

5 Key Themes

for the Second Half of the Year

Market Insights

SUMMARY

So far, it has been a challenging year for global markets, mainly reflecting the elevated level of policy uncertainty regarding macro volatility. Against this backdrop, it has become more complicated to hold a high conviction call on being long duration, owing to a number of central banks adopting a more cautious approach (Theme 1). Nonetheless, credit remains well positioned to perform in the period ahead, in our view, especially as we think that credit spreads may not be as stretched as they appear due to the higher risk premium embedded in underlying US Treasury yields (Theme 2). While equity markets are facing potential headwinds, including being priced for perfection, fixed income is back to being an attractive de-risking asset class, especially as we anticipate that the equity–bond correlation will continue to normalize lower (Theme 3). Global diversification has become critical, following the challenge to US exceptionalism. EM local currency debt is making the most of this new market theme and, with the US dollar under increasing pressure (Theme 4), we believe that the stars are aligned for that asset class. Finally, the popularity of private credit no longer needs any introduction, but we believe that the asset class may face some headwinds. While an allocation to private debt still makes sense in the broader strategic asset allocation, we would encourage global investors to right-size their exposure, given the anticipated challenges (Theme 5).

Fixed income remains well positioned in the face of a challenging market environment, but global diversification is as critical as it has ever been. ▲

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The Duration Lull

Neutral seems to be the right gear for duration in many markets.

Absent a large macro shock, it has become increasingly complicated to hold a high conviction view on being long duration across a number of markets. This is because most central banks have turned more cautious, while at the same time, higher fiscal risks have applied upward pressure to long-end rates in many places. In the United States, the US Federal Reserve is now stuck in wait-and-see mode, waiting to get a clearer picture of the macro impact of tariffs. The rates market is pricing in some Fed easing over the next twelve months, but the bar is high for the Fed to deliver a dovish surprise. Meanwhile in Europe, the

ACTIONS TO CONSIDER

- ➡ Manage duration exposure carefully in the face of elevated macro uncertainty
- ➡ Exploit attractive carry as the main source of potential returns
- ➡ Focus on security selection as main driver of alpha

European Central Bank is about to complete its easing cycle amid a much-improved macro outlook in the region, compliments of substantial fiscal stimulus. As a result, the signals in favor of being long duration in the eurozone have weakened considerably.

What are we watching in the period ahead? For the time being, macro uncertainty remains elevated, which is the main obstacle to establishing a high-conviction rate view. On the global growth front, the main sources of downside risk include the impact of tariffs, poor consumer and business confidence and disruptions to global trade. In the US, we would add the potential impact of the immigration freeze. While tariffs are potentially inflationary, we expect that the focus will be on growth risks in the period ahead. We therefore need to see a tangible deterioration in the growth outlook, followed by more dovish central bank signals,

for a clearer picture on duration to emerge. Given local macro developments, the United Kingdom and Australia stand out as the two main countries where the case for being long duration makes more sense. Separately, a restoration of fiscal discipline would help support demand for long-end rates in many markets, but we do not expect this to happen at this juncture.

EXHIBIT 1: THE US 10-YEAR BACK IN MIDDLE OF YEAR-TO-DATE TRADING RANGE



Source: Bloomberg. US 10-year Treasury yields, daily data up to 17 July 2025.

Are Credit Spreads Mismeasured?

