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Q2 2025

Active Fixed Income Outlook:

Expect the unexpected

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An unexpected rotation

2025 began with the US unexpectedly yielding leadership to Europe and China; how else could markets defy expectations?

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Head of Global Bond Strategies

In the final weeks of 2024, if you said that by the end of February US markets would not only underperform the rest of the world, but that the market's least loved countries (China, the UK and Europe) would be leading returns for the year to date, nobody would have believed you.

This rotation has been around a rising trend – albeit with the leadership stocks and sectors losing momentum and starting to underperform. Markets have been relatively insulated to headline risk as positive investor sentiment continued to protect markets from the noise. Despite the blizzard of policy announcements from the new administration in the US, there has been little concrete evidence of any lasting economic damage at this stage. We believe it has been hard to find any data trends that capture the impact of policy announcements, partly because there have been more announcements than actual implementation. This is now changing. The threat of a US growth inflection point may be approaching and there has been little allowance for policy risk in valuations.

In fixed income markets, investors are still having to deal with the uncomfortable combination of tight credit spreads and total yields that continue to attract significant inflows to the asset class.

Playing chicken?

For pure credit spread investors, this feels like a game of brinkmanship.

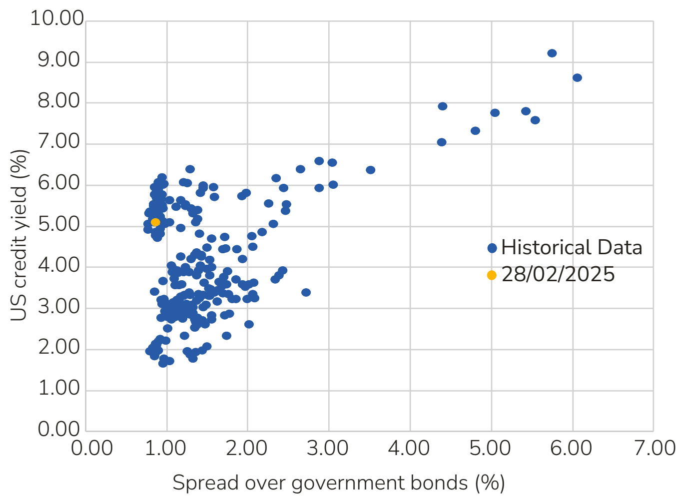
Valuations are rich but the underlying fundamentals are not suggesting portfolios should be moved to outright bearish positions. Whether you believe the change in the US administration has signalled the beginning of a new cycle or not, you cannot ignore the unattractiveness of credit spreads in isolation. However, we have to play the market as it is, and not how we would like it to be.

We feel a derisking strategy is prudent, recycling risk into higher-quality exposures where reasonable credit spread is still on offer. We like exposures to emerging market debt as the fiscal sustainability debate will remain a live issue in developed economies. In looking for red flags, we struggle to see many. Leveraged loan default rates are running at three time the high yield market and worthy of monitoring, but we think investment grade credit should remain lower beta than other risk asset classes.

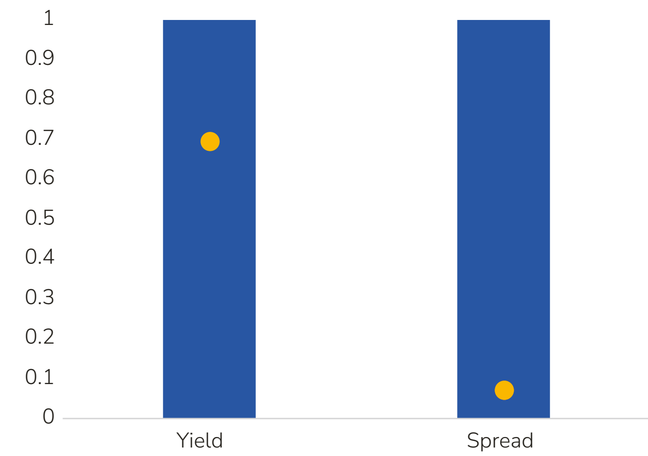
You could argue that general investor bullishness is more about equity prospects than actual GDP growth. That said, the impact of a heightened sense of chaos and uncertainty from the new US administration is neither good for investment nor broader animal spirits. We think investors should expect the unexpected in 2025 as confusion around the Trump administration's actions will continue to have an influence over market outcomes.

