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Q1 2025

Active Fixed Income Outlook: Trump arrives

LGIM

The US Capitol Building, Washington

2025: Time to challenge consensus?

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Will the market in 2025 be defined by Trump or technicals?

For more than a year, there has been continuous debate among fixed income investors on the relative importance of spreads or yields to the health of our asset class. We think this debate has been answered by the continued inflows into fixed income (at the time of writing, for the past 59 weeks into US investment grade). In our view, these flows have been driven by the yields on offer, which has in turn lead to spreads compressing to multi-decade tights.

In response, we maintained a long credit position across our benchmark and unconstrained portfolios for much of 2024, based on our belief that yields would remain attractive to investors. Fundamentals have also been supportive, both from a top-down position with strong US growth, and bottom-up with improving credit quality. However, it was the technical picture that dominated. We have taken advantage of the compression in credit spreads due to improving credit quality, particularly in European real estate and financials.

As usual, our duration positioning has been very active. We generally held a longer duration bias for most of last year. The disinflation momentum that started in 2023 has been strong, and the beneficial negative correlation between rates and spreads that investors enjoyed for much of the 21st century has re-asserted itself after the shock of 2022/23.

Therefore, we think there is again insurance value in duration for fixed income investors. We have also taken advantage of strong consensus beliefs in inflation, against which we successfully took opposing positions (e.g. in Japan's August 'flash crash') as we believe that accurately forecasting inflation is very difficult.

Whither Trump?

Outlooks for 2025 place a lot of emphasis on the new Trump administration and the sharp reductions in European growth that could result from a combination of Trump's tariff policies, economic challenges in Germany and political dysfunction in France. Strong views on the actual trajectory of US fiscal and trade policies are hostages to fortune and confidence is difficult to justify, but the market seems both happy that the new government's package will be supportive for growth and unconcerned about the impacts of tariffs on domestic growth.

We think the risk to the consensus view is to the downside, as the touted tariff package is several times larger than that of Trump's last term of office. We think this supports our constructive view on US duration and our underweight position in US credit, where spreads at similar tights have not been seen since 1998[2].

Turning to Europe, we see an abundance of caution. Hence we are positioned against the consensus, with a preference to be short on German duration and continue to have a preference for EUR over USD credit.

However, the 'Santa squeeze' in December benefited European credit more than USD credit, so we have trimmed that relative position.

Is inflation really behind us?

Our main debate for 2025 revolves around what could cause the strength of investor technicals to reverse.

A rebound in core inflation strong enough to drive the US Federal Reserve to pivot towards a hiking cycle would likely cause that reversal of the technical dominance, as investors would fear negative total returns from credit. Over the last 12 months, any backup in spreads has been bought by investors as the rate-cutting trajectory has given confidence that the yield on fixed income is attractive and accessible. We think it will take multiple months of upside inflation data, or the actual implementation of aggressive Trump policy, to reverse that trend. We are therefore comfortable maintaining a long credit bias to access that yield from fixed income, despite the paucity of spreads on offer.

The LGIM credit scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score: January	Score: December	Change
UK credit	-1	-1	Unchanged
US credit	-1	-1	Unchanged
Global credit	+1	N	Upgraded

Scale: -3, -2, -1, N, +1, +2, +3

Source: LGIM as at 17 December 2024 - can be subject to change at any point.

1. Source: Bank of America, 13 December 2024
2. Source: Bloomberg as at 13 December 2024

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European credit: Embracing challenges as opportunities

Marc Rovers
Head of European Credit

Lan Wu
European Credit Portfolio Manager

Markets have priced in a lot of good news. Are they right to, or is a more cautious approach warranted?

The American humourist Mark Twain once wrote, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

Let's see how this applies to European fixed income assets as we enter a quarter full of uncertain inputs.

"It ain't what you don't know that gets you in trouble. It's what you know for sure that just ain't so."