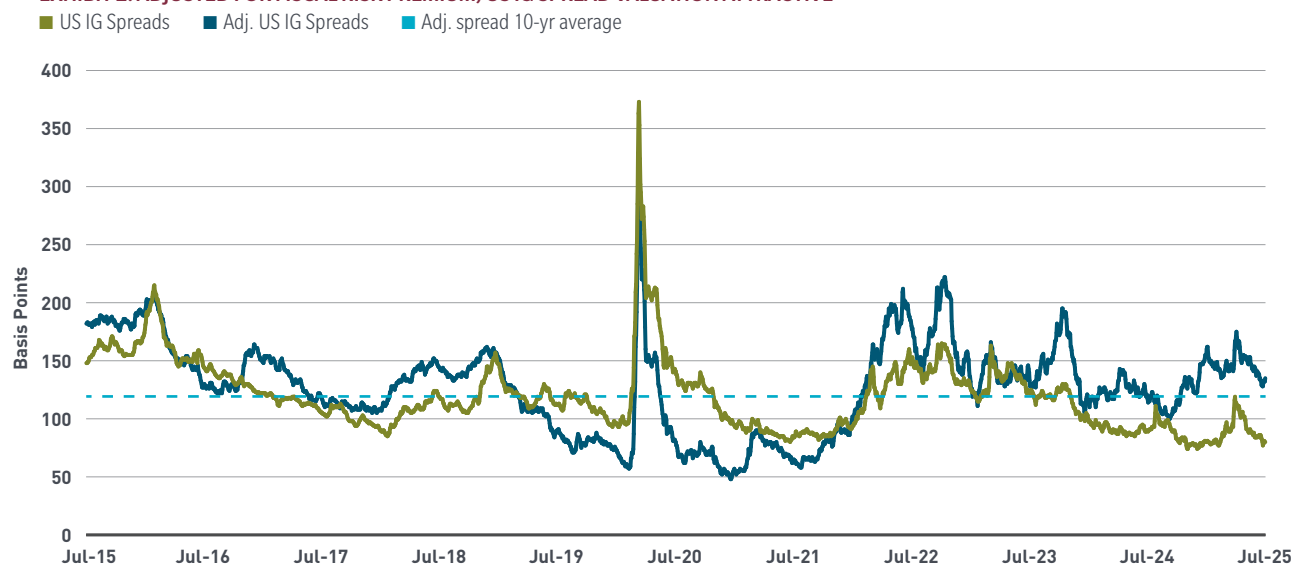
Can US Treasury yields still be considered risk-free rates? The US Treasury market used to be viewed as the ultimate safe haven, but recent market developments suggest that the defensive qualities of US Treasuries have been undermined as the US has been the major source of policy uncertainty since Liberation Day. One could even argue that the credibility of the policy framework has been called into question by global investors. In the process, we have observed a sharp rise in long-end UST yields, mainly driven by the increase in the fiscal risk premium and, more generally, the erosion of US

sovereign credit quality. Our market-implied measure of the fiscal risk premium is the highest since 2011.

From UST yields to credit spreads. If UST yields can no longer be considered a risk-free rate, is it still appropriate to calculate credit spreads against these UST yields? What if corporate spreads were mismeasured? And more importantly, what if corporate spreads were a lot more attractive than investors thought? At the risk of being a bit experimental, Market Insights proposes to calculate adjusted credit spreads, which adjust for the rise in

sovereign credit risk embedded in US Treasuries. It works like this: The adjusted credit spread is estimated as the difference between the corporate yield and the adjusted treasury yield, with the latter correcting for the change in sovereign risk over time. The results are particularly revealing. Adjusted corporate spreads for US IG are currently estimated at 140 basis points, corresponding to a 60% 10-year percentile.¹ In other words, when factoring the embedded erosion in sovereign risk, investment-grade credit spreads may be more attractive than the absolute level of unadjusted spreads suggest.

EXHIBIT 2: ADJUSTED FOR FISCAL RISK PREMIUM, US IG SPREAD VALUATION ATTRACTIVE



Sources: Bloomberg, MFS. Bloomberg US IG credit index. Spreads = option-adjusted spreads. Adjusted spreads are estimated by subtracting the term premium to the rates to adjust for the change in credit risk. The term premium is used as a proxy to the US CDS given its high correlation, and is therefore interpreted here as a proxy risk premium. Data as of 11 July 2025.

Important Risk Considerations:

Investments in debt instruments may decline in value as the result of, or perception of, declines in the credit quality of the issuer, borrower, counterparty, or other entity responsible for payment, underlying collateral, or changes in economic, political, issuer-specific, or other conditions. Certain types of debt instruments can be more sensitive to these factors and therefore more volatile. In addition, debt instruments entail interest rate risk (as interest rates rise, prices usually fall). Therefore, the portfolio's value may decline during rising rates.

Emerging markets can have less market structure, depth, and regulatory, custodial or operational oversight and greater political, social, geopolitical and economic instability than developed markets.

Diversification does not guarantee a profit or protect against a loss.

