

FIXED INCOME OUTLOOK THIRD QUARTER 2025

TARIFF IMPACT AHEAD

We expect the US economy to pivot towards higher inflation and slower growth. In Europe, inflation should fall further. These trajectories may well lead both the US Federal Reserve and the European Central Bank to loosen monetary policy in the third quarter.

US

At the start of the third quarter, we acknowledge the passage by the US Congress of a more stimulative budget bill, but remain concerned about the prospects of a damaging tariff schedule.

Although President Trump once again delayed the 9 July deadline for an EU trade deal, he has ramped up pressure on other trade partners – threatening 30% tariffs from 1 August on imports from the EU, 25% on Japan and South Korea, as well as 50% tariffs on Brazil and copper imports.

For now, the equity markets trade as if Trump is bluffing. But we think there are several reasons to expect confrontation.

- First, risk assets have recovered from the drawdown after April's 'Liberation Day' tariffs announcements, which the administration probably interprets as a sign of confidence
- Second, Trump is a committed protectionist who rejects the standard arguments that trade can be mutually beneficial, instead seeing trade as a zero-sum game
- Third, Trump's rejection of his own [USMCA](#) deal with Canada and Mexico signals to other trade partners that the US is not a dependable trade partner, and that making concessions simply invites demands for further concessions
- Fourth, China's strategy of confronting the US by raising its own tariffs and limiting exports of strategic inputs and popular consumer goods forced a US climb-down, and demonstrated to the EU that large economic blocs can stand up against the unilateral imposition of tariffs by the US.

We are concerned that the EU will show only limited flexibility vis-à-vis US demands, and will wish to ensure the US feels the consequences of its protectionist turn, even as, geopolitically, the EU will not wish to accelerate a US military withdrawal from Europe.

In sum, we continue to expect a tariff schedule that will inflict serious damage on US growth, with an effective rate closer to 20% than the 10% consensus. The market's apparent assumption of a TACO (Trump Always Chickens Out) outcome only has validity if asset prices actually take Trump's threats seriously and impose discipline on the White House. For the moment, risk assets appear complacent instead.



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Overall, the net result of these protectionist trade and expansionary fiscal policies is probably negative for long-term growth, but likely positive for near-term growth (given the front-loading of tax cuts), with core goods prices rising on a one-off basis. While we may have more clarity on the fiscal path, the trade outlook remains uncertain.

We forecast that the fed funds rate will likely remain at 4.25-4.50% until the Fed's September policy meeting and that the Fed will provide two further cuts in 2025, taking the rate to 3.75-4.00%. However, we are now less confident that the central bank will reduce rates to the 3.00% neutral level in 2026, given the passage of the stimulative fiscal bill.

Of course, it is hard to have a firm view on policy rates beyond May 2026, given that President Trump will be nominating a new Fed Chair, but our best guess is policymakers on the Federal Open Market Committee will stall rates at around 3.50-3.75%, versus our previous view that rates would fall back to the 3.0% neutral level. Indeed, should immigration curbs lead to labour shortages and tariffs have second-round price effects, it is even conceivable that the FOMC might need to resume rate *hikes* in late 2026 – which could trigger concerns about the fiscal situation.

On this topic, we remain worried about investors' willingness to continue financing elevated US deficits. Recent comments from Treasury Secretary Bessent suggest a recognition that the term premium is already high, and hence there is a reluctance to add to longer-dated bond issuance. A shift in the maturity profile of Treasury issuance could provide a reprieve of the curve steepening trend, but will not solve the underlying problem — unsustainable deficits that are placing upward pressure on yields.

Recent sharp sell-offs in the UK and Japanese government bond markets driven by debt sustainability concerns illustrate investor nervousness on this topic — and it would be naïve to assume that US Treasuries will be forever immune. Furthermore, attempts by the US administration to pressure this (or a future) Fed Chair have the potential to backfire if investors conclude that the Fed's operational independence and inflation credibility are being compromised.

As a result, we are, on the one hand, tempted to sell US Treasuries to position for further increases in term premia, but, on the other hand, also tempted to buy given the historically elevated real yields.

While we find ourselves in this dilemma, we remain tactical and are trading a 4.25-4.75% range for 10-year yields. We begin the third quarter with portfolios reflecting a modest modified duration contribution in 10-year real yields.

