FIXED INCOME OUTLOOK
FIRST QUARTER 2025

COME WHAT MAY

The US bond market will once again lead global fixed income markets in 2025, with a stronger US economy and uncertainty surrounding the new administration's policies setting the tone. We expect the US economy, over time, to pivot towards structurally slower growth and stickier core inflation. This more 'stagflationary' trajectory should encourage the Federal Reserve to take a more cautious approach towards further rate cuts.

We expect the eurozone economy to grow at a moderate pace with the European Central Bank continuing its march back to a more neutral policy setting until the deposit rate reaches around 2%. With risk to economic growth tilted to the downside, the ECB may be forced to cut the rate to below neutral.

The recent rise in bond yields in the US, UK, and eurozone has primarily been a function of rising real yields. We see current levels as attractive on a historical basis.

US

As we wait for more clarity on the US policy landscape following President Trump's inauguration, we make the following observations on recent economic developments:

- The US economy has exhibited remarkable underlying strength and momentum.
- Significant wealth effects, the overhang of fiscal stimulus and a tech investment boom supported 2023 and 2024 growth.
- High growth rates were enabled by rising labour force participation rate, rapid immigration, and improvements in productivity as new technologies were deployed.
- On the labour market, the pace of hiring has been slowing, fewer workers quitting, and wage gains moderating. The market now appears to have fully rebalanced, and unemployment seems poised to begin exceeding the 'natural rate'.
- Favourable immigration, labour force participation and productivity trends would imply the 'neutral' policy rate has been higher in recent quarters. Whether that remains the case depends on the persistence of these supply side trends.

With the Republican victories in the presidential and Congressional races, we have made significant revisions to our outlook for the US economy and policy.

The new Trump administration has outlined four key policy priorities:

- **Tighter immigration policy, including securing the nation's borders and forced deportations of undocumented immigrants.**
- **Protectionist trade policy, via increased tariffs and trade controls in sensitive technologies and goods.**
- **Deregulation to spur investment, job creation and financing, as well as energy extraction**.
- **An extension of the 2017 Tax Cut and Jobs Act, with further reductions in corporate and income taxes promised.**

Our assessment is that the administration will be keen to make rapid progress on these priorities before the November 2026 mid-term elections.

We believe the new administration will have difficulty pushing through the fiscal objectives. In short, President Trump may not win the backing of several Republican Senators, enjoys only a razor thin majority in the House, and may be advised against largely unfunded tax cuts by his own Treasury Secretary, Scott Bessent.

Furthermore, October's 2023's 'supply Treasury tantrum' could easily occur again should the administration actually pass large unfunded tax cuts. Correspondingly, we think the fiscal stimulus is likely to be far smaller than promised.

Overall, then, we anticipate the US economy to face supply side headwinds from slow immigration, higher tariffs and supply-chain disruptions. Meanwhile, the gains from deregulation are likely to take longer to be felt. The result is likely to be a pivoting towards structurally slower growth with stickier core inflation, as a result of tariffs, less global competition, and a tighter US labour market.

However, the inflationary impact of tariffs is likely to be modest since the US dollar should appreciate as a partial offset.

A more 'stagflationary' economic trajectory should encourage the Fed to take a more cautious approach towards further rate cuts. Our view is that the Fed will pause when rates are at 4.25%–4.50% to assess how supply and demand factors develop over coming months.

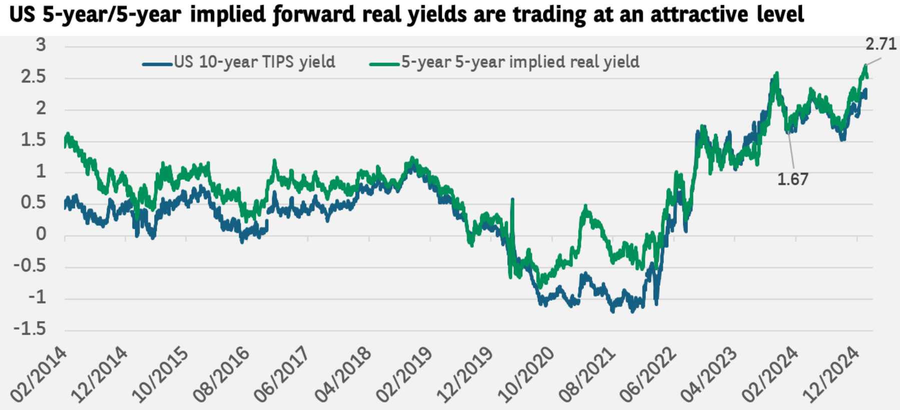
US TREASURY YIELDS

This rate cutting cycle has been highly unusual. White the Fed has lowered rates by 100bp since September 2024, the 10-year US Treasury yield has <u>climbed</u> by about 100bp. This surge was concentrated in 5 to 10-year maturities rather than in 30-year maturities. It has driven implied forward yields back to levels that look attractive, at least from a historical perspective.

