Fixed Income asset class overview

December 2025

M&G Investments

The sovereign bond market remained volatile in December, with interest rate cuts from both the Federal Reserve and the Bank of England, while the Bank of Japan hiked. Meanwhile, both investment grade and high yield bonds ground tighter into the end of the year.

Month in review

In December, developed market sovereign bond curves continued the steepening that has been characteristic of 2025. Inflation beat expectations to the downside for November in the US, UK and eurozone, supporting the rate-cutting cycle. In spite of cuts from the Fed and Bank of England (and the European Central Bank having held rates on hold at 2% since June), longer-end yields continued to rise on the back of fiscal sustainability concerns. This contributed to losses from the US Treasury and German bund indices over the month. It is also noteworthy that Japan's monetary policy rate is now at its highest since 1995, having been raised to 0.75% at the December meeting. The 10-year JGB yield also surpassed 2% for the first time since 1998.

Overall, 2025 was a positive year for government bond markets, despite the volatility. The gilt index returned 5.0% on a total return basis. US Treasuries (UST) were the standout outperformer, with the index returning 6.2%, the strongest year for returns since 2020. The 10-year UST yield fell 40 bps over the year, ending a run of four consecutive annual increases.

In December, the European investment grade (IG) credit market spreads remained at historical tight levels, grinding slightly tighter as we approached year-end. Absolute valuations remain expensive, in our view. Global IG declined 0.2% over the month, with losses driven primarily by underlying government bond moves despite spread tightening. Regionally, US IG underperformed in December, returning -0.3%, reflecting an increase in underlying US risk-free rate. EUR IG fell by 0.2%, benefiting from more supportive spread dynamics but suffering from the rising bund yield. In contrast, sterling IG outperformed, delivering a 0.4% return. Despite the weak end to the year, full-year performance remained robust across all regions. The US led with a 7.8% return, followed by sterling IG at 7.1%, global IG at 6.2% and EUR IG delivering a 3.0% return for the year. The global IG bond market performed well in 2025, despite a backdrop of economic uncertainty, shifting policy signals and periods of market volatility. Returns were supported by strong demand for high-quality bonds and by inflation continuing to ease. At the same time, credit spreads remained close to their tightest historical levels, meaning investors have been receiving only limited additional yield for taking on credit risk. This has reinforced the importance of selective, disciplined investing.

High yield (HY) assets delivered another month of positive returns in December, buoyed by supportive macroeconomic conditions – including a mid-month Fed rate cut and broadly resilient economic data – which bolstered investor risk appetite. Global HY returned 0.7%, led by EM HY markets (0.8%), while European HY underperformed (0.4%) as rising sovereign yields partially offset the benefits of spread compression. Spreads tightened by approximately 10–15 bps during the month, reflecting continued investor confidence underpinned by resilient fundamentals and subdued default activity. The market also benefited from seasonally light supply, which, combined with steady inflows and limited new issuance, created a favourable demand-supply dynamic. Additionally, the absence of meaningful default activity in Q4 further underpinned sentiment, allowing spreads to grind tighter into year-end despite lingering geopolitical and policy uncertainties.

In emerging markets (EM), all major indices delivered positive returns. During December, hard currency sovereigns gained 0.7%, hard currency corporates rose 0.5%, and local currency sovereigns advanced 1.5%. December's trends mirrored those seen throughout the year: hard currency sovereigns outperformed corporates, while local currency sovereigns led the asset class. Year-end returns stand at 14.3%, 8.7%, and 19.3%, respectively. Relative performance trends held steady throughout 2025: hard currency sovereigns outperformed corporates, while local currency sovereigns led the asset class. The latter posted one of its strongest years on record for local currency sovereign performance. Spreads outperformed rates during the month, continuing the broad tightening theme.

Developed market sovereigns

In the US, December saw the return of the usual macroeconomic data following the end of the US government shutdown in mid-November. However, the Fed were 'flying blind' going into their policy rate decision on 10 December. The policymakers chose to cut rates to 3.75%, their third successive cut. The dot plot and the 'Fedspeak' implied that this was possibly the final cut of the cycle, or perhaps a pause. Indeed, futures are pricing in just over two cuts to the end of 2026, but less than half a cut in Q1 2026.

