# Investment Strategy Insights

Monthly Views From Our Diverse Global Investment Teams

PineBridge® INVESTMENTS

# Winners and Losers in a Higher-Rate World

**Hani Redha, CAIA,** Global Multi-Asset Portfolio Manager

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Recent progress on disinflation in the US has stalled somewhat, and potential reflationary pressures from tariffs, fiscal stimulus in China, and revised Fed forecasts of only one or two rate cuts in 2025 are reviving concerns about higher rates for longer. While we still expect a soft landing, featuring modestly below-trend US GDP growth of 0%-2% and successful disinflation to the target level, our attention has shifted to a scenario where US growth remains at trend-like levels or higher (2%-3%) over the intermediate term. Such a scenario would likely entail fewer rate cuts than currently indicated and 10-year yields stabilizing in the 4.5%-5% range. What would be the impact of such a growth and rate environment across asset classes?

The overarching question with persistently higher interest rates is the relative magnitude of the impact on various classes of borrowers. On the consumer side, while lower-income groups already show signs of stress with elevated delinquency levels, it is important to note that overall household debt levels are well below those in previous cycles, as households deleveraged their balance sheets in the post-financial-crisis years. On the corporate level, the greatest difficulties typically arise not when rates are consistently high, but during the transition period, when borrowers – previously prepared for lower rates – must now contend with a higher-rate regime. Businesses that struggle to adapt their capital structures will experience the most significant setbacks. While this is not expected to be a marketwide problem, we could still see more challenges during this transition period for unprepared firms.

In the credit space, fundamentals remain strong, with robust interest coverage that's well above average across both investment grade and high yield segments. Thus, even in a higher-rate environment, these segments' credit fundamentals should remain resilient, with problematic situations being largely idiosyncratic. It's the leveraged loan and private credit markets that may see more widespread stress over time, as these borrowers have most of their debt in floating-rate financing and could find themselves paying a substantial (and growing) share of their revenues toward debt servicing. This is the weakest link in the credit complex, and the availability of capital to refinance this debt will largely determine ultimate outcomes. At this point, we see only muted risks of a disruptive resolution to this issue, as dry powder is plentiful and the maturity profile is relatively manageable. But our work also suggests that rate levels in this scenario will be a persistent headwind to US growth, as the financing structure of the economy grinds higher over the medium term.

In emerging markets, persistently higher rates could pose a headwind for EM debt, but this is likely to be manageable as EM fundamentals have strengthened alongside improving market conditions. The primary concern is less about the level of rates – as long as growth remains robust – and more about their longevity. Potential issues loom between 2026 and 2029, with a maturity wall that could present significant challenges to specific countries if rates stay elevated. Perhaps even more than the US economy itself, higher US rates will also be a growth headwind for emerging markets as they contend with higher borrowing costs.

In the equity market, higher yields generally have a negative impact on valuations, particularly affecting longer-duration sectors. However, this is only if the rise in yields is due to inflation sans growth; contrary to common perception, if growth is also robust, higher bond yields are consistent with higher equity valuations. Among sectors, the response to higher rates is mixed. The financial sector often benefits as higher interest rates (and steeper yield curves) boost net interest margins, enabling banks to leverage their deposits more profitably. Conversely, industrial sectors could see dampened

### About This Report

PineBridge believes that not only do differences of opinion make markets, but they also foreshadow substantial moves ahead as these differences are resolved. Once a month, investment leaders from our global multi-asset, equities, and fixed income teams meet to share their diverse viewpoints. This report reflects those discussions and debates by providing insight on the topic of the month along with snapshots of our asset class views and convictions across the firm.

capital expenditure intentions due to prolonged high rates, particularly affecting industries like construction with heavy capex demands. For now, prevailing rate levels are manageable; capex opportunities that take advantage of new technologies offer highly attractive returns on investment capital, albeit with modestly lower net returns.

While a higher-rate environment could pose challenges for certain segments during the transition period, the key message from both our top-down and bottom-up networks is that higher rates driven by higher inflation *and higher growth* are not problematic. In fact, this is a *healthier* environment that most business owners welcome, in contrast with the previous regime of weaker growth, inflation, and lower rates.

We also appreciate that eventually *the cure for higher rates is higher rates,* with the level and distribution of debt, and the rising burden of interest expense, acting as an anchoring weight that tugs growth lower over time. Crucially, this protects the economy from what would be a disastrous scenario, namely a runaway economy that sees growth and inflation reaccelerate unsustainably. This reflexivity is what keeps the soft-landing scenario of slowing growth and inflation our base case, and provides for an attractive risk-reward tradeoff for investors to continue leaning into risk.

