamouring to renegotiate trade deals and concessions with the US to avoid tariffs that go above the 10% baseline currently in place, and ideally removing that altogether. The 90-day grace period does provide some respite, but a lot can happen during that time and Trump's untethered unpredictability is a factor for the world to consider. This will have to be balanced with the outcomes of legal challenges, with judges in the US recently ruling some of the tariffs imposed by Trump as being unlawful.

The downward revision in growth expectations following 'Liberation Day' could improve should the grace period allow for deals to be reached and baseline levels be kept away from the initial highs touted. In a more benign growth environment and EM inflation continuing to fall, EM central banks will have more room to cut rates.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	1.4	9.2
Hard currency government	336	1.1	3.2
Hard currency corporate	271	0.6	2.6

Source: Bloomberg, 31 May 2025

Currencies

The dollar continued to weaken, although at a slowing pace in May, with the DXY index down 0.7% and down 8.4% over the year. All currencies in the G10 strengthened over the month with the exception of the Japanese yen, which fell 0.8%, breaking a four-month long streak of appreciation relative to USD. European currencies took a break from being the best performing of the month, with the Taiwanese dollar and South Africa rand being the strongest performers in May.

The USD started the month well, with markets continuing to recover from the lows of tariff-induced market volatility, but lost steam mid-month as concerns over the fiscal situation ticked up, with Moody's downgrading its US rating by one notch. The attractiveness of USD assets continue to be weighed down also by uncertainty on the future direction of US policy. EM currencies strengthened during the latter part of the month with those in Asia performing particularly well. With FX volatility subsiding in EM, and attractive yields on offer, the carry trade is beginning to pick up pace, standing to benefit some of the higher yielding currencies such as the Brazilian real and Mexican peso.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	1.0	7.5
GBP/EUR	0.8	-1.9
EUR/USD	0.2	9.6

Source: Bloomberg, 31 May 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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