The subsequent inflation data supported the Fed decision, with the November number beating expectations to the downside at 2.7%. Economic data in the US remained robust. Third-quarter GDP, which was delayed by the government shutdown, surged by an annualised 4.3%, beating the 3.3% forecast. This marks the fastest pace of growth in two years. In addition, the Atlanta Federal Reserve's (Fed) GDPNow estimate for Q4 economic growth came in at +3.0%, reinforcing optimism around economic momentum. Despite President Trump's strong desire to continue with the rate-cutting cycle, Fed governors will be conscious of this continual strong growth. US Treasuries were the standout performers in developed market sovereign bond markets in 2025.

In the euro area, there was a sell-off in government bonds with growing expectations that the ECB's next move will be a hike. Although there is speculation of a hike in 2026, swaps markets are currently not pricing a move in rates over the year. At the December meeting, the ECB upgraded their forecasts for growth and core inflation, projecting growth at 1.2% for 2026 and inflation "somewhat below 2%". Over the course of 2025, European government bonds suffered in the wake of the lifting of the debt brake in Germany and increased defence spending that was announced in March. Markets rebounded, but fiscal sustainability concerns led to a sell-off in Q4, and ultimately European government bonds ended the year in negative territory on a total return basis.

In the UK, inflation came in lower than expected at 3.2% (expected 3.5%), while Q3 growth remained sluggish at 1.3%. This created a supportive backdrop for the Bank of England to cut rates at its December meeting to 3.75%. This was the Bank of England's fourth cut in 2025. The labour market remains weak, and with the Office for Budget Responsibility expecting CPI to return to the 2% target in 2027, it could be expected that the BoE may continue to cautiously cut rates in 2026. UK gilts delivered a healthy positive return of 5.0% in 2025, and continue to appear to offer good value heading into 2026.

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	-0.5	6.2
Bunds	2.9	-0.8	-1.5
Gilts	4.5	0.2	5.0

Source: Bloomberg, 31 December 2025

Investment grade credit

The global IG bond market has performed well in 2025, despite a backdrop of economic uncertainty, shifting policy signals and periods of market volatility. Returns have been supported by strong demand for high-quality bonds and by inflation continuing to ease. At the same time, credit spreads have remained close to their tightest historical levels, meaning investors have been receiving only limited additional yield for taking on credit risk. This has reinforced the importance of selective, disciplined investing.

Interest rate policy has shaped market dynamics throughout the year. Central banks entered 2025 with policy rates still high, preferring to see clear evidence that inflation was fully under control before easing. In the US, the Fed did not begin cutting rates until September, when signs of a more moderate labour market emerged. The ECB moved earlier, cutting rates as inflation edged towards target and growth remained soft. Even with selective rate cuts, financial conditions remained relatively tight, although the US economy showed greater resilience than expected midway through the year.

Geopolitical developments, and trade tensions in particular, were the main source of volatility. Early tariff threats escalated into broad measures in April, prompting a temporary widening in credit spreads and a short-lived risk-off shift in markets. Although later policy reversals supported sentiment, negotiation-related uncertainty persisted. Despite these swings, spreads remained at the tighter end of long-term ranges, and episodes of widening – such as during the April tariff shock and October's surge in US new issuance – were brief.

Technical factors also mattered. The US saw heavy corporate issuance linked partly to AI-related investment, while Europe experienced record supply, with euro IG issuance exceeding €718 billion by November. Strong investor demand, supported by attractive overall yields, absorbed this supply effectively.

The outlook remains balanced. Trade policy continues to pose risks, monetary easing is progressing slowly, and credit valuations remain tight, leaving limited room for error. In this environment, we believe an all-in yield approach, together with active management across credit selection and interest-rate positioning, will be vital for navigating volatility and identifying opportunities.

Past performance is not a guide to future performance.

Investment grade total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US IG	79	-0.3	7.8
Euro IG	78	-0.2	3.0
UK IG	83	0.4	7.1

Source: Bloomberg, 31 December 2025

High yield credit

High yield assets delivered another month of positive returns, buoyed by supportive macroeconomic conditions, which bolstered investor risk appetite.