European Central Bank building, Frankfurt, Germany

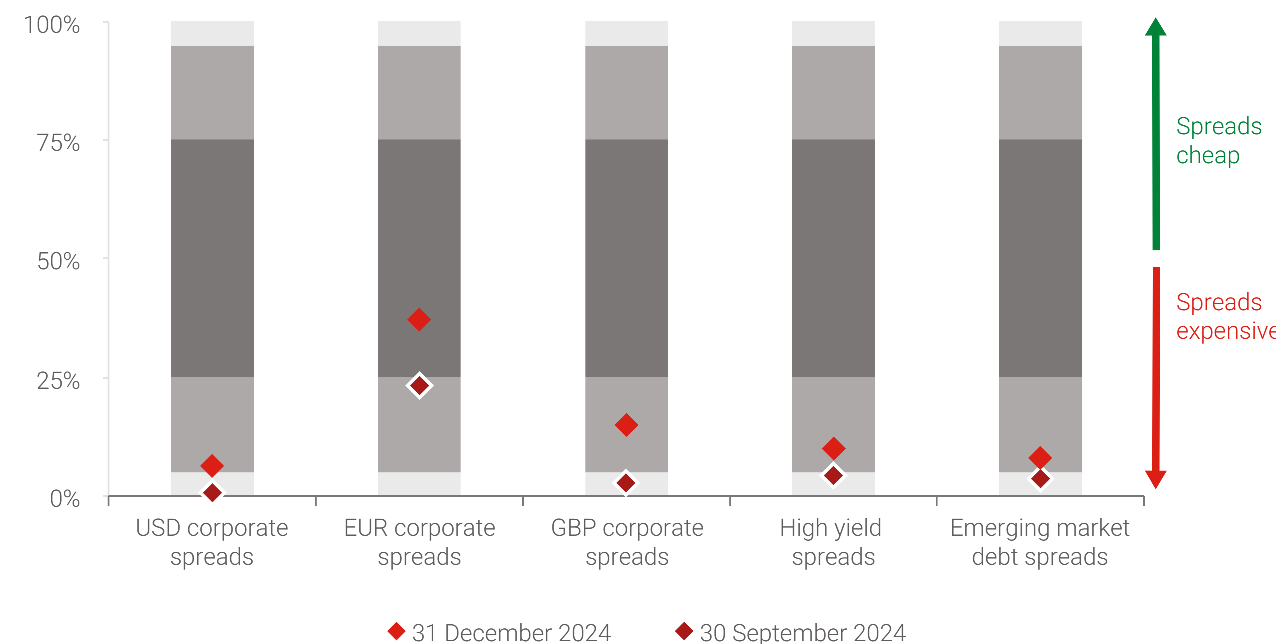
The past: what just happened?

Toward the end of 2024, the European Central Bank (ECB) cut interest rates by a quarter point to 3%, its fourth cut since June. The weaker growth outlook and reduced pressure in the labour market enabled the ECB to adopt a more aggressive easing path and the market has priced in further cuts in 2025.

Over the fourth quarter, European investment grade (IG) spreads continued to tighten. When we look at spreads versus government bonds, we think Euro IG bonds still look attractive in comparison to their US or UK peers. In our view, these numbers and the still-attractive all-in yields of over 3%, continue to support the technical picture as we witness strong recurring inflows into the asset class.

Credit spreads are low in historical context, yields remain elevated

EUR IG in our view compares favourably to other fixed income asset versus historical spread levels