Credit spreads are tight, but yields attracting buyers

Yields vs spreads since 1995



Percentile rank of yields and spread



Source: L&G, Bloomberg, as at 28 February 2025. Data is monthly yield-to-worst and OAS spread for US corporate credit from 31 March 1995 to 28 February 2025

Key risk
Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may not get back the amount originally invested.

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Credit Scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score							January	March	
UK Credit	-3	-2	-1	N	+1	+2	+3	-1	-1	▬ Unchanged
US Credit	-3	-2	-1	N	+1	+2	+3	N	-1	▼ Downgraded
Global credit	-3	-2	-1	N	+1	+2	+3	N	+1	▲ Upgraded

Source: L&G as at 25 February 2025 – can be subject to change at any point.

Key risk
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> "We think investors should expect the unexpected in 2025, as confusion around the Trump administration's actions will continue to have an influence over market outcomes."

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Which way for Germany?

Amid market uncertainty, will Germany's new government unlock growth – or will Trump's tariffs bite the auto industry?

Mark Rovers
Head of European Credit

Magdi Yasin
Fixed Income Investment Specialist

The past: what just happened?

Developed market government bond yields spiked in January, with the yields on 10-year German bunds rising to 2.65%, a level last touched last summer[1].

The spike in yield was primarily driven by a strong US jobs report, which cast doubt over a continuation of central banks' easing cycle.

These fears were allayed by softer inflation prints in the US and UK and earnings announcements from several of the *'magnificent seven' companies that failed to meet very high expectations, with yields giving back some of the spike. European credit spreads have tightened significantly over the quarter as ongoing strong flows into the asset class continue to support returns.

This pronounced market reaction is a sign of investors' focus on rates, with concerns growing about expanding national debts and 'sticky' inflation. In Europe, the German bund – traditionally the anchor point on the European bond market – is giving up ground compared to the so-called risk-free swap rate – while corporate bonds moved towards this.

It was assumed that after the elections a new German government would favour reforming the 'Schuldbremse' (or debt brake) to invest more in the economy but this played out even quicker than expected, with the recent vote by the outgoing parliament allowing substantial additional expenditures on defence and infrastructure to be financed with new debt.

In other countries such as the US and the UK, the risk-free swap rate has been well below the yield on government bonds for some time now and Germany has followed with a spike in 10-year bund yields to almost 3%. Marc Rovers further shared his thoughts in his aptly named blog Elephant in the room.

Meanwhile, European credit has outperformed USD corporate bonds, with attractive valuations overcoming tariff concerns raised by Trump's term beginning at the start of the year.

1. Source: Bloomberg as at 24 March 2025
*For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an L&G portfolio. The above information does not constitute a recommendation to buy or sell any security.

Q2 2025 | Active Fixed Income Outlook: Expect the unexpected

The present: strong technicals

We are more negatively biased (-1) in our risk scoring, class despite the more supportive German politics and helpful technicals.

Our expectation is that yields over 3%, combined with the limited duration of around 4.5, will continue to appeal to investors as the ECB continues on its path of further reducing rates.

