Macro Talking Points

Fixed Income Insights

Week of 12 May 2025

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In brief

- **Tariff truce = risk-on**
- **The main risk to the USD comes from FX hedging**
- **Our investment team remains fairly prudent towards HY**
- **Global fixed income is back to providing attractive risk-adjusted returns**

Incarceration Day. If April 2 was Liberation Day, today may feel like Incarceration Day. In any case, let's party like it's pre-April 2025. The pendulum appears to be swinging hard following the announcement of major 90-day reductions in tariffs between the US and China, a major boost to risk sentiment. Risky assets are recovering aggressively while US Treasury yields are rising as the risk of recession is priced out. While this is a positive development, it is worth highlighting that policy uncertainty is likely to stay elevated, and therefore there is a risk that macro volatility may represent a major challenge in the period ahead. However, if we get confirmation that there will now be more stability and permanency in the policy environment, this will go down in market history as a major turning point. The most favorable version of Trumpilocks, the prevailing macro regime, is characterized by supportive macro drivers for risky assets: stronger growth expectations, higher yields, tighter spreads and reduced tariff-related inflation fears. With that in mind, inflation-linked instruments may underperform their nominal counterparts — if inflation risks are repriced lower in the face of higher yields. If the Trumpilocks best-case takes hold, we will also likely observe a decline in correlation between equities and bonds — albeit gradually — which means that fixed income is back to providing diversification benefits. Looking ahead, it will be interesting to watch whether flows swing back to the US after the Liberation Day shock to investor confidence.

The dollar on the hedge. While the US dollar appears to be bouncing back, at least for now, benefiting from the trade war truce announcement, there are still some fundamental risks for the US currency. The main one relates to the hedging strategy of international investors. After years of structural dollar strength, it appears that the average hedge ratio of large institutional investors — such as Japanese life insurers — has fallen to historically low levels, partly reflecting the higher cost of hedging. Specifically, the Bank of Japan reported that the hedge ratio of the nine largest life insurance companies fell to just over 40% in 2023 from 60%, historically.[1] Likewise, traditionally, from the European equity investor standpoint, exposure to US equities on an unhedged basis used to offer Europeans both higher returns and lower volatility. This year has proven quite different, however. Overall, if international investors — who have owned an increasingly large share of USD assets — raise their FX hedge ratio, it will likely contribute downside pressure on the USD.

A fairly prudent approach to US HY. Talking to US high yield portfolio manager Mike Skatrud, it's not the right time to turn full-on bullish on high yield. While it is true that the latest developments have been constructive, including potential trade deals and the resilience of the macro data, the valuation backdrop is not compelling to us. US HY spreads have already aggressively recovered since early April, which means that the near-term buying opportunity at the index level is probably gone. We believe that there are still attractive opportunities for the asset class, but they mainly reflect idiosyncratic dislocations and bottom-up security selection. The good news is that asset class fundamentals exited the first quarter in good shape for most high yield credits. The not so good news is that the prospective fundamental outlook is more uncertain than usual, and valuation is back to being full. Perhaps one silver lining for HY at the broader level is that many other segments of global fixed income screen as being even richer from a valuation perspective. Overall, we feel that exposure to HY continues to make total sense in a diversified fixed income portfolio, but a neutral allocation seems to be appropriate at this juncture.

Global fixed income is back. Looking at the fixed income asset class performance leaderboard, I see two key take aways from the year-to-date highlights: (1) The more global, the stronger the performance and (2) fixed income is back to delivering attractive risk-adjusted returns. The top performer in the global fixed income universe has been emerging market local debt, with an impressive 9.03% year to date.[2] All the global indices are at the top of the leaderboard, including Global Agg and Global Credit, both producing returns well north of 4%.[3] We believe that the higher the volatility and uncertainty, the better a globally diversified approach will pay off. And to be clear, we are only talking about index performance here. An active asset manager may be able to take advantage of the global dislocations, relative value opportunities or even currency moves to potentially produce some excess return on top of the index return. At the bottom of the leaderboard stand US tax-exempt munis, the only asset class in the red so far, as well as European aggregate, European investment grade (in EUR terms) and leveraged loans. Beyond the absolute performance, it is also worth pointing out that the risk-adjusted returns in fixed income have been particularly attractive. For many fixed income classes, the ratio of annualized return to annualized volatility stands at well above 1.5, signaling a compelling performance per unit of risk. Overall, with risk management being critical these days, fixed income is back to providing relatively attractive risk-adjusted returns.

Endnotes

[1] Sources: The Bank of Japan. Financial System Report, currency hedge ratios among life insurance companies, October 2024.

[2] Sources: Bloomberg, J.P. Morgan. GBI-EM div index. Data as of 9 May 2025. Returns are gross and in USD.

[3] Sources: Bloomberg. Bloomberg Global Aggregate and Global Indices. Data as of 9 May 2025. Returns are gross and in USD.

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