Fixed Income asset class overview

January 2025

Global sovereign yields moved higher early in January as renewed inflation concerns were fuelled by US President Trump's proposed policies, including tax cuts, immigration restrictions, and tariffs. Ultimately, the sell-off unwound and sovereign bonds rallied on the back of a softer-than-expected December consumer price index (CPI) print, which saw monthly core CPI inflation fall to +0.2%. This marked the end of a four-month streak of +0.3% increases and fostered optimism that the Federal Reserve (Fed) might still cut rates this year.

Month in review

In global investment grade (IG), credit spreads tightened over the month, resulting in positive returns across the IG spectrum. Spread compression, predominantly driven by strong demand for credit, has reduced the yield differential between BBB rated and A rated corporate bonds to just 33 bps. This trend is evident across various credit markets, and to us it suggests limited compensation for taking on additional risk.

Global high yield (HY) also had a strong start to the year, returning 1.2%, led by the US at 1.4% which outperformed the EU at 0.7% due to favourable rates and a significant rally in spreads. Global HY floating rate notes (FRNs) returned 0.5%, benefiting from a spread rally despite lower market beta. The HY market is shrinking as issuers turn to private markets and loans, reducing supply amid strong demand. However, new tariffs and US inflationary policies may impact export-sensitive sectors and create rate volatility. Despite this, HY, being a low-duration asset class, should remain relatively insulated, in our opinion, with volatility offering opportunities for actively managed funds.

In emerging markets (EM), local currency (LC) sovereigns returned 2.1%, hard currency (HC) sovereigns returned 1.4% and HC corporate bonds returned 0.8%, reflecting a risk-on sentiment. The underperformance of the US dollar boosted LC sovereigns, with Latin America, particularly Brazil and Colombia, leading the gains. EM sentiment remains cautious following the US election and the Fed's rate cut prospects, despite positive growth and improving inflation. While markets have shown resilience, anticipating that Trump's proposed tariffs may be temporary if his concerns are addressed, the broader trade relationship between the US, Mexico, and Canada is expected to deteriorate.

Inflation

US inflation once again came in exactly in line with expectations. Either economists are suddenly becoming really good at forecasting, or inflation is becoming very predictable and boring. If the latter, we do not expect this predictability to persist for long, as 2025 is likely to reintroduce some volatility, both upwards and downwards.

Back to December's CPI report, headline inflation was 2.9% year-over-year, while core inflation remained almost flat at 3.2%. Although still above target, inflation is gradually trending in the right direction, with limited inflationary pressures on the horizon.

The best way to analyse this report is to examine its three major components:

Core goods: previously, we noted that core goods inflation was unusually low, even by historical standards, and a normalisation was needed. This normalisation is now occurring, with core goods inflation rebounding from extremely low (negative) levels. While some further normalisation may be ahead, significant inflationary pressure from this category is unlikely, due to the ongoing struggles of the Chinese economy and the strength of the US dollar.

Rents: this is the largest and "stickiest" category in the inflation basket. We have long held the view that rents were slowly (very slowly!) going to normalise, reflecting the actual dynamics of the rental market. This trend is currently unfolding, and the disinflation trend in rents is likely to continue over the coming months.

Core services excluding rents: often referred to as 'super-core', this category is closely monitored by the Fed, as it is largely driven by wages. If a wage-price spiral were to occur, it would manifest here. The latest report indicates that while inflation in this category remains elevated, it is trending in the right direction, providing some reassurance to Fed officials.

In summary, core goods inflation is normalising upwards, while rents continue to normalise downwards. The 'super-core' category, which is the most closely watched by the Fed, is gradually moving in the right direction. Overall, this report continues to suggest a gradual, yet very slow, decline in inflationary pressures.

Developed market sovereigns

As 2025 began, inflation concerns were prominent among investors. This was partly due to the potential imposition of tariffs by the newly inaugurated Trump administration. This, together with the December US jobs report released on 10 January, led to a significant global bond sell-off, as investors grew increasingly doubtful about central bank rate cuts; following the robust jobs report, the expectation dropped to just 29 bps of cuts by the Fed in 2025. The trend partially reversed after a softer-than-expected core CPI print in the US. By the end of January, futures markets were pricing in 47 bps of Fed rate cuts by December, slightly more than the 43 bps anticipated at the start of the month. UK gilts sold off sharply mid-month, with the 30-year yield reaching its highest level since 1998 on concerns about the government potentially breaching its fiscal rules. The move reversed in the last two weeks of January.