Source: LGIM, Bloomberg, Barclays as at 31st October 2024. Analysis of spreads since December 2006.
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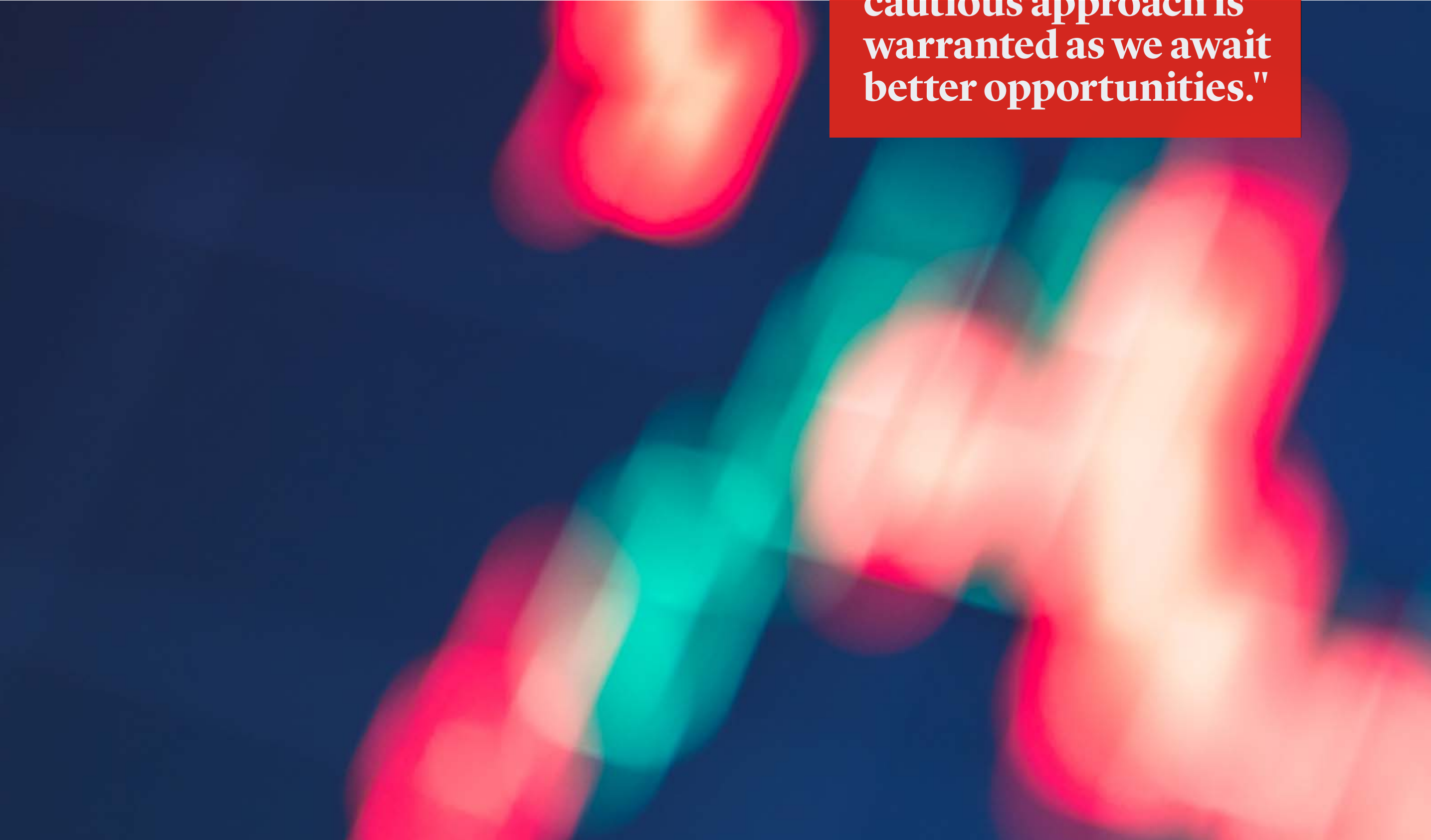

> **"We believe a more cautious approach is warranted as we await better opportunities."**

The present: Key themes

While we are constructive on Euro investment grade credit, we remain cautious due to the subdued economic outlook, geopolitical uncertainty and the lack of dispersion between higher and lower quality credit which may be a sign of a late credit cycle. While we acknowledge the risk of a further grind tighter as we move deeper into 2025, credit markets are pricing in a lot of good news without worrying too much about more adverse outcomes. We believe a more cautious approach is warranted as we await better opportunities.

In terms of positioning, our portfolios are defensively positioned, favouring higher quality ratings. The spread between higher (single A) and lower (triple B) rated companies has compressed to historically low levels. We also prefer less cyclical sectors and – maybe most importantly - ensure we own credits that our credit analysts believe have sound fundamentals.