ACTIONS TO CONSIDER

- ➔ Don't view the tight spread level as a deterrent to IG credit exposure
- ➔ Favor IG credit exposure over sovereign credit in countries plagued by elevated fiscal risks

The Ongoing Normalization of the Bond–Equity Correlation

We are well past the peak of the bond–equity correlation. Two powerful macro regimes that predominated over the past few years can explain why the bond–equity correlation peaked some time ago. It all started with the so-called “fear of the Fed” regime, when central banks raised their policy rate aggressively, causing havoc in global fixed income and equity markets. That period, ended in December 2023 with a Fed dovish pivot, was characterized by a sharply rising bond–equity correlation. Then Goldilocks followed, this time driving stronger

ACTIONS TO CONSIDER

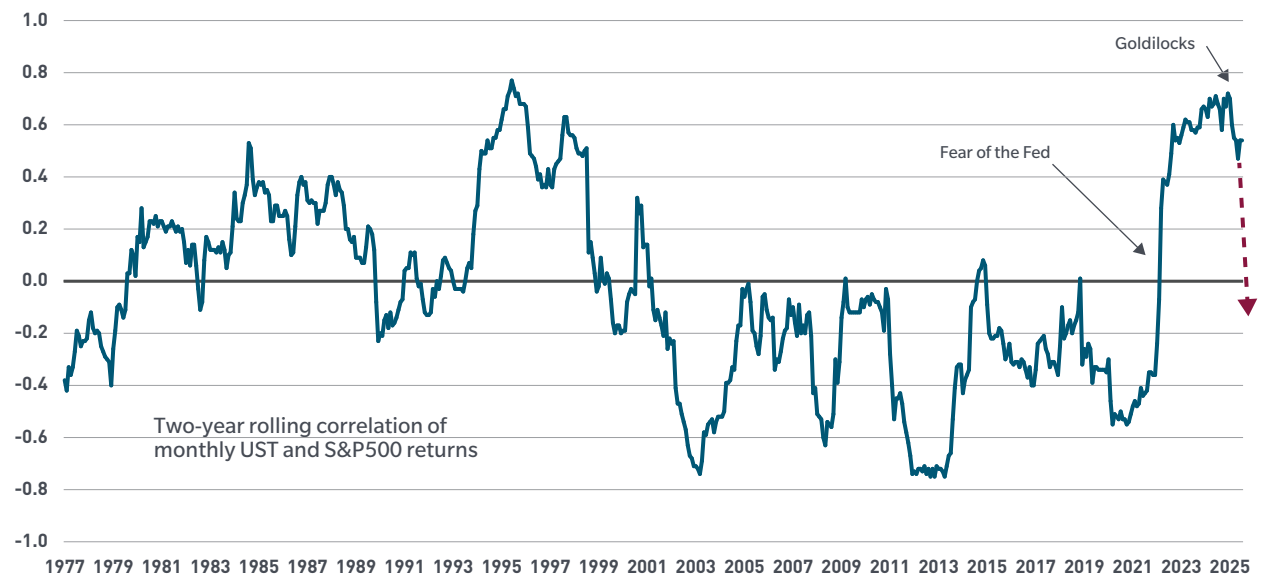
- ➔ Favor fixed income as an attractive de-risking asset class
- ➔ Focus on diversification across asset classes and geographies as a risk-management approach

performance of both fixed income and equity markets as central banks turned dovish and investor appetite sharply recovered. This led to a peak in the cross-asset correlation. However, the new macro regime is quite different. It is characterized by significant global risks, higher policy uncertainty and elevated macro volatility. Under the new regime, we see early signs that the bond–equity correlation stands ready to correct lower.

Fixed income is set to regain its status as a portfolio diversifier. Looking ahead, we believe that fixed income is well positioned to provide attractive defensive characteristics in the context of a more complex macro and market environment. This is likely to be facilitated by the further normalization of the cross-asset correlation. Irrespective of where the correlation goes in the future, it is also important to stress that fixed income can act as an effective volatility management asset class. Fixed income performance

is unlikely to be driven by rate or spread compression, but carry, which sits at historically high levels, may be able to provide a solid foundation for expected returns. Meanwhile on the equity side, performance has been particularly robust over the past few months, but there is growing concern that the market is now priced for perfection, especially with multiple expansion currently the main driver of returns. While rising rates are always a threat to higher fixed income allocations, we believe the current global economic environment of looser monetary policy and attractive rates of carry should help offset and alleviate any rate volatility. Against this backdrop, fixed income stands ready to act as an equity risk hedge.