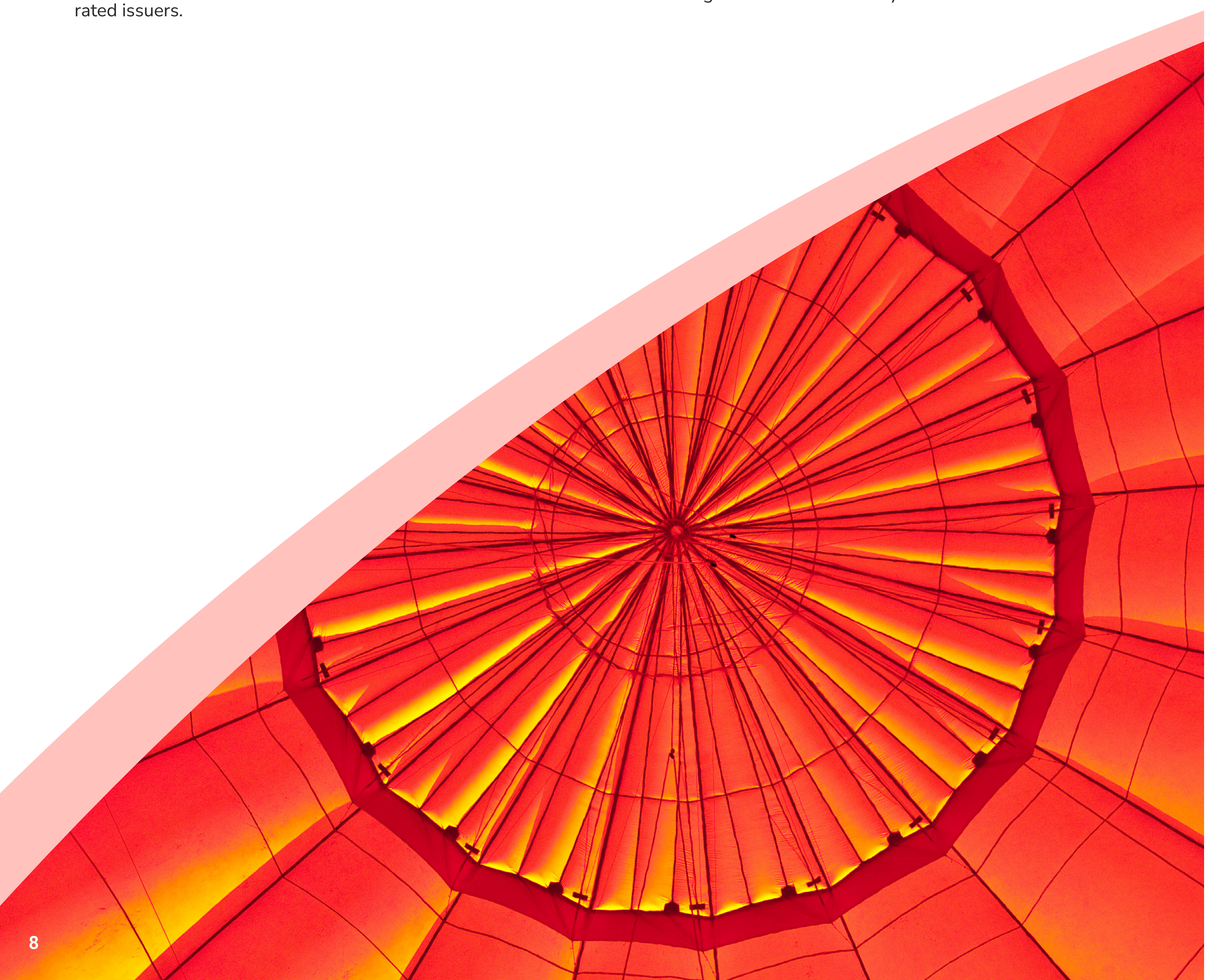
On the flip side, spreads are compressed based on historic percentiles, especially in the lower rated part of the market, and potential headwinds that keep us cautious include a US tariff 'discount', geopolitical tensions and uncertainty on the interest path as further economic data is released. Our positioning reflects that cautious approach, with an overweight in defensive sectors like utilities and a preference for higher rated issuers.

What could go wrong?

Inflation could prove to be stickier as tariffs kick in and spending on defence is ramped up, putting the major central banks' rate-cutting cycles in potential jeopardy.

Also, market participants continue to hold their breath as we await further news on Trump's policy agenda; this uncertainty could itself harm growth momentum and sentiment.

Germany remains a primary concern, as Trump's tariff package could impact its economy as it relies heavily on industrials and includes a large auto sector that faces growing competition from China. On the positive side, the reform of the debt brake might provide room for fiscal stimulus, and the European Commission has announced relief measures for automotive companies, extending the window for meeting carbon emission targets from one to three years.