What could go wrong?

With the major central banks signalling 'peak rates', more rate cuts may arrive as the fabled 'soft landing' is at last achieved. This would enable spreads to continue their grind tighter and lower-quality bonds to potentially continue to outperform. Another risk scenario is a 'double whammy' of weaker growth and higher inflation that can pose risks, especially for Europe when a number of factors come into play. This includes the second Trump administration's policy agenda, supply chain disruption and deglobalisation, while major economies like France and Germany wrestle with weak growth and political risks.

Outlook

Looking ahead, there appears to be a growing divergence between the US, where economic growth remains strong, and Europe, with signs that the weakness in manufacturing is spreading out to the service sector, fuelling concerns about the European economy as a whole. We expect to see more dispersion and differences between sectors and regions.

As we get more clarity around the US policy agenda beyond the immediate market reaction, we think we will be better able to assess the longer-term implications for sectors and companies. These are both challenges and opportunities for us to embrace, and we will continue to balance portfolio risks and seek opportunities through careful selection and diversification*

***It should be noted that diversification is no guarantee against a loss in a declining market**

The LGIM credit scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score (January / December)						
Euro credit	-3	-2	-1 (December)	N (January)	+1	+2	+3

Source: LGIM as at 17 December 2024 - can be subject to change at any point.

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Emerging market debt: Will strong fundamentals drive resilience?

Raza Agha
Head of EM Sovereign Strategy

Viraj Nadgir
Senior Fixed Income Investment Specialist

Compared to the beginning of the last Trump administration, we think emerging markets are well positioned to overcome potential challenges.

After a turbulent few years, we think emerging market debt (EMD) has weathered the storm and a broad range of factors mean the asset class is in our view positioned well to perform despite a complex global picture.

The past: what just happened?

After a solid 2023, EMD showed tremendous resilience in 2024, despite facing multiple headwinds from rising US government bond yields, geopolitical tensions, uncertainty around US politics, and persistent outflows.

Hard currency debt delivered another year of total positive returns, with the sovereign index witnessing 8.0% returns and the corporate index experiencing 8.3% returns[3]. Carrying on the theme from 2023, returns in 2024 were driven by high yield issuers across sovereigns and corporates.

3. Source: JP Morgan indices as at 13 December 2024

Investors appeared attracted to the rewards for taking risk against a backdrop of improving fundamentals and resilient global growth.

In contrast, EM local currency significantly underperformed the wider asset class owing to a strong US dollar, displaying -0.6% (USD terms)[4] in total returns.

The present: spread compression

Within EM sovereigns, spread tightening was the major driver of total returns last year, with hard currency sovereign spreads tighter by c.63bps (including Venezuela)[5]. Even though spreads appear expensive at the headline level, there remain pockets of value that could provide upside opportunities. Several sovereign issuers have defaulted and as such continue to trade with a premium, which we expect will tighten over the next 12 months. In addition, rating improvements through the year could continue, given the positive tone of several ratings outlooks. We think this will continue to enhance access to capital markets, lowering refinancing risk in many high yield issuers, as we saw with Nigeria last year.

At a broader level, we expect spreads to be supported by strong macro fundamentals in emerging markets. Growth has been resilient in the aftermath of Covid-19, averaging over 4% over 2022-24, higher than 2019, and compared to under 2% in advanced economies.

Price pressures continue to recede, particularly in countries experiencing high inflation. Globally speaking, EM government debt levels are just 5% of GDP higher since the pandemic, and remain below 70% of GDP overall, compared to nearly 110% of GDP in advanced economies. That reflects broadly stable fiscal deficits - below 5.5% of GDP over 2022-25. Meanwhile, the external sector remains in surplus at an aggregate level, aiding rising levels of foreign exchange reserves of around $11 trillion. The latter are more than double the level of external amortisation due in 2025[6].