At time of writing, 5-year/5-year implied forward real yields are trading above 2.65%, a level that over the last 20 years has repeatedly been a profitable entry point to buy duration (see Exhibit 1).

Exhibit 1

US 5-year/5-year implied forward real yields are trading at an attractive level



In %; source: Bloomberg, BNP Paribas Asset Management; January 2025

The Treasury bond sell-off likely reflects a mix of factors:

- The pricing for the fed funds rate at end 2025 adjusting from 2.80% in September to around 3.95% at the start of January
- Anticipation of rising Treasury supply given Trump's fiscal agenda and the possibility of a shift to notes and bonds issuance
- Higher term premia, as macro-policy uncertainty has risen before and since the election.

We believe the front end of the US Treasury curve could adjust higher in coming weeks once the narrative that the Fed will pause is accepted. On Treasury issuance, supply fears are likely overdone. Macro-policy uncertainty could rise further as the administration releases executive orders and Congress begins legislating. We are also mindful of Trump's unpredictability, on the economic policy front as much as on the geopolitical stage, likely creating asset price volatility.

EUROPE

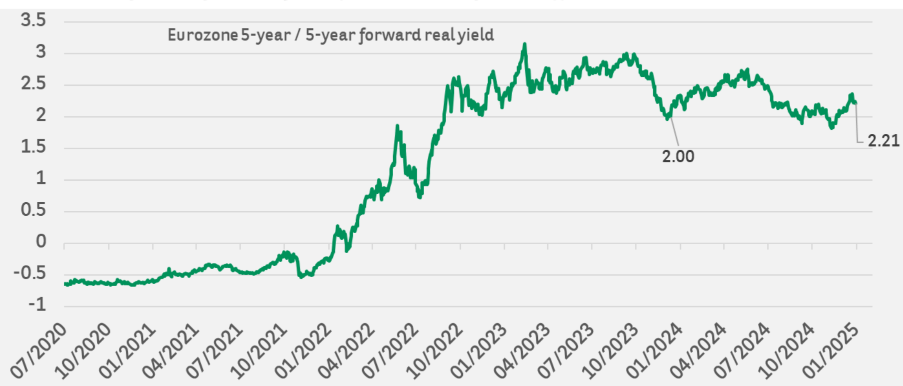
We expect the eurozone to grow at a moderate pace. On the one hand, we see rising real incomes, easing credit conditions, and strength in the 'peripheral' economies. On the other, heightened trade policy uncertainty, malaise in Germany's manufacturing sector, and France's tightening fiscal stance will likely weigh on the economic recovery.

Employment growth is slowing in the eurozone. We believe a further loosening in the labour market should contain wage growth, which should help services inflation to moderate, albeit slowly, in the coming year. The 'last mile' in the ECB's fight against inflation will remain difficult as the 'quick wins' of lower goods and energy inflation are exhausted.

In balancing a weaker growth outlook with still-sticky price pressures, we believe the ECB is likely to continue its march back to a more neutral policy setting until the depo rate reaches around 2%, a level which we would consider broadly neutral. The ECB may be forced to cut to below neutral if the economy weakens more than expectation in response to an escalation in trade tensions or if trade rerouting causes a larger disinflationary impulse.

Exhibit 2

Eurozone 5-year/5-year implied forward real yields offer attractive value



In %; source: Bloomberg, BNP Paribas Asset Management; January 2025

At the time of writing, front-dated interest rate pricing implies an ECB depo rate at around 2% by the third quarter of 2025, which we see as largely fair. Nominal 10-year Bunds have reached 2.60%. Given the downside risk to growth, we believe yields at these levels offer attractive value, and the recent sell-off offers the opportunity to initiate or increase overweights in euro duration.