Outlook

Looking ahead, politics will be a key focus, with the full impact of President Trump's tariff policy continuing to be gauged.

Different growth engines in the US like government spending, immigration and AI-related capex are subject to uncertainty and disruption, which may slow economic momentum and business investment.

However, there is also upside risks should Trump successfully ease geopolitical risks, particularly the Ukraine-Russia conflict, which would alleviate pressure on energy prices – especially in Europe.

It will be important to see how central banks react, whether the focus is on long-term growth prospects or on near-term price increases.

While overall corporate fundamentals remain robust, we may see increasing discrepancies between regions and sectors, with winners and losers emerging. Therefore, diligent credit analysis and selection will be of key importance.

Credit Scorecard

Upgraded | Downgraded | Unchanged

Strategy	Score						
	-3	-2	-1	N	+1	+2	+3
Euro credit			March (Downgraded)	January			

Source: L&G as at 25 February 2025 – can be subject to change at any point.

Key risk
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Emerging market debt: Going from strength to strength?

After a positive 2024, can EMD continue its strong run?

Uday Patnaik
Global Head of Emerging Market Debt and Asia Fixed Income

Raza Agha
Head of Emerging Market Sovereign Strategy

Q2 2025 | Active Fixed Income Outlook: Expect the unexpected

The past: what just happened?

After decent returns in 2024, emerging market debt (EMD) has had a good start to 2025. At the time of writing, returns year-to-date are sitting at 2.2% for EM hard currency sovereigns and 1.7% for EM hard currency corporates[1].

Despite tight spreads, returns have been driven both by spread compression and US Treasuries. Continuing the theme from 2024, returns in both sovereigns and corporates were led by high yield issuers, with investors focusing on idiosyncratic stories that included the resolution of defaults in several sovereigns such as Ghana, Zambia, Sri Lanka and Ukraine.

Meanwhile, in contrast to last year, EM local markets are leading returns in EM fixed income (+3.5% in USD terms[2]), driven by the better performance of their currencies given the downward move in the US dollar.

1. Source: Bloomberg as at 21 February 2025
2. Source: Bloomberg as at 25 February 2025

The present: continuing resilience?

As things stand, we believe the case for EMD rests on the attractive yields on offer, with the sovereign index at 7.7% and corporates at 6.8%[3].

When we look at issuance numbers, the pull of all-in yields is clear. Total EMD primary supply has been over $165bn so far this year, dominated by sovereigns at $76.3bn[4] - a record. That investors have absorbed this supply despite geopolitical noise, tight spreads and continued outflows from the asset class in our view speaks of the resilience of emerging markets.

This resilience rests on improving credit fundamentals, exhibited in improving ratings and declining defaults in both EM corporates and sovereigns. These dynamics reflect a strong macroeconomic outlook. Highlighting this, in its most recent forecasts the IMF expects emerging markets to grow at 4.2% in 2025, flat to 2024, and around the same level in 2026[5].

Meanwhile, forecasts for EM fiscal deficits (excluding China) have been forecast to decline from last year's 4.9% to 4.3% in 2025, whereas the overall EM current account balances are anticipated to still be in surplus, albeit to a modest degree of less than 1% of GDP. We think these continued surpluses will mean EM foreign exchange reserves will remain healthy at over $10.5 trillion, more than 2.5x the total external debt amortisation due in 2025.

What could go wrong?

The above suggests that risks in the period ahead continues to be from global issues – particularly US macro and markets – and less from idiosyncratic challenges in emerging markets.

However, should tariffs be applied on a universal basis and for an extended period, the impact on emerging market GDP growth could be significant. High tariffs could also impact the US inflation outlook, and with it the trajectory of US rates and the US dollar. All of this could impact capital flows to emerging markets. Even if the application of tariffs by the US more selective, dealing with it will require differentiating between the more vulnerable countries – potentially Mexico and China – and sectors, like automobiles and semiconductors.