EXHIBIT 3: THE BOND–EQUITY CORRELATION HAS STARTED TO NORMALIZE LOWER



Source: Bloomberg. Correlation is calculated using monthly data over two years. UST = Bloomberg US Treasury index. Data up to July 2025 (as of 16 July).

The Stars Are Aligned for EM Local Currency Debt

Two key attributes: global diversification and currency exposure. One of the key lessons we learned from the experience of 2025 so far is the importance of global diversification. Global investors were perhaps over-allocated to the US due to perceived US exceptionalism, but that narrative faced significant challenges as the US instigated a trade war. The other major story is the end of the strong dollar cycle, in part reflecting the global rotation away from the US. Against this backdrop, we believe that emerging market local currency debt is ideally positioned to take advantage of these two market forces. By construct, EM local debt offers substantial country diversification. Indeed,

ACTIONS TO CONSIDER

- ➡ Consider increasing allocation to EM local currency debt
- ➡ Take advantage of the potential global diversification benefits and attractive yields that it may offer

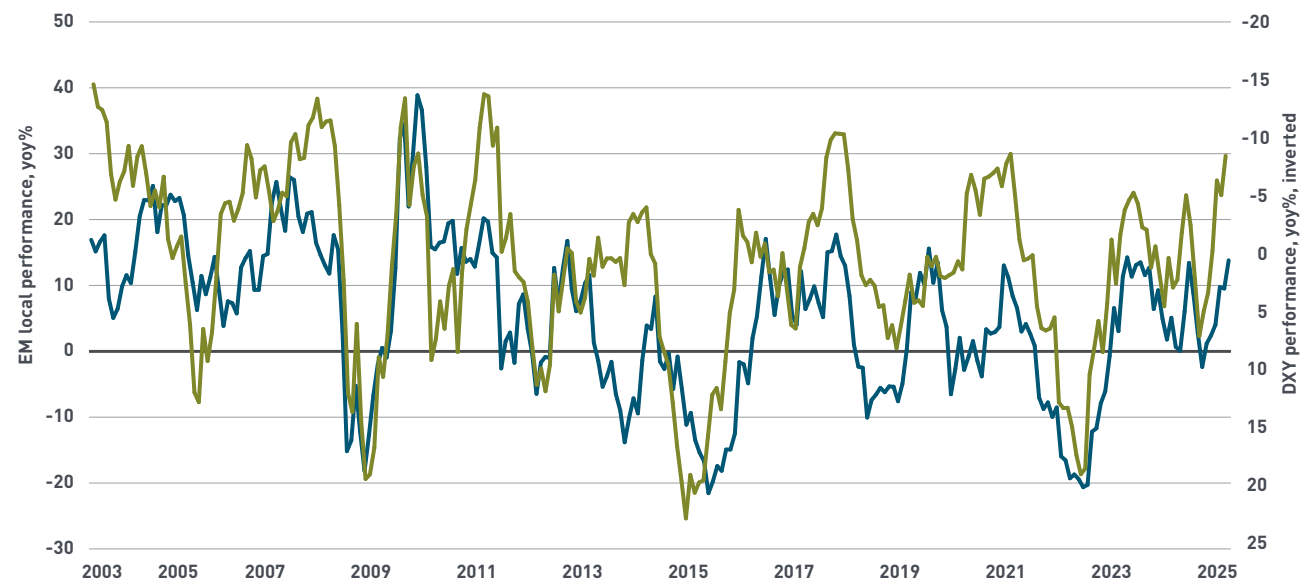
the main reference index — the J.P. Morgan GBI EM Diversified — includes 19 countries covering Asia, EMEA and Latin America. More importantly, while the global macro environment remains critical for the asset class, local macro drivers, especially central bank policy and domestic inflation, tend to have a major influence on local market performance. Meanwhile, on the currency exposure front, one of the key features of EM local currency debt is obviously the embedded EM currency risk. That means that there are times when it is appropriate to be quite prudent towards EM local currency debt. But when the dollar turns — as we are experiencing now — the stars are aligned for EM local currency debt to potentially do well.