## Conviction Score (CS) and Investment Views

The Conviction Scores shown below reflect the investment team's views on how portfolios should be positioned for the next six to nine months. 1=bullish, 5=bearish, and the change from the prior month is indicated in parentheses.

### Global Macro

**Sam McDonald**
Sovereign Analyst,
Global Emerging Markets
Fixed Income

CS 3.00 (unchanged)

With the US economy supported by a robust labor market and continuing consumer demand, the theme of US exceptionalism has reemerged, with growth remaining on trend in the near term. However, with major policy decisions coming from the new administration, the outlook for the latter part of 2025 is less certain. Push/pull factors and sequencing of policies will determine the path for the US economy, even if the structural outlook, underpinned by AI, regulatory changes, and relatively lower energy prices, is positive. Current expectations around immigration, tariffs, tax cuts, and deregulation point to a drag on net growth from the fourth quarter onward, but remain compatible with a "soft landing" scenario over a 12-month view.

December's robust 256,000 non-farm payroll numbers, which again pointed to a firming labor market following the weakness in August, underscores the economic resilience that is expected to hold until after the year's first half. Services were the main driver of the strength, with an increase of 43,000 jobs and a 73,000-job swing from October. Separately, other labor market indicators pointed to stabilization, with Job Openings and Labor Turnover Survey (JOLTS) and initial jobless claims having found their footing in recent months following gradual moderation since mid-2023. Immigration restrictions and potential deportations will reduce labor supply growth, constraining the unemployment rate in the near term; the hiring rate continues to moderate gradually, but job separations remain low.

Recent concerns around strong sequential Consumer Price Index (CPI) prints have subsided somewhat following the release of the December CPI and Producer Price Index numbers, which point to a deceleration. Core goods inflation slowed, and downward surprises in health services and car insurance offset the expected rebound in rental inflation. Both indicators suggest a resumption in the disinflationary path going forward, notwithstanding the uncertain impact of tariffs. However, the Fed will remain cautious amid continued signs of robust economic activity and the effects of residual seasonality in the first quarter.

Retail sales data also indicate that the Fed does not need to cut rates in the near term. Total retail sales increased 0.4% month over month, while the control group rose by 0.7%. Some of this strength is likely underpinned by frontloading of purchases ahead of tariffs, as well as a rebound from hurricanes in September and October. Nonetheless, the firmness in the labor market will keep income growth robust in the near term, supporting the consumption outlook.

China's fourth-quarter GDP data came in above expectations, showing an economy growing by 5.4% and boosted by export-encouraging stimulus measures that were front-loaded. Western Europe's weakness appears to have continued in the fourth quarter, with growth in Germany and the UK expected to be flat or slightly negative. The European Central Bank (ECB) remains concerned about the level of service inflation in the euro area, but favorable base effects over the coming months should be supportive; rising energy prices pose upside risks.

## Rates

**Gunter Seeger**
Portfolio Manager, Developed Markets Investment Grade

CS 3.25 (+0.25)

Our overall forecast for 2025 is that 10-year yields will rise globally, with our top picks losing the least. We see the US 10-year reaching 5.00% before settling down to around 4.75% at year-end. We view the risk as skewed to higher rates, not lower. If the 10-year were to approach 4%, it would be a fantastic short; if it approaches 5%, it still would not necessarily be cheap.

Our favored developed market (DM) investment-grade 10-year is Japan, which closed last year at 1.07%. It is cheap on a hedged basis. Next in line is last year's worst performer, the UK 10-year, at 4.55%. We expect the German 10-year, which closed 2024 at 2.35%, to be the worst performer in 2025. Almost as bad as Germany will be Canada, whose 10-year closed 2024 at 3.21% and will likely be significantly higher in 2025. With France's 10-year closing the year at 3.19% and Greece at 3.18%, we believe one of the two is mispriced by a magnitude.

## Credit

**Steven Oh, CFA**
Global Head of Credit and Fixed Income

CS 3.50 (unchanged)

In recent weeks credit markets have been driven by the upward move in the yield curve, a response to strong economic data and the Fed's resetting of expectations regarding easing in 2025 in light of stronger-than-expected employment data, which extended the buoyant outlook for the US economy. In contrast, the European economic outlook has been less favorable, particularly in Germany and with concerns relating to the UK. Expectations of central bank easing therefore diverged, with the Bank of Japan, in fact, expected to hike rates. While the rates market received some relief in mid-January with favorable inflation data, expectations of near-term volatility remain. For US credit in particular, spreads have moved inversely to rates, since the move up is being driven by the strength in fundamentals. Combined with strong technicals in the form of high demand and low net supply, spread valuations continue to tighten.