We think spreads could also be helped by supportive technicals in 2025. In EM sovereigns, net financing is forecast to be just over $3bn, down from c.$40bn this year[7]. Further, with improved growth expectations in the US alongside a rate cutting cycle, US high yield and investment grade spreads should remain anchored, which could in turn support EM spreads.

Meanwhile, returns in EM corporate credit have been led by spread tightening of c.74bps last year[8] owing to strong fundamentals, falling default rates and net negative refinancing. These trends are expected to continue into 2025 with default rates falling to 2.7% (as per JP Morgan estimates). And although spreads are currently close to post GFC tights, all-in yields remain attractive.

As things stand, the risk structure, low duration profile, and exposure to diverse countries EMD offers can in our view deliver diversification and we think this will continue to support demand. Sector selection remains key - tariffs from the incoming Trump administration will negatively impact some industries while other credits will benefit from nearshoring.

As such, we do not see a scenario where spreads blow up significantly in EM sovereigns or corporates, but current levels suggest they could remain relatively range-bound next year.

"Price pressures continue to recede, particularly in countries experiencing high inflation."

4. Source: JP Morgan indices as at 13 December 2024
5. Source: JP Morgan indices as at 13 December 2024
6. Source: Bloomberg as at 20 December 2024
7. Source: JP Morgan estimates
8. Source: JP Morgan indices as at 13 December 2024

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What could go wrong?

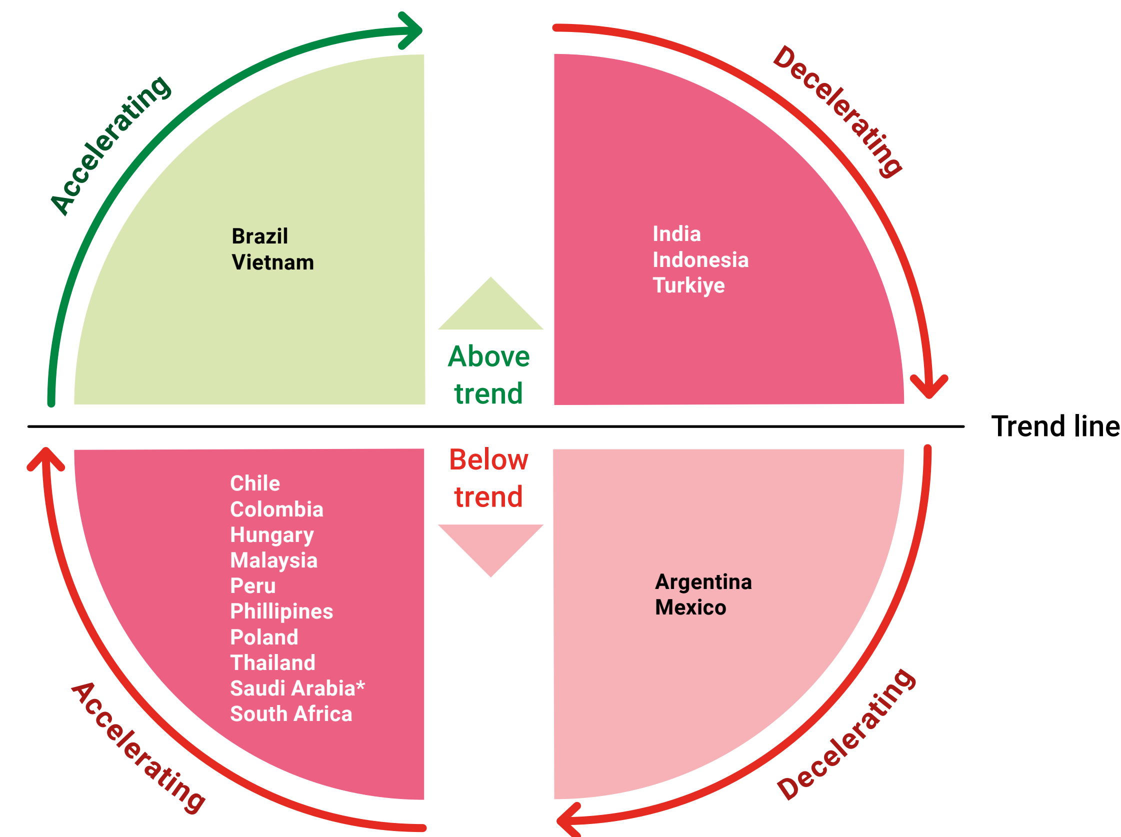
We think the biggest risk for emerging markets does not stem from idiosyncratic factors, but rather developments in global macro and markets. Herein, the key will be the extent, duration and sustainability of policies under the incoming Trump administration, particularly with respect to tariffs, immigration and US public finances. Together, these policies could impact US inflation, global trade, supply chains, private investment and US monetary policy. Coupled with higher rates volatility, this could impact flows into the asset class.