2025 in Review: Global HY returned 8.1%, driven largely by carry and a sustained rally in spreads, despite macroeconomic uncertainty and rate volatility. Resilient fundamentals, low defaults, and solid technicals – especially in H2 as central banks pivoted toward easing – were supportive. Limited net supply and attractive yields fuelled demand, despite the growing disconnect between valuations and economic fundamentals.

Outlook

- Carry remains king: We believe that against a mixed macroeconomic backdrop with ongoing volatility, carry is expected to continue driving total returns, providing income and cushioning against adverse price moves.
- Defaults easing, dispersion rising: Default rates remain modest and concentrated in stressed CCC segments. The market is increasingly split: better-rated names trade at tight levels while weaker credits struggle, making active, value-driven selection critical.
- Spreads broadly expected to widen modestly in 2026: While carry remains a key driver of returns, upward pressure on spreads is likely due to normalising supply conditions and lingering macroeconomic uncertainty – particularly around the pace and timing of central bank easing.
- A more selective environment is likely overall, in our view, with dispersion and credit quality differentiation playing a larger role in performance. We believe that this environment benefits active managers who can navigate increased dispersion and capitalise on relative value opportunities.

Against this backdrop, HY floating rate notes stand out as a compelling proposition for 2026, as in our opinion they offer competitive yields with minimal duration, reducing exposure to volatility while delivering attractive risk/reward.

Past performance is not a guide to future performance.

High yield total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
US HY	281	0.7	8.5
Euro HY	282	0.4	5.5

Source: Bloomberg, 31 December 2025

Emerging market bonds

Emerging market debt (EMD) extended its strong performance into late Q4, with major indices delivering positive returns. December's trends mirrored those seen throughout the year: hard currency sovereigns outperformed corporates, while local currency sovereigns led the asset class.

The relative underperformance of hard currency corporates versus sovereigns reflects their lower duration profile, limiting upside during the rates rally, and their IG bias, which tempered gains amid significant spread compression in HY. This dynamic is also evident in the disparity between IG and HY segments of the hard currency sovereign index, where YTD returns now stand at 10.4% and 18.3%, respectively.

Local currency sovereign bonds remained the primary driver of EMD returns, with currency contributing 0.9% and carry adding 0.6% in December. 2025 performance ranks among the strongest on record, coinciding with the US dollar's weakest year since 2017, down 9.4% on the DXY index.

December's rally in hard currency sovereigns saw broad-based positive returns, with only Senegal experiencing spread widening.

Emerging market bonds total returns

	Credit spread (bps)	Total return % (1m)	Total return % (ytd)
Local currency government	n/a	1.5	19.3
Hard currency government	260	0.7	14.3
Hard currency corporate	237	0.5	8.7

Source: Bloomberg, 31 December 2025

Currencies

The US dollar ended December weaker, depreciating by 1.1% on the DXY index, extending the broader trend of softness seen throughout 2025. Year-to-date losses closed at 9.4%, marking the dollar's weakest annual performance since 2017. While brief periods of strength occurred earlier in the year, sustained pressure dominated the trend.

G10 currencies broadly strengthened against the dollar, with the exception of the Japanese yen, which continued a four-month depreciation streak.

Yen weakness accelerated in November following the announcement of a large fiscal stimulus package, triggering a sell-off in Japanese assets. Further softness in December came after a quarter of a percentage point rate hike by the Bank of Japan, which raised concerns over fiscal sustainability in a rising rate environment. Despite these headwinds, the yen finished the year marginally higher, up 0.3% versus the dollar.

EM FX performance was generally positive, supported by favourable carry dynamics. While November saw broad-based strength across Latin America, December was more mixed, with notable resilience from the Chilean and Mexican pesos. Asian and European EM currencies led gains, while the Brazilian real, Turkish lira, and Russian rouble were among the weakest performers in December, though the rouble remains the best-performing EM currency year-to-date with returns standing at 44.15%.

Past performance is not a guide to future performance.

Key currency pairs

	Change % (1m)	Change % (ytd)
GBP/USD	1.8	7.7
GBP/EUR	0.5	-5.1
EUR/USD	1.3	13.4

Source: Bloomberg, 31 December 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.

The views expressed in this document should not be taken as a recommendation, advice or forecast.