We have a core 7s30s curve steepening exposure, but also emphasise that it is roughly half the size of what we held in early June. Paradoxically, US 10-year breakeven inflation rates have traded with an inverse correlation to the tariff developments as announcements of tariffs hurt risk assets and stoked fears of a disinflationary recession. In breakevens, we continue to trade the 2.15-2.45% range in effect since October 2024.

Exhibit 1**US real yields are historically high** (5-year 5-year inflation-adjusted yields)

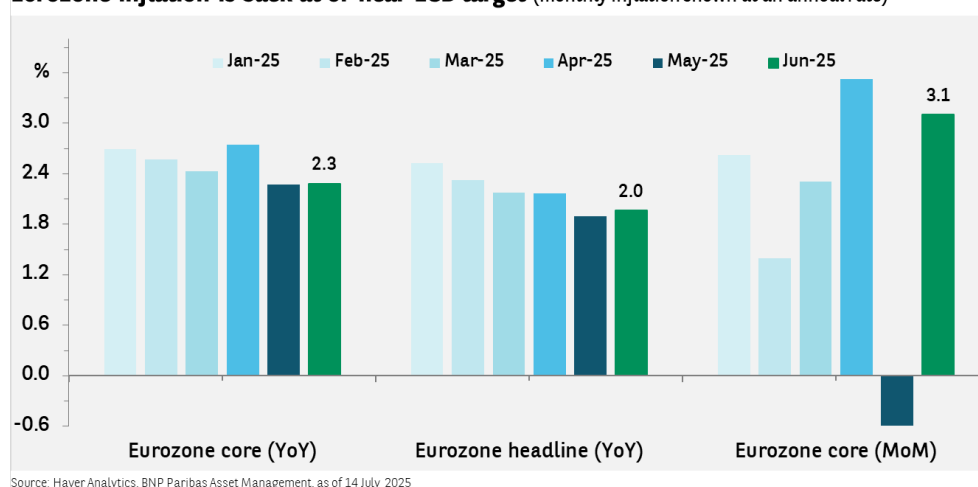
Source: Bloomberg, BNP Paribas Asset Management, as of 15 July 2025

EUROZONE

The European economy continues to face uncertainty over the Trump administration's trade policy. At the time of writing, the EU is threatened with a baseline tariff rate of 30% from 1 August (plus add-ons if the bloc were to retaliate), and potentially higher sector-specific tariffs. Discussion has been focused on cars, with negotiators exploring a mechanism that would allow EU carmakers producing in the US to benefit from reduced tariffs when exporting vehicles to America, a move that would primarily benefit German carmakers. The US appears open to lowering tariffs on aircraft, medical devices and spirits, although wine remains a sticking point. The main uncertainty is still around pharmaceuticals, which account for the largest share of EU exports to the US.

Europe's fiscal policy shift is likely to offset some of the drag from higher US tariffs. Beyond an initial boost to sentiment, the combination of the EU's ReArm Europe plan, Germany's infrastructure investment fund and an increase in defence spending will likely lift growth in the medium term. The German economy has been running below potential growth due to both structural and cyclical issues, but the government's fiscal plans could boost demand and help the economy to close the gap. The sizeable investment component of the financial package can also lift the country's potential growth rate.

Headline inflation in the eurozone has already returned to the ECB's 2% target. We expect progress in disinflation to be maintained in the near term given the recent rise in the euro and the dissipation of the threat of a renewed surge in energy prices. The trend in underlying inflation has also been encouraging as services inflation nudged down further in the second quarter, to 3.3% year-on-year in June. Forward-looking measures of wage pressures point to a further cooling in pay growth. We expect the net effects from the trade tariffs on inflation to be disinflationary as downward price pressures from the direct hit to growth, weaker confidence, and a re-routing of Asian exports away from the US to European markets will likely outweigh upward price pressures from potential EU retaliatory measures.

Exhibit 2**Eurozone inflation is back at or near ECB target** (monthly inflation shown at an annual rate)

Against this backdrop, ECB President Lagarde described the central bank as ‘well positioned’ to navigate the uncertainty. Although the risk to growth is still viewed as being tilted to the downside, stemming from trade policy uncertainty, this is offset by optimism about the impact of rising government investment in defence and infrastructure that would make the EU economy more resilient. We believe the prospects of a more dovish monetary policy are largely reflected in market pricing and have therefore taken a more tactical approach in our euro duration strategies.