Over the month in the US, various data releases indicated heightened demand pressures. Notably, the ISM services PMI report on 7 January revealed that the prices paid index surged to 64.6 in December, its highest level in nearly two years. US jobs data for December exceeded expectations, with nonfarm payrolls increasing by 256k, the fastest growth in nine months. The US's core CPI figure for December fostered optimism that the Fed might still cut rates this year. Further support came from Fed Governor Christopher Waller, who expressed openness to a rate cut as early as March and suggested that three or four cuts could be possible this year if the data supported it. This was a more dovish outlook compared to the December dot plot, which indicated a median expectation of only two rate cuts for 2025. In the eurozone, the European Central Bank (ECB) cut interest rates (as anticipated) again as inflation nears 2% and growth remains weak. The latest ECB monetary policy decision came as the eurozone economy ground to a halt in the fourth quarter of 2024, according to earlier preliminary data from Eurostat, with Germany and France, the bloc's two largest economies, posting worse-than-expected contractions.

Eurozone gross domestic product (GDP) remained unchanged from the previous quarter, a sharp slowdown from the 0.4% growth recorded in the third quarter and below the 0.1% expansion forecast by analysts. Germany's economy shrank by 0.2%, worse than the anticipated 0.1% decline, while France's GDP fell by 0.1%, missing expectations of stagnation. Italy's economy remained flat for a second consecutive quarter, defying projections of a modest 0.1% increase. On the other hand, some peripheral economies outperformed, with Portugal (+1.5%) leading the growth rankings, followed by Lithuania (+0.9%) and Spain (+0.8%).

In the UK, gilts sold off following the latest labour market data. It showed that the number of payrolled employees was down by -47k in December (versus -8k expected), and the unemployment rate in the three months to November ticked up to 4.4%. That helped to cement the idea that the Bank of England (BoE) was on course to cut rates at its next meeting on 6 February.

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	4.5	0.6	0.6
Bunds	2.5	-0.4	-0.4
Gilts	4.5	0.8	0.8

Source: Bloomberg, 31 January 2024

Investment grade credit

The December sell-off in government bond yields continued into the first half of January, until an inflation print served as a timely reminder for markets that economic fundamentals remain the cornerstone of what drives yields, rather than an excess of either optimism or pessimism.

In the first half of the month, global sovereign yields moved higher due to renewed inflationary concerns following recent tariff threats from President Trump.

The UK market has been closely tracking movements in the US rather than Europe, despite the UK's economic challenges being more akin to those faced by European countries. While global factors have been a major influence, the UK's fiscal position also played a crucial role in the gilt market's movements, with ongoing concerns regarding the ability of fiscal and monetary policies to address the challenges ahead.

The bond market breathed a sigh of relief on 15 January, when inflation in both the UK and US came in softer than expected, implying that pricing pressures are indeed continuing to slow.

Central bank decisions aligned with market expectations. The Fed maintained current interest rates, while the ECB proceeded with a rate reduction, both moves anticipated by investors. The Bank of England also cut its key rate in early February.

Against this backdrop, global IG credit spreads moved tighter, with Europe outperforming. With sovereign yields recovering in the second half of the month, returns across the investment-grade space were positive.

Credit markets are observing significant levels of spread compression. For instance, the current additional yield pick-up for investing in global BBB rated corporates over their A rated counterparts is a mere 33 bps. This is driven by sustained demand for credit in an environment where yields remain attractive. Such compression is evident across various markets. Whether comparing IG to HY debt, or senior financials to subordinated financials, the trend persists.

In this context, the rationale for avoiding additional risk—given the minimal compensation for doing so—is compelling. We find it prudent to refrain from taking on additional risk when the incremental returns do not justify the potential downsides.

Looking forward, despite concerns around Trump, tariffs and inflation, it is worth remembering that we are still in restrictive monetary policy (which works with a lag) and slowing should therefore continue. While we acknowledge that money supply has started to rise since 2024, it has not yet breached levels which were in the past consistent with achieving the 2% inflation target. For now, we believe that inflationary pressures should remain constrained, although where we see money supply go from here is important to monitor.

All of this speaks to bond yields at lower levels than currently priced. Amid ongoing concerns surrounding President Donald Trump's policies on tariffs and the broader implications for inflation, it is crucial to remember that we are still operating under a restrictive monetary policy regime. We know that monetary policy works with a lag, taking time for to exert its full effects, suggesting that the current economic slowdown is likely to persist in the near term.

In our opinion, the interplay between restrictive monetary policy, lagging economic indicators, and controlled inflationary pressures all point towards a scenario where bonds perform well from here.