We are starting 2025 in the environment we had been predicting — supportive credit spreads in the face of tight valuations. As a result, we maintain our defensive conviction score while our more beta-neutral portfolio positioning remains unchanged.

## Currency (USD Perspective)

**Anders Faergemann**
Senior Sovereign Portfolio Manager, Emerging Markets Fixed Income

CS 3.00 (+0.25)

Foreign exchange and rates markets are pricing in our "trend/high for longer" scenario for the next three to six months, suggesting the Fed's inaction in January could turn into a longer pause in monetary easing. Rising global yields, led by the US, have strengthened the US dollar, supported further by US exceptionalism and divergence in monetary policy expectations. However, over a longer time frame, delayed policy normalization and more restrictive Fed monetary policy may eventually push growth lower in the US and unwind some of the current market moves, including US dollar strength. We favor a "soft landing" scenario over a 12-month horizon and therefore are moving our conviction score to 3.00 (neutral on the US dollar) on a tactical basis. Timing will be critical in positioning for a reversal in the US dollar, but with parity vis-à-vis the euro firmly in play in the first quarter, an opportunity to take profits in long US dollar positions may arise, especially amid signs that the pace of ECB rate cuts could be tempered by sticky inflation in Germany and budding signs of recovery in peripheral EU countries.

A combination of an extension of US exceptionalism, a hawkish Fed pivot, and higher inflation expectations into the first quarter – primarily driven by fears of Trump 2.0, as well as by residual seasonal factors – have driven US yields more than 100 basis points (bps) higher since September, in stark contrast to the Fed cutting interest rates by 100 bps. There is a significant term premia element to the rise in yields since September. The source of this change in risk perception is less clear, but uncertainty surrounding the magnitude and sequencing of Trump's policy announcements is influencing market sentiment.

## Emerging Markets Fixed Income

**Sam McDonald**
Sovereign Analyst, Global Emerging Markets Fixed Income

**USD EM (Sovereign and Corp.)**
CS 3.00 (unchanged)

**Local Markets (Sovereign)**
CS 3.25 (unchanged)

The macro environment remains favorable for most emerging markets (EMs), with fundamentals improving. These improvements are reflected in the number of sovereign credit rating upgrades, with 2024 being the best year for upgrades since 2011. Looking ahead, the number and aggregate index weight of upgrade candidates far exceed those of downgrade candidates, and include several potential rising stars: Oman, Serbia, and Azerbaijan. Our expectation for commodity prices is also optimistic for the asset class, with new sanctions on Russian oil shipments, continued OPEC quota compliance, and colder-than-average weather leading to higher prices.

EM spreads remain supported by US macro data, pointing to a robust growth environment in the near term. Rising risks around tariffs will be harmful for some EMs, and near-term trade uncertainty will weigh on growth and investment. Nonetheless, the EM-DM growth differential outlook for 2025 continues to paint a positive picture for EM assets, and some EMs (such as Turkey, Montenegro, and India) may benefit from Trump 2.0. With waivers and exemptions, we expect the actual tariff rate to be lower than the initial headline number.

In the corporate space, EM's fundamental picture remains resilient. Third-quarter results have come in as expected, with a skew toward the positive in line with expectations. The default expectation for 2025 for the CEMBI BD High Yield Index is 1.7%, at the lower end of the 10-year range. While gross supply expectations for 2025 are higher than the 2024 figure, the net should be about US$83 billion lower, which underpins a firmly positive technical for EM corporates. January supply, while active, has been well absorbed, with elevated cash levels and ongoing crossover demand.

We expect the market will discern those EM issuers that boast sound policymaking and a credible direction of travel for fiscal and monetary policy. International financial institutions and bilateral lending continue to provide momentum for external sector improvement in some countries, including Egypt, Jordan, and Nigeria.

More persistent inflation and the anticipation that the policy mix under President Trump will keep the Fed more cautious, as well as the added uncertainty around the sequencing of policymaking and any second-order effects from these policies, will likely keep EM central banks on the conservative side. Especially in the face of a potentially stronger US dollar, this means a slower pace of cuts, with many countries possibly leaving rates above their neutral level.

## Multi-Asset

**Sunny Ng, CFA**
Portfolio Manager, Global Multi-Asset

CS 2.50 (unchanged)

The December Federal Reserve meeting took markets by surprise by resetting inflation expectations higher and policy cuts lower. Following the meeting, core personal consumption expenditures (PCE) data for November suggested that the inflation trajectory portends continued progress rather than stickiness. We see this confluence of temporary reflationary pressures as a potential buying opportunity should market participants get head-faked on this reflation, just before disinflation recommences and productivity increases in the second half of 2025. We do, however, expect a scaled-down and stretched-out version of tariff and immigration policies alongside pursuit of other approaches to trade resets, extending the current flatlining.