On the yield curve, we believe the weight of rising bond issuance in Germany and fiscal concerns in France could lead to a further steepening in the medium term. Over a shorter horizon, we are cognisant that the usual summer hiatus in issuance could support longer-dated bonds. German Bunds could benefit from their rising safe-haven status relative to US Treasuries in bouts of risk aversion.

On breakeven inflation (BEI), we are maintaining a modest underweight bias in long-dated euro BEI against a long bias in US BEI as the recent euro appreciation will likely contain inflation in the eurozone while the rise in tariffs will likely be passed on to US consumers.

On sovereign bond spreads, we are maintaining an overweight in Italy and Spain against France and Germany in the portfolio. The ReArm EU proposal is an encouraging first step to fostering deeper integration. Italy’s fiscal outlook has improved as the government is running a primary surplus this year and is looking to exit the EU deficit procedure in 2026. In contrast, the task of reducing fiscal deficits remains challenging in France. There is persistent political risk given the fragmentation of parliament. The government faces a potential no-confidence motion during the budget process, and another snap election cannot be ruled out as President Macron regains the ability to dissolve the National Assembly in July. We anticipate ‘peripheral’ spreads to be well supported over the summer, with Germany in the process of increasing its debt issuance to fund its spending plans amid the continued search for yield by investors in a range-trading environment.

UK

As we head into the summer, the UK’s public finances have returned to a familiar situation. Efforts to put the public finances on a more sustainable footing have met with only limited and temporary success, and the headroom against the government’s fiscal rules has once again been depleted after major policy U-turns. Elevated Gilt yields, the

uncertain growth outlook, and the [overly optimistic productivity assumptions](#) in the Office for Budget Responsibility's forecasts mean that Chancellor Reeves' fiscal challenges still lie ahead. Given the government's commitment to its 'non-negotiable' fiscal rules, this means that further consolidation measures will likely be needed to ensure the rules are not broken.

Whether Rachel Reeves stays as chancellor or not, the fiscal fragilities persist. Our baseline assumption remains that the government will look to shore up its fiscal credibility through tax increases in the autumn as the chancellor delivers her budget. Delivering on spending cuts is politically challenging, particularly when other spending needs, including on defence, are rising. That said, the Labour Party pledged in its 2024 election manifesto and recent statements not to increase VAT and not to increase taxes on 'working people', including income tax and National Insurance. A meaningful rise in tax revenue will likely involve backtracking on these promises, which will be politically contentious. Therefore, the risk scenario is that the government decides that it has no mandate to raise taxes and no appetite to push through more spending cuts, particularly when its popularity is declining. In this scenario, the government might tweak or abandon its fiscal rules to justify more borrowing. In the near term, our expectation is that Prime Minister Starmer will continue to reiterate his support to the chancellor, and she will continue to signal her commitment to the fiscal rules. In the medium term, we believe the government will look to raise revenue, and hopefully also redouble its efforts in legislating growth-oriented policies to shore up its fiscal credibility.

In terms of monetary policy, the Bank of England (BoE) will remain focused on pay settlements as well as employment trends to judge whether it can lower interest rates, despite the projected rise in headline CPI over the coming months. So far, with services inflation at 4.7% and wage growth at 5.1%, the BoE's caution is justified. Although inflation expectations remain elevated, survey results have pointed to their continued normalisation. We expect the slowing in the labour market and normalisation of wage growth will eventually allow for faster and deeper cuts later this year.

From a valuation perspective, UK real yields remain attractive. After dipping briefly to 1.8% at the end of January, the yield of 30-year UK index-linked Gilts bounced back to its historical high in April and has been moving sideways since. As the recent U-turns in government policies brought the UK's fiscal fragility back into the spotlight, we saw long-dated UK real yields moving back to the highs of the second quarter. Ten-year/10-year forward real yield revisited levels above 3%, a high not seen since 1997, and one that far exceeds the level of UK trend growth.

