Fixed Income Insights
June 2025

Fixed Income Under the Spotlight

Managing Risks and Finding Opportunities in Fixed Income

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In brief

- Diverging macro policies are creating uncertainty and anxiety in markets
- US downgrade from AAA is likely to impact the dollar more than Treasuries
- Maintaining liquidity and agility are key to investing in opportunities from market dislocations

In the current economic landscape, global fixed income markets face significant uncertainty and volatility. Investors are contending with fluctuating growth rates, inflationary pressures and unpredictable policy decisions. Tariffs and diverging macro policies across regions add complexity to the investment environment, necessitating a strategic approach to managing risk and identifying opportunities.

Managing risks and finding opportunities in fixed income markets

Investors are primarily concerned with the implementation of macro policies. The current policy environment, especially in the United States (US), is marked by significant uncertainty, leading to increased market anxiety. Central banks are downgrading growth expectations and are likely to continue gradually cutting rates; however, the US Federal Reserve is expected to lag behind other central banks in adjusting its monetary policy. On the fiscal side, the reconciliation bill in the US is under significant scrutiny for its future fiscal deficit implications, potentially impacting market dynamics, capital flows and the dollar's strength.

Concerns over US debt levels and potential volatility are shaping the global fixed income market. The substantial amount of public debt raises questions about leverage and transparency in fixed income markets. Investors are wary of crowded trades which could trigger forced selling and rapid unwinds of leverage, creating challenging conditions particularly in the illiquid over-the-counter fixed income market. The peak of macroeconomic uncertainty is anticipated in late summer, coinciding with the release of hard data and the resolution of debt ceiling negotiations.

US downgrade by Moody's poses a longer-term philosophical question rather than a present danger to Treasury investors. The recent downgrade of the US sovereign AAA rating by Moody's has initiated discussions about its implications. This downgrade may not significantly alter daily investor activities, particularly as the other two large rating agencies downgraded the US a while ago, but it requires adjustments for some institutional clients with guidelines on AAA securities. It challenges the conventional view of what constitutes a flight to safety or quality as the US Treasury market is traditionally seen as the epitome of safety and raises questions about what determines the nature of risk-free assets.

The US dollar will be under more pressure than Treasuries but be wary of being materially underweight given the downward correction to date. The secular path towards de-dollarization may be difficult to change, meaning the currency may remain under long-term pressure. Reducing trade deficits in the US will also reduce the capital surplus, leading to fewer dollars going out of the US and therefore fewer dollars coming back into investments in the US. Despite this, it is too extreme to conclude that the US dollar will lose its reserve currency status any time soon as there are few, if any, viable alternatives and a large majority of global contracts are denominated in US dollars. Being short the dollar is a crowded trade and there may be upside surprises in the face of an economic downturn.

Tight valuations put a premium on liquidity to make the most of future opportunities. A period of lower growth and overall lower inflation is supportive of investment-grade credit, but spreads have generally recovered most of the wider moves since the end of Q1, so we're comfortable with long, albeit defensive, exposure in this market. Given the asymmetry of risk-adjusted returns when spreads are so tight, maintaining liquidity in portfolios is key to taking advantage of potential future dislocations in the market. Positioning is stretched in many areas of the market, and an unwind of crowded trades could lead to some disruption due to the more illiquid nature of fixed income markets.

Portfolio positioning

The global fixed income market offers a broad universe for investment. European markets are drawing interest due to favorable valuations and continued rate cuts by the European Central Bank. Emerging markets present potential opportunities, particularly in regions with favorable rate paradigms. Within the US, certain segments like asset-backed securities and short-duration high yield remain attractive, with the Fed likely to be slower than other central banks to reduce rates. Capitalizing on these opportunities requires a strong bottom-up research approach to identify good credits and managing downside risk in a volatile environment.

Investment grade

While spreads have fallen almost to pre-Liberation Day levels and reduced dispersion, specific opportunities are emerging across sectors in both Europe and the US. Utilities are particularly attractive due to their relatively cheap valuations despite significant issuance driven by the push for decarbonization. The need for substantial capital expenditure in utilities, along with potential growth from advancements in artificial intelligence and increased energy demands, are likely to provide interesting investment opportunities, especially through the new issue market. Similarly, European banks, especially subordinated debt, are gaining interest due to strong stock performance and anticipated European economic growth from infrastructure and defense investment plans. They have also lagged somewhat in the recent recovery rally. Defensive sectors like capital goods, food and beverage and health care continue to offer better visibility and cash flow generation, making them preferable over cyclical sectors such as retail and autos.

Emerging market debt

Emerging market hard currency debt has traditionally been viewed as a less risky option compared to local currency debt due to its lower volatility and risk profile. However, hard currency spreads have recovered the widening and outperformed other credit asset classes such as high yield. Given the weakness in the US dollar and the attractiveness of some local rates markets, we are finding interesting risk-adjusted return opportunities in this area. Regional diversification within emerging markets is essential for optimizing returns and managing risks. For example, Latin America could offer attractive investment potential due to upcoming electoral cycles that may result in favorable macro policies.

Duration

Globally, there are various opportunities to be long duration, depending on the country and part of the curve. In the US, the five-year and ten-year Treasury curves are attractive, while in Australia and Korea, the front end of the curve is more appealing. European exposure, particularly in periphery markets like Spain, Italy and Greece, provides still-attractive carry, with occasional interest in some supranational issuance, in particular the European Union at the long-end of the curve. In the United Kingdom, both the front end and long end of the curve are attractive. This diversity in fixed income markets allows investors to capitalize on dislocations and opportunities across different curves and regions.

Conclusion

The global fixed income market is experiencing heightened uncertainty and volatility due to macroeconomic factors and policy decisions. This environment presents risks but also opportunities for investors who can strategically manage these challenges. A strong research focus and adaptability to changing conditions are essential for identifying attractive opportunities and mitigating risks to capital. Staying focused, vigilant about potential risks and flexible in investment strategies is crucial for effectively navigating the evolving market dynamics.

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