The attractiveness of EM local currency debt. In our view, the place to look for attractive real yields is EM local currency debt. EM real yields stood at over 3% as of the end of May. This is more than double what

developed markets delivered (based on a reference basket of 2/3 UST yields and 1/3 bund yields). Not only are yields attractive, but there is also significant potential for yield compression, given the scope for future rate cuts in EM. Indeed, many EM central banks are still firmly in easing mode, from Latam to central Europe — less so in Asia at this juncture — which means that EM local fundamentals are supportive. Overall, the three components of EM local debt returns are all pushing in the right direction for the asset class to continue producing attractive returns in the period ahead: attractive yields, rate compression, and finally FX appreciation under a weaker USD scenario. However, we remain vigilant to any turn upwards for the dollar or any emergent growth shock that would hamper EM FX appreciation.

EXHIBIT 4: EM LOCAL DEBT PERFORMANCE AND THE US DOLLAR

■ EM local debt returns (LHS) ■ DXY performance (inverted, RHS)



Sources: Bloomberg, J.P. Morgan. J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD. Returns are in gross and USD. Monthly data up to June 2025.

Private Debt Headwinds

An allocation to private debt makes sense in the broader strategic asset allocation. By now, the merits of private debt are well known. Private debt offers diversification benefits, produces yields that tend to be more attractive than those in public debt markets while also offering lower volatility — although we may argue that the lower volatility reflects lack of real-time valuation marking and may mask higher underlying riskiness. In addition, private debt provides access to specialized lending strategies such as direct lending, mezzanine financing, real estate debt, or distressed

debt. These strategies often involve customization, negotiated terms that can be tailored to meet specific risk-return objectives. Finally, private debt may also be viewed as an effective inflation hedge given the large proportion of floating rate deals. Private debt really took off as an asset class following the global financial crisis. Since then, it has grown exponentially to reach an estimated AUM of about US\$1.2 trillion².

Reflecting its recent success, the asset class has become more saturated. This entails two interrelated implications. First, it has become more difficult to deploy cash given there has been increasing competition to find private lending opportunities. This in turn has not only caused dry powder to rise, but it may also undermine expected returns for the asset class in the period ahead. While there is still an illiquidity premium that may be captured, our view is that the premium is now considerably smaller than it used to be. It is worth noting that private-credit, closed-end funds posted a 6.9% annual return in 2024, according to the MSCI Private Capital Universe, which means that they underperformed the US high yield index by some 130 bps last year³.

The recent focus on liquidity risk is also likely to represent a challenge for private debt going forward. Private debt is considerably less liquid than public fixed income given it is not tradable through conventional means and is far less transparent than public debt. The 2022 UK pension crisis and the banking stress in the United States and Europe in March 2023 were stark reminders that sound liquidity risk management is an important pillar of any investment process. In other words, liquidity management is now top-of-the mind for global investors. In extreme market situations, the cost of giving up portfolio liquidity can be very difficult to manage. With that in mind, we believe that an overweight allocation to private debt may be harder to justify, especially for investors with significant liquidity needs. In contrast, public fixed income offers a much better alternative when it comes to maintaining adequate portfolio liquidity.

ACTIONS TO CONSIDER

- ➡ Review appropriate sizing of allocation to private credit
- ➡ Explore attractive alternatives to private credit, including public fixed income

KEY THEMES FOR THE SECOND HALF OF 2025

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¹ Sources: Bloomberg, MFS, Bloomberg US IG credit index. Spreads = option-adjusted spreads. Adjusted spreads are estimated by subtracting the term premium to the rates to adjust for the change in credit risk. Data as of 30 May 2025.

² Sources: BIS author's calculations, Pitchbook. Data as of 31 December 2024.

³ Source: Bloomberg, MSCI. Annual data as of 31 December 2024. Private Capital = MSCI Private Capital Universe. US HY = Bloomberg US High Yield Index.

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