Outlook

However, even these risks require a caveat.

EM exports to the US have declined since 2000, while emerging markets are trading increasingly with each other, both of which could provide a degree of insulation from US tariffs. More flexible EM currencies can also be used to blunt the impact of tariffs. In addition, as the experience of Covid shows, deeper domestic capital markets and strong support from multilateral institutions such as the IMF can provide alternative sources of capital and reform anchors.

We do note that in contrast to potential headwinds from US macro and markets, the possible resolution of conflicts in the Middle East and the war between Russia and Ukraine could provide a fillip to regional credits. This, though, does not make us sanguine about the potential for continued volatility around rates. Hence, we continue to focus on the short end of credit curves, and on idiosyncratic credits which could benefit from spread and yield compression driven by reform anchors and curve normalization as they emerge from default. These includes credits like Nigeria and Ivory Coast, where a reformist government is in place, and Sri Lanka, where the short end should continue to benefit as the country exits a debt restructuring.

Within corporates, some of our likes include the Indian renewables sector, which continues to benefit from a government policy focus. In banks, we like Tier 2 cap structures with high call probabilities as financials are doing fundamentally better in the current environment of relatively higher rates, benefitting net interest margins.

3. Source: Bloomberg as at 21 February 2025
4. Source: Bloomberg as at 21 February 2025
5. Source: IMF as at April 2024

Q2 2025 | Active Fixed Income Outlook: Expect the unexpected

Credit Scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score						
	-3	-2	-1	N	+1	+2	+3
EMD				March ▼	January		

Source: L&G as at 25 February 2025 – can be subject to change at any point.

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Global high yield: Goldilocks still possible

Abundant capital seeking income, low defaults and a low supply of bonds may drive prices higher – if everything goes right.

John Ryan
Head of Global High Yield

Sophia Hunt
Senior Fixed Income Investment Specialist

The past: what just happened?

High yield has generated strong returns so far in 2025 (+2%)[1], with the macro backdrop remaining supportive for the asset class and the hunt for yield continuing.

Inflows into European high yield have outweighed net new issue supply which is further supporting spread tightening. The US is close to all-time tights and loss rates remain very low compared to history – which has contributed to our view this is a good environment to 'earn the yield', given at the time of writing the current yield on the global high yield index is close to 7%[2].

The present: buoyant markets

In this environment, the strategy continues to target a higher income than the comparative benchmark, expressed through an overweight position in higher-spread global names.

Our view remains that, at present, spreads are adequately compensating for the degree of credit risk undertaken, particularly for BB and B rated credits. However, this applies less to credits rated below B.

From a regional perspective, we are overweight emerging markets, which we believe offers much better excess yield for similar fundamental strength than developed markets. We have reduced exposure to the US, based on tight valuations and likely sustained policy volatility.

What could go wrong?

The reach for yield could be disrupted if consensus shifts to the next move from the US Federal Reserve is a hike, so we are watchful of US inflation data and the trade war narrative. At present, US assets are priced for strong economy, while the executive has a mandate for policy volatility.

1. Source: ICE BAML Global High Yield Index as at 26 February 2025
2. Source: ICE BAML Global High Yield Index as at 26 February 2025

Credit Scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score: -3	-2	-1	N	+1	+2	+3
Global high yield				N (March) ▼	+1 (January)		

Source: L&G as at 25 February 2025 – can be subject to change at any point.

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Outlook

We believe 2025 still has the potential to play out as a 'Goldilocks' year – with the combination of abundant capital seeking income, a backdrop of low defaults and a low supply of bonds all potentially driving prices higher.

We expect continued central bank cuts to overnight rates as 2025 unfolds, which we think will keep higher-yielding income assets appearing attractive to investors.

The team is comfortable with cyclical risk, but we are wary of structural risk – the market does not always clearly differentiate between the two, which can create opportunities for us to invest. From a sectoral perspective, we have a higher focus on supply chain-intensive sectors such as autos and retail. If we witness a global transition from 'shooting wars' to 'trade wars', these sectors are more exposed to supply chain disruptions.

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