In sovereign spreads, we see scope for France to underperform Spain. We expect Spain's outperformance versus core economies to continue as activity in Spain's services sector remains dynamic and investment flows from Next Generation EU (NGEU) funds support growth. In France, the new government faces the challenging task of consolidating public finances at a time of political fragmentation. The risk of successive government collapses until new legislative elections are held cannot be ruled out. Further sovereign credit rating reviews are due in the second quarter. Continued uncertainty over France's fiscal trajectory suggests market tensions around French sovereign bonds could reemerge.

UK

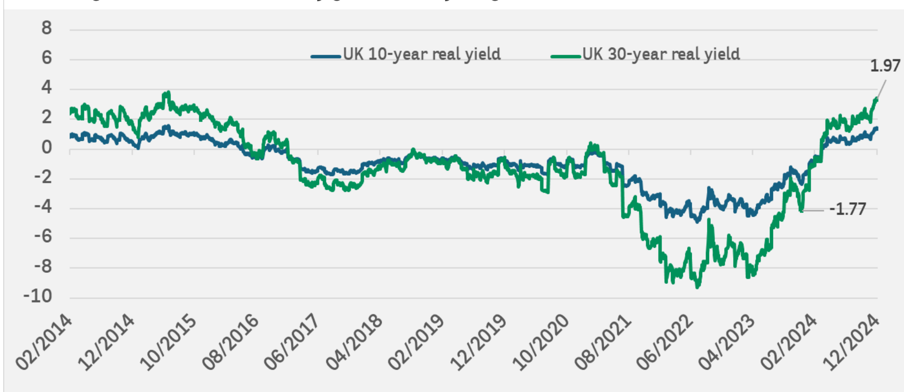
The UK suffered a significant loss in economic momentum in the last quarter of 2024. Fiscal uncertainty and impending tax increases led to a decline in business and consumer confidence, which in turn dampened investment and hiring plans. In 2025, we expect the economy to find stronger footing as the government is set to increase spending. Still, the acceleration in growth will likely be modest as many uncertainties remain.

In the near term, we expect the Bank of England to maintain its cautious and gradual approach in its rate-cutting path, keeping with the 25bp per quarter pace. We believe the risk to this baseline scenario is skewed to deeper and faster rate cuts as we expect the labour market to take a more decisive downturn later in the year.

From a valuation perspective, UK real yields are attractive. At the time of writing, the yield of 30-year UK index-linked Gilts has breached 2%. Similarly, 10-year/10-year forward real yield forward is now above 2.7%, a high not seen since 1998.

Exhibit 3

UK real yields have risen sharply over the past year



In %; source: Bloomberg, BNP Paribas Asset Management; January 2025

The attractive valuation and deteriorating employment outlook lead us to hold a bias to be overweight in UK duration, although the sizing should be modest to reflect the general concerns surrounding debt sustainability, resurgence of inflation and potentially inflationary Trump policies.

On a cross-country basis, we would maintain an overweight in UK Gilts versus US Treasuries. We anticipate continued slowing growth and loosening in the labour market to help ease concerns over the UK's inflation problem. The two countries' growth differential warrants a decline in Gilts yields relative to those on US Treasuries.

On the UK yield curve, we expect steepening of the curve between 2 and 10 years in nominals. In our view, front-dated yields should be well anchored by expectations for steady BoE rate cuts. At longer maturities, the record level of net supply and concerns about debt sustainability could drive further underperformance.

CREDIT

Global corporate bonds performed well in 2024 despite periods of economic uncertainty and political volatility. While uncertainties remain, we retain our positive outlook for the asset class, supported by resilient growth in the US, steady demand and the supportive monetary easing cycle that is under way in Europe.

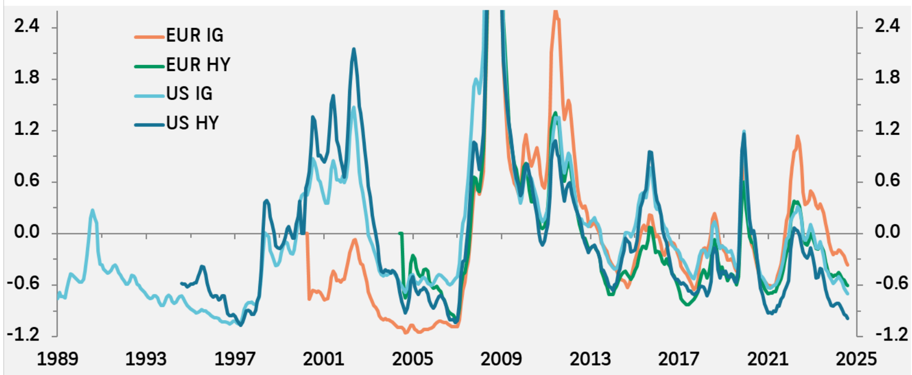
US investment-grade corporate debt continues to benefit from the resilient macroeconomic backdrop in the US and the initial loosening of monetary policy by the US Federal Reserve (Fed). We see no signs of recession in the short/medium term. Indeed, we expect the US economy to remain well orientated in the first quarter of 2025.