Meanwhile, the labor market continues to slowly soften, as highlighted by the quits rate, initial jobless claims, and JOLTS data. The overall labor market has shifted from its previous overheating state to more normal conditions and is, in fact, currently transmitting disinflation. This is reassuring, given the key role wages play in services inflation over the intermediate term. Our view is that US economic growth is already stable at a healthy pace and likely to improve in the years ahead, fueled by a pro-growth agenda featuring tax cuts and deregulation as well as the nation's current grip on AI enablers.

In Europe the growth backdrop remains subdued, with some stickiness to services inflation, particularly in Germany. The slowdown in China's policy stimulus may subside once Trump's trade initiatives are rolled out. All told, growth gaps are poised to expand in favor of the US.

## Global Equity

**Rob Hinchliffe**
Portfolio Manager,
Global Equities

CS 3.00 (unchanged)

Markets remain volatile, driven by the optimism and uncertainty surrounding Trump, sticky inflation, and higher rates. Time will tell, but the market is expecting an extension of the Trump 1.0 personal income tax cuts, deregulation, and a lower corporate tax rate. Tariffs and a stricter immigration policy are expected too, with the impact uncertain.

Consumer spending is steady and real wage growth has been positive since 2023. While a key manufacturing indicator, the Institute for Supply Management's Purchasing Managers' Index, remains bearish, it has the potential to expand based on management commentary. Earnings forecasts suggest the tech sector's relative strength will continue this year. Small caps are more exposed to higher rates.

Volatility highlights the many ways to be wrong in this market, yet themes including efficiency, innovation, near-shoring, and digitalization continue. Capex and R&D spending are robust. Companies are competing and the market is rewarding winners.

We expect that 2025 will offer active managers a good environment. We maintain balance in the portfolio across our stable and cyclical holdings, as always. This has proven to be particularly important as market debates remain elevated.

## Global Emerging Markets Equity

**Taras Shumelda**
Portfolio Manager,
Global Equities

CS 2.75 (-0.25)

The drivers of EM equities are coming almost full circle to the beginning of 2024, when US rate cut views dominated the markets. Today, however, concern about a lack of rate cuts is what is driving behavior. Fears of trade wars and sanctions and their impact on corporate earnings are raising volatility. The US dollar's 10%-plus increase is pressuring equities in some markets irrespective of fundamentals. Since 30 November, only two sectors exceeded the benchmark.

In China, investors are trying to position for the slowing economy and the risk of a tariff war. Earnings forecasts are still trending up, but with wide sector variations. In Korea and Taiwan, the focus is on chipmakers' quarterly reporting and guidance. Thus far we saw indications of one large miss and three beats. In India, concerns about growth are beginning to dampen investor confidence and earnings expectations.

In the Middle East, there are tentative hopes for a peace deal. In Latin America, markets are pressured as disappointing macro news trickles into bottom-up fundamentals. In EMEA, there are concerns about GDP growth in Poland and Hungary, but thus far they do not appear in earnings forecasts.

Amid the current uncertainty, we continue to focus on companies with strong and improving business models, quality management, sound financial structure, and adherence to ESG values. Such companies are less likely to be impacted by political outcomes.

## Quantitative Research

**Qian Yang**
Fixed Income
Quantitative Strategist

Entering the optimistic zone, our US Conviction Score saw a solid improvement due to rapid curve steepening of 27 bps, while credit spreads held their footing and even tightened by 2 bps.

Global credit forecasts worsened and continue to be negative. Our relative model favors EM over DM. In DM industries it favors brokerage and banking and dislikes basic industry, consumer goods companies, and utilities. Among EM industries, the model likes financials and pulp and paper, and it dislikes transportation, oil and gas, and metals and mining.

Our global rates model forecasts lower yields for North America and Oceania and higher yields for Japan and most European countries. The rates view expressed in our G10 model portfolio is neutral to slightly overweight global duration. It is overweight the UK, New Zealand, Australia, Sweden, and Japan and underweight Europe and North America. Along the curve, it is overweight six-month, 10-year, and 20-year durations and underweight two-year, five-year, and 30-year durations.

All market data, spreads, and index returns are sourced from Bloomberg as of 21 January 2025.

## About PineBridge Investments

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 30 September 2024, the firm managed US$203.1 billion across global asset classes for sophisticated investors around the world.

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