A deteriorating employment outlook (which argues for a more dovish BoE policy stance), and attractive valuations should support UK Gilts. We are nonetheless cognizant that in the near-term concerns surrounding UK debt sustainability could contribute to a further sell-off, which would provide even better entry levels. Furthermore, against a backdrop of rising interest rates and extremely tight fiscal headroom, weaker economic growth could exacerbate the debt sustainability issues as a decline in tax revenues weighs on the fiscal calculus. With fiscal sustainability fears lingering in the background, we prefer to take a tactical approach when trading UK duration. In the longer term, however, we believe slowing growth and a loosening in the labour market should help ease concerns over the UK's inflation problem and allow for deeper and faster BoE rate cuts. On the yield curve, we are maintaining a modest 2s10s nominal curve steepener. In our view, front-dated yields should be well anchored by market expectations for rate cuts. At longer maturities, the record level of net supply and concerns about debt sustainability could drive further underperformance as the term premium rises.

CORPORATE CREDIT

We are constructive on both US and euro investment grade (IG) credit as company fundamentals and technicals remain supportive despite slower growth and fiscal and trade policy uncertainties. This view translates into a neutral positioning favouring carry-oriented selective strategies.

Exhibit 3

Credit spreads of investment-grade corporate bonds are back at the lows



At the macroeconomic level, the market is pricing in a no-recession outcome across IG and high-yield bonds (HY), leaving little upside, but plenty of downside. This underpins our generally cautious view on both valuations and relative values.

We believe companies are generally in good shape with stable debt levels, improving revenues and margins, and a more disciplined approach to capital allocation. Companies have built sufficient cushions to face the risks a slowing economy could pose.

Credit market participants de-risked aggressively in the aftermath of April's tariff news. That left them underweight when President Trump chose to de-escalate the trade conflict and the market began to rally. May and June were about playing catch-up to rebuild positions, mostly through absorbing supply.

While supply helped investors cover their underweights, they have had to absorb new inflows. In US IG credit, for instance, foreign demand has proven surprisingly resilient despite the significant risks those investments face from a weaker US dollar.

In euro credit, French and Italian life insurers have been competing with asset managers for assets after raising significant new funds through gross premium collections in April. Anecdotally, there is evidence that foreign investors are showing renewed interest in euro credit.

Valuations are approaching the tightest of the year once again as strong technicals add to the supportive fundamentals. BBB-rated corporate bonds now represent 46% of US IG benchmarks — the lowest level in 10 years. Relatively low dispersion between sectors favours credit selection, with opportunities in the car, media, utilities and financials sectors. Yield curves are generally flat, and we see more value in the front end or the belly of the curve. As concerns ratings,

the BBB/A spread ratio has come down since ‘Liberation Day’ but remains high. We like BBB corporates ahead of what we expect will be a summer of carry.

Credit default swap (CDS) indices are likely to underperform cash, not least given moderating supply going into the summer months.

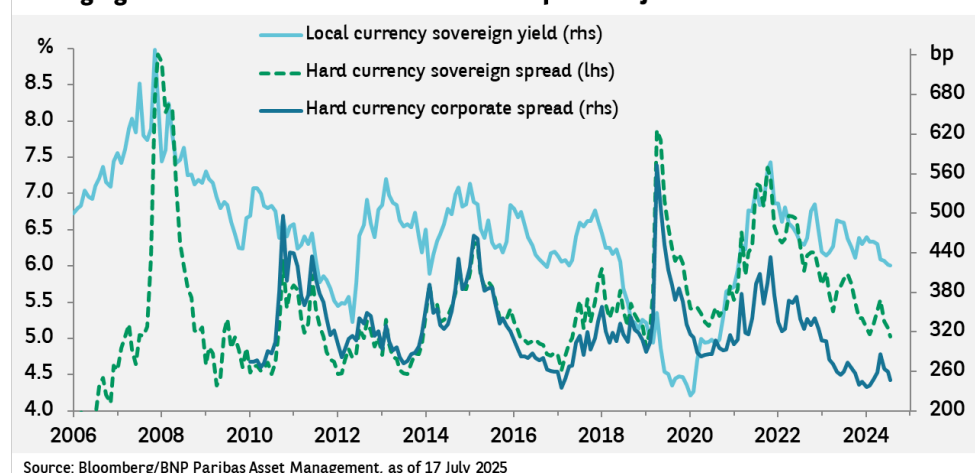
Technicals are a key driver of the market as investors search for yield and duration despite softening of buying interest from exchange-traded funds and money market funds, which are more total return-oriented. The diversity of IG buyers and their different incentives remain a key support. Gross and net supply are running lower than in the same period in 2024. This dynamic, a tailwind for credit spreads, should continue for the rest of 2025 given lower levels of mergers and acquisitions activity and market uncertainties.