Any impact on corporate balance sheets of a slowdown in consumer spending is likely to be mitigated by improved cost management, and rising levels of household debt are partly offset by higher real wages and increased wealth. The new administration's policy agenda remains a source of uncertainty, although a business-friendly approach and deregulation should provide initial tailwinds for corporates.

In terms of credit fundamentals, the peak in credit quality for this cycle is now behind us. Nonetheless, both US and European investment-grade corporates are still in good shape compared to the pre-Covid era. They generally have bigger reserves of cash on their balance sheets, lower net debt and better net margins.

While interest expenses are rising, this is a relatively benign factor for investment-grade debt, most of which is at fixed rates over a longer maturity. Investment-grade corporates have done a good job at managing their balance sheets conservatively in the context of an environment of higher interest rates and uncertainties around the trajectory of the economy.

Exhibit 4
Corporate bonds present selected opportunities



Source: Bloomberg, BNP Paribas Asset Management; January 2025

At the start of the Fed's rate-cutting cycle, the funding environment became more attractive, and credit issuance rose. We expect some issuers to stretch their balance sheets, engage in some form of consolidation and return cash to shareholders.

Recent trends in consumption have uncovered some weak spots in the market, especially in lower-income credit card repayments and car loans. We are mindful of this trend and remain selective in terms of investment opportunities, especially towards the lower-rated, high beta part of the market.

We expect US credit spreads to be supported by relatively high yields and strong fundamentals. US investment-grade credit spreads are tight, leaving the segment vulnerable to any negative change in sentiment. As such, we are selective, seeking to benefit from carry with the expectations that credit spreads will remain range-bound in the first quarter.

In recent months, market technicals have consistently surprised to the upside, with historically high yields generating demand for both US and European corporate debt from across the investment spectrum. We see strong inflows into the segment from exchange-traded funds (ETFs), mutual funds and non-resident investors. It is likely that bond yields will have to fall significantly for there to be a meaningful shift from money-market funds into investment grade debt.

In the primary market, we expect the pipeline of new issuance to meet strong demand, with maturing debt and coupons likely to be reinvested into the asset class. Credit yield curves have flattened overall, led by 10-year and 30-year maturities. We continue to anticipate strong demand for longer-dated yields. In our view, 2025 will continue to see healthy inflows as yields have reached attractive levels for investors seeking to lock in carry.

We see prospects as particularly favourable for financials (banks, non-office real estate investment trusts (REITs)) on account of strong fundamentals and attractive valuations.

The exceptional strength of the US economy relative to other developed markets has to be weighed against the risks of escalating trade tensions. With that in mind, we favour, where possible, issuers mostly exposed to the US economy.

In Europe uncertainty and concerns over the risks of a trade war loom large. European growth is slowing, but only gradually. A recovery in consumption has been dampened by the ongoing structural slowdown in Germany. We expect disinflation to continue this year and next, with inflation to fall below the European Central Bank's target in 2026. We anticipate this to pave the way for further rate cuts from the ECB, with the depo rate falling below neutral in 2025.

Notwithstanding the uncertainties over the US policy agenda, we expect European investment-grade credit to remain well orientated due to healthy fundamentals and the ongoing demand for yield as money-market rates fall. Although spreads are tight, we see scope for further tightening in the first half of 2025. We particularly favour the banking sector, which has benefited from higher interest rates at a time of strong asset quality with capital and liquidity ratios historically high .Costs at European banks have been significantly reduced after widespread restructuring. The sector benefits from strong diversification in terms of geography and business, which should provide resilience against macroeconomic shocks.

Despite the uncertain macroeconomic outlook, we expect default rates in Europe to remain around 3%-4% in 2025. For us, as active managers, security selection is critical in this challenging macro and geopolitical environment.