Beyond macro, political noise in emerging markets is expected to decrease due to a light election schedule this year, while the incoming Trump administration has committed to ending conflicts involving Russia, Ukraine and Israel. If successful, this would help lower geopolitical risks, although there is potential for higher tensions between the US and China and Iran.

Outlook

In our view, the global growth outlook remains favorable. EM fundamentals are robust, as evidenced by rating upgrades, high levels of external liquidity, increased market access for high-yield credits, and low default rates among sovereigns and corporates. Compared to the first Trump administration, EM sovereigns and corporates are now better positioned, having navigated two wars, the Covid-19 pandemic, and an aggressive rate hiking cycle since 2016. Given our expectation of EM spreads being range-bound, coupled with rate cuts in the first half of the year in the US, we expect EM hard currency total returns to be in the region of mid to high single digits for 2025.

Current economic cycles in emerging markets



Note: We use an Hodrick-Prescott filter on seasonally-adjusted GDP levels to define above/below trend, and the average of the latest two quarters compared to the average of the previous two quarters to define accelerating/decelerating.
*Saudi Arabia's non-oil GDP is above-trend and accelerating. Sources: Haver Analytics and S&P Global Ratings. Copyright © 2024 by Standard & Poor's Financial Services LLC. All rights reserved.

The LGIM credit scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score (January / December)
EMD	-3 -2 -1 N **+1** +2 +3 (January: +1; December: +1, unchanged)

Source: LGIM as at 17 December 2024 - can be subject to change at any point.

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Global high yield: Will this be a Goldilocks year?

John Ryan
Senior Portfolio Manager

Sophia Hunt
Fixed Income Investment Specialist

As the rate cutting cycle continues, we think investors will look for income which could support high yield

As we move in into 2025, we think investors may be able to reap the rewards of structurally lower defaults and a potential regime shift to relatively higher yields.

The past: what just happened?

2024 turned out to be a year where relief as the feared US recession failed to materialise translated into a general sense of positivity and willingness to embrace risk. Risk assets saw very strong returns, with high yield among them.

The US economy grew beyond the expectations of most market participants while developed market central banks paused their rate hiking regimes and then saw falling inflation as the catalyst to begin reducing rates. In this environment, high yield markets across all regions and rating segments saw spread tightening of at least 25% and total returns greater than their starting yields. Emerging markets were the clear outperformer, returning more than 10%, followed by the US and Europe which saw around 7% total returns[9].

The present: leaning to emerging markets

We have positioned our portfolios for income in pursuit of yields higher than the benchmark. With resilient US growth, falling interest rates worldwide and low distress ratios, we expect downside risks to be low. We think spreads are unattractive on a historical basis, but in our view prices and yields remain attractive – which has kept demand high.

Our strategy is to position with a preference for emerging markets, in an effort to capture the additional yield on offer while taking advantage of solid corporate and national fundamentals. The portfolios target further spread compression in high and medium-quality securities while being wary of issuers with material default risk whose bond prices we think are becoming over-enthusiastic. In Europe, we retain our underweights to France, Italy and Germany, based on concerns over sovereign debt, the automotive industry and the uncertainty of the political landscape.

From a sector perspective, our focus on the 'flexible' part of the economy remains, with an overweight exposure to consumer, services and certain industrial sectors. Conversely, we have underweight positions in the global automotive, utilities and shipping sectors.