EMERGING MARKET DEBT

While geopolitical concerns and trade uncertainty are likely to continue weighing on investor sentiment in the near term, emerging market (EM) fixed income continues to offer investors compelling select opportunities. Taking advantage of them, however, will require careful navigation of the markets amid heightened volatility.

Exhibit 4

Emerging market debt did well in the second quarter of 2025



Emerging economies are benefiting from resilient fundamentals and a generally stronger pace of growth relative to their developed market peers. Combined with the expected resumption of the rate cutting cycle in the US (albeit at a slower pace) and in most other EM countries, this environment is likely to support the asset class during the second half of the year.

Hard currency EM bonds

- Fundamentals:** EM credit fundamentals across both sovereign and corporate issuers are largely intact. For sovereign issuers, many EM countries maintain a healthy balance of payments and are more prudent in external debt issuance and fiscal policies. According to Fitch, EM sovereigns saw moderate net positive rating actions over 2024. For EM corporates, many issuers maintain lower levels of net debt and have higher interest coverage ratios versus their developed market peers.



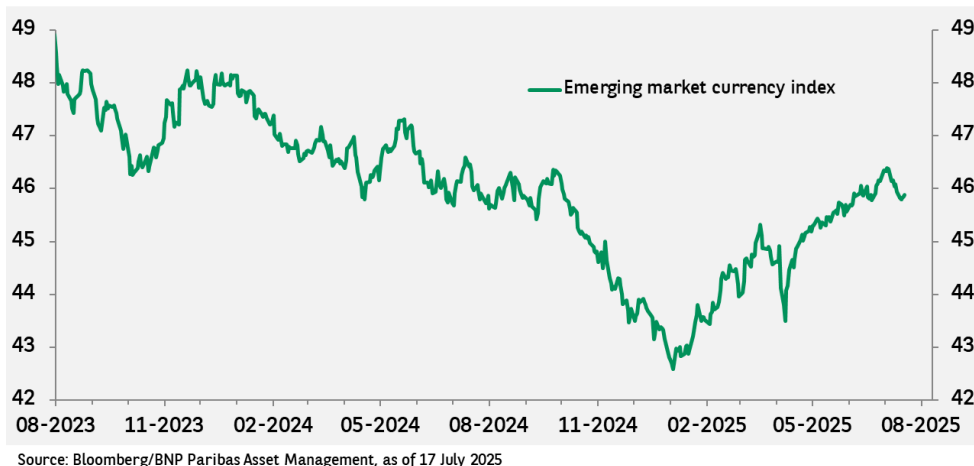
- **Valuations:** We see EM spreads offering better value than developed markets. We recognise, however, that generic spreads are currently less appealing compared to earlier in the year, and some corporate credits have become more expensive. We are focusing on some idiosyncratic names and selected frontier markets, which we believe offer more attractive opportunities. We note that credit spreads within the investment-grade segment have become expensive and therefore remain selective.
- **Technicals:** We expect a moderate supply of bonds in 2025, which should provide technical support for EM bonds over the year. We have already seen strong inflows resume in 2024 and 2025, and we expect this to continue.
- **Duration:** We see US duration risk as broadly balanced. For the Federal Reserve, the focus remains on inflation data and President Trump's policy agenda. While the central bank may not be inclined to cut rates further, signs of a weakening economy could change the Fed's mind. In our hard currency portfolios, we have maintained a neutral range in terms of duration.

Local currency EM bonds

- **Fundamentals:** We expect economic fundamentals to remain strong. Several economies are moving into an easing cycle that will support growth.
- **Valuations:** We believe local currency bonds offer selected opportunities. We expect a number of EM central banks to move to a more accommodative stance. Valuations for some local markets (e.g., Latin America and frontier) look appealing.
- **EM foreign exchange:** We anticipate US dollar weakness in the short term. Over the medium term, EM currencies should benefit from a more resilient growth outlook and a wider growth differential between emerging and developed markets. Some EM currencies look attractively valued, but we are applying a more selective approach when looking for near-term opportunities.
- **Technicals:** Demand/supply dynamics for local currency EM bonds generally are partly a function of local investors (e.g., central bank/reserve managers, pension funds, insurance companies), who tend to provide a stable demand base. 2025 is a 'refinancing year' for several economies, so in those cases gross issuance could be larger relative to history.

Exhibit 5

Emerging market currencies could appreciate further



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