EMERGING MARKET DEBT

With a supportive backdrop of strong external demand, stabilising inflation and monetary policy easing, many emerging market (EM) economies have robust fundamentals. While their GDP growth is projected to outpace that of their developed market (DM) peers, the first few months of 2025 could see headwinds from renewed uncertainty around the US Federal Reserve's (Fed) rate cutting cycle, the Trump administration's policy agenda, geopolitics and a strong US dollar.

China, the largest EM economy, has been the centre of attention for many investors tracking the country's progress over 2024. It will likely remain a key focus in 2025, as policymakers work to deliver a more proactive macroeconomic policy biased towards consumption and technology, stabilising trade and foreign investment, and rejuvenating the workforce and entrepreneurship. Other critical areas into which policy support is expected to be channelled are the property and stock markets.

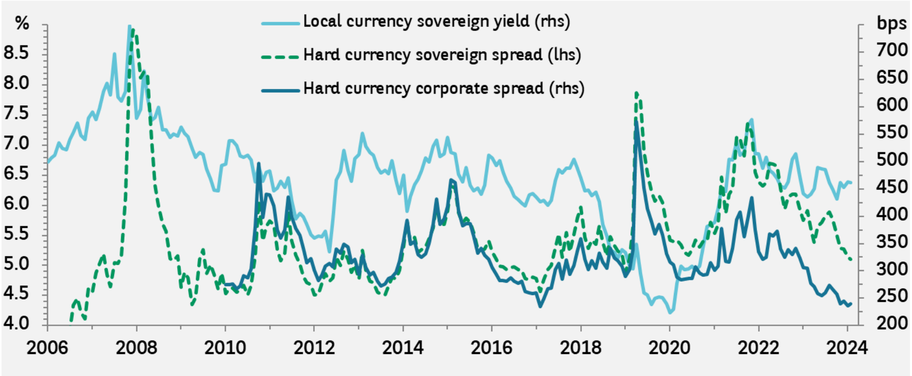
Many countries among broader EMs have a healthy balance of payments and EM sovereign issuers have generally become more prudent in debt issuance and fiscal policies. The Fitch ratings agency accorded EM sovereigns moderate net positive ratings in 2024 as numerous financially fragile emerging market economies improved through progressive economic reforms. We expect further fine-tuning from sovereign issuers over 2025 as some of these countries continue to correct distortions in their foreign exchange markets, rein in public debt, accumulate foreign exchange reserves, and lay the foundations for sustainable growth.

Within EM corporate debt, many issuers are maintaining lower levels of net leverage and have higher interest coverage ratios relative to their developed market peers. We expect their solid fundamentals, along with falling default rates (vs. prior years), and lower valuations relative to DM peers to provide an attractive proposition.

For hard currency EM bonds (across sovereign and corporates), we see US duration risk as broadly balanced. While the consensus view is for the Fed to ease further, the election of Donald Trump has prompted concerns around the pace of rate cuts given his fiscal and trade stances, which could reignite inflation. Given these recent developments, we are comfortable keeping duration positioning within a neutral to slight positive range.

Exhibit 5

Emerging market bonds offer attractive value



Source: Bloomberg, BNP P{aribas Asset Management; January 2025

We maintain our view that EM spreads offer better value vs. their DM peers but acknowledge that they underwent significant compression during 2024. We therefore remain more positive on idiosyncratic cases and selected frontier markets, which we believe still offer attractive opportunities. We view investment grade valuations as excessively stretched, and therefore remain very selective here.

For local currency EM bonds, the overall environment looks attractive. EM economies should remain strong thanks to solid private consumption, investments and exports. Over 2024, a number of EM central banks pivoted to a more accommodative monetary stance, prompted by the start of the US rate cutting cycle. We expect some further easing in 2025, albeit at a slower pace. Some local rates (Latin America and frontier markets) look appealing from a valuations perspective.

Turning to EM currencies, we see improvements in fundamentals, valuations and technicals as reasons to remain positive, despite bouts of volatility. We expect the strength of the US dollar to ease off by the second half of 2025. EM currencies look to benefit from the more resilient EM growth outlook and a wider EM-DM growth differential over the medium term.

In summary, emerging market debt remains an exciting asset class which requires careful navigation of markets over the shorter term. We remain optimistic over the longer-term prospects of the asset class and its ability to offer attractive opportunities to investors.

DISCLAIMER