Outlook

In our view, global growth looks set to remain in a band that favours high yield credit: not too warm and not too cold, Goldilocks-style. 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.

Corporate fundamentals appear firm, with high profit margins, moderate leverage and financial policies still relatively defensive. This supports a normalised outlook for defaults and we expect low default rates and low loss rates for high yield bonds.

Downside risks hinge on policy and geopolitical volatility, and the risk that inflation is reignited by government policies and supply chain disruption. We consider these as presently relatively low impacts to high yield fundamentals, and likely to be mostly offset by accumulating income. Upside risks include weak to low growth and falling inflation creating a 'golden age' for fixed income, as abundant liquidity and demand for income forces yields and spreads to new tights.

The LGIM credit scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score (January / December)						
	-3	-2	-1	N	+1	+2	+3
Global high yield					January	December	

Source: LGIM as at 17 December 2024 - can be subject to change at any point.

9. Source: ICE BAML Indices as of 13 December 2024

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Research and Active Engagement: Surveying the UK water sector

Jonathan Constable
Senior Credit Analyst

2024 was not a banner year for British water providers. Could a new package from the regulator allow the sector to move on?

This quarter, we're considering the impact of regulatory changes on the UK's water sector, which experienced several challenges over the course of 2024. Overall, we are constructive on the sector – barring the weakest names.

The past: what just happened?

On 19 December, UK water regulator Ofwat published its long-awaited Final Determinations (FD) for tariffs for the five years from April 2025. The draft version released in July had been considered very tough and prompted a sell-off in UK water bonds.

The FD is a very complex set of documents and will take time for industry and the markets to digest. But looking at the headlines, there have been significant improvements over the draft version and we think the improvements overall have exceeded market expectations. For some of the weaker companies, though, the improvements left big gaps remaining versus the companies' requests.

The present: tightening spreads

Overall, UK water bonds performed well on the FD announcement, tightening significantly, although they are yet to retrace fully the moves wider we saw early last year. Southern Water unwrapped bonds also performed relatively well, although the issuer remains on a knife-edge, just about clinging onto investment grade composite ratings.

> **"The FD is a very complex set of documents and will take time for the industry and the markets to digest."**

What could go wrong?

In spite of the large improvements from the regulator, it's not clear how the rating agencies will react. Both S&P and Fitch have indicated they could revise the water sector's business risk assessments after the FDs. The size of the movement from Ofwat may well be enough to avoid such a revision from the agencies, reducing the scale of rating actions in the sector, but it's difficult to be confident.

Among the weaker names, Southern Water and Thames Water each could consider referring their FDs to the Competition and Markets Authority (CMA). This could delay resolution towards the end of 2025, disappointing markets, and in the case of Southern Water it could trigger a downgrade to high yield.

Outlook

We're expecting companies to consider their FDs and decide whether to accept them or refer them to the CMA by mid-February. We may see measures from companies following this decision to offset any rating pressure, and then we expect the agencies to conclude rating reviews. For companies that appeal to the CMA, this process could last for between six and 12 months.

Other than for the weakest companies, we are constructive on the outlook for UK water spreads as we believe the improvement will mostly be sufficient for the companies to move on. While we anticipate plenty of issuance, we think spreads can compress further as rating reviews are completed and the companies move onto delivering investment and improved operating performance.

The outlook for the weakest companies is less clear. It remains a difficult call whether Southern Water will now receive unconditional support from its main shareholder Macquarie Asset Management; in the mean time, we think holders of the unwrapped bonds are in a precarious position. Thames Water is already heading for restructuring, but a better FD might have reduced the chance of a CMA referral, enabling a quicker resolution. Again, it's difficult to say confidently which way it will go, but, in the case of Thames Water bonds, the good news is that forced selling appears mostly to be behind them and it is now mainly a valuation argument and a question of timeline to resolution.

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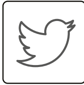

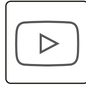

Key risks

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