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Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	82	0.6	0.6
Euro IG	90	0.5	0.5
UK IG	92	1.2	1.2

Source: Bloomberg, 31 January 2024

High yield credit

The global HY market had a positive start to the year, returning 1.2% in January, led by US HY (1.4%) which had a strong month outperforming EU HY (0.7%) mostly due to rates and a strong rally in spreads. The global HY FRN market returned 0.5%, benefiting also from a decent rally in spread albeit with a lower market beta.

The macroeconomic backdrop of stable growth, downwards-trending inflation, a resilient private sector and slow monetary easing remains supportive for HY assets – as is the technical backdrop (strong issuance matched by strong demand supporting tighter spreads).

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

With the announcement of US tariffs, we see some potential overshadowing of company fundamentals, with the greater pressure on export-vulnerable sectors such as auto and machinery. US inflationary policies are also likely to create a ‘higher for longer’ environment for interest rates, or at the very least some ongoing volatility in rate expectations. HY is a low duration asset class and could potentially be somewhat insulated from this. Volatility is always good for actively managed funds where you see price moves but no fundamental changes.

Going forward

• **All-in yields are historically attractive, in our view:** While spreads are relatively low, yields on HY bonds remain historically elevated. Yield has traditionally been a strong proxy of future return. With today’s yield-to-worst around 7.0%, there is arguably potential for the asset class to generate reasonable returns in 2025.

• **Greater confidence in the economy:** Recent economic performance has shown continued strength, with corporate profits and consumer spending remaining largely resilient in the face of high interest rates. This environment suggests to us a benign default cycle going forward, also evidenced by diminishing levels of market distress.

• **HY fundamentals look resilient, despite uncertainty:** Improved growth expectations are likely to further support fundamental metrics, in our opinion. It is 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.

• **Potential for attractive returns in 2025:** Given the power of carry and expected low defaults, mid-to-high single digit returns are possible over the next 12 months, in our opinion. Further, as the index trends towards par, the effective yield (currently c. 7%) becomes more predictive of total returns for the year ahead.

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High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	268	1.4	1.4
Euro HY	310	0.7	0.7

Source: Bloomberg, 31 January 2024

Emerging market bonds

Unhedged LC sovereign bonds emerged as one of the strongest performing fixed income assets, while HC sovereign bonds also posted robust gains, outperforming the US HY market. Latin America stood out among LC assets, with Brazil and Colombia particularly notable performers. In the HC sovereign space, Africa led performance, whereas Asia and the Middle East were laggards, despite still achieving positive returns. This performance dynamic was closely linked to movements in spreads over the month. Both rates and spreads delivered positive returns across HC sovereign and corporate indices, with spreads tightening as the year commenced, albeit with some volatility and disparity between HY and IG. IG HC sovereign spreads marginally widened in January. Overall, HY sovereigns and HY corporates outperformed their IG counterparts within their respective benchmarks. Despite a positive growth narrative and improving inflation dynamics within many EMs, sentiment remains subdued following the US election, even as the Fed has commenced its rate-cutting cycle —a development typically viewed as a bullish turning point for EM debt.

The uncertainty associated with Trump's return to the global stage is already evident. In January, there was an increase in rhetoric towards the imposition of tariffs on Mexico, Canada and China, with the stage set for 25% tariffs to be applied to Mexico and Canada, and 10% tariffs to China on 1 February. Despite this, the isolated sell-offs observed were not significantly substantial, suggesting that markets anticipate these tariffs may not be long-term if countries take steps to address Trump’s concerns. Attention will soon shift to other countries or trading blocs that may come into focus for Trump, who has already intensified his efforts to apply tariffs to imports from the EU. The impact of tariffs will not be confined to emerging markets, with the US consumer also likely to be affected. The tariff on Mexico is estimated to add US$3,000 to car prices, with the broader trade relationship between the US, Mexico and Canada set to deteriorate, which will adversely affect both sides.

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Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	2.1	2.1
Hard currency government	317	1.4	1.4
Hard currency corporate	247	0.8	0.8

Source: Bloomberg, 31 January 2024

Currencies

In a month characterised by a broadly weakening US dollar, Latin American currencies performed particularly well, with the Brazilian real recovering from a period of underperformance. Currencies that weakened relative to the dollar typically did so due to country-specific pressures. The Canadian dollar and Mexican peso were among the worst performing currencies in January, with the former being the worst performing G-10 currency, reflecting the ongoing threat of tariffs under Trump’s administration.

The South Korean won recovered amid a broader recovery for the country's assets following the political turmoil witnessed in December. The Japanese yen performed well on the back of expectations for additional hikes from the Bank of Japan and was the strongest performing G-10 currency over the month.

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Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	-1.0	-1.0
GBP/EUR	-1.0	-1.0
EUR/USD	0.1	0.1

Source: Bloomberg, 31 January 2024

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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