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2025 Midyear Fixed Income Outlook: Going Global Amid Deglobalization

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- US credit and its underlying fundamentals have long been viewed as superior, but the differential is shrinking – and given the tight valuations across financial assets, we favor reducing the substantial overweight to the US toward more neutral exposures.
- European leveraged loans are looking more and more like an attractive alternative to US risk assets, with many investors underexposed to the region, which is looking at a resurgence amid pressure to retool its fiscal expenditures, especially in Germany.
- Parts of emerging markets are also on a solid footing, with the vast majority of EM corporates having fairly minimal direct exposure to trade to the US. We also believe recent volatility highlights Asian US dollar credit as an interesting alternative to US and European fixed income, particularly in a drawdown environment.
- Credit spreads have tightened dramatically from the wides in April, and the primary market is coming back to life. While we do not expect further spread compression, and returns will be driven by yield going forward, we believe high yield bonds, bank loans, and CLO debt tranches all have attractive relative return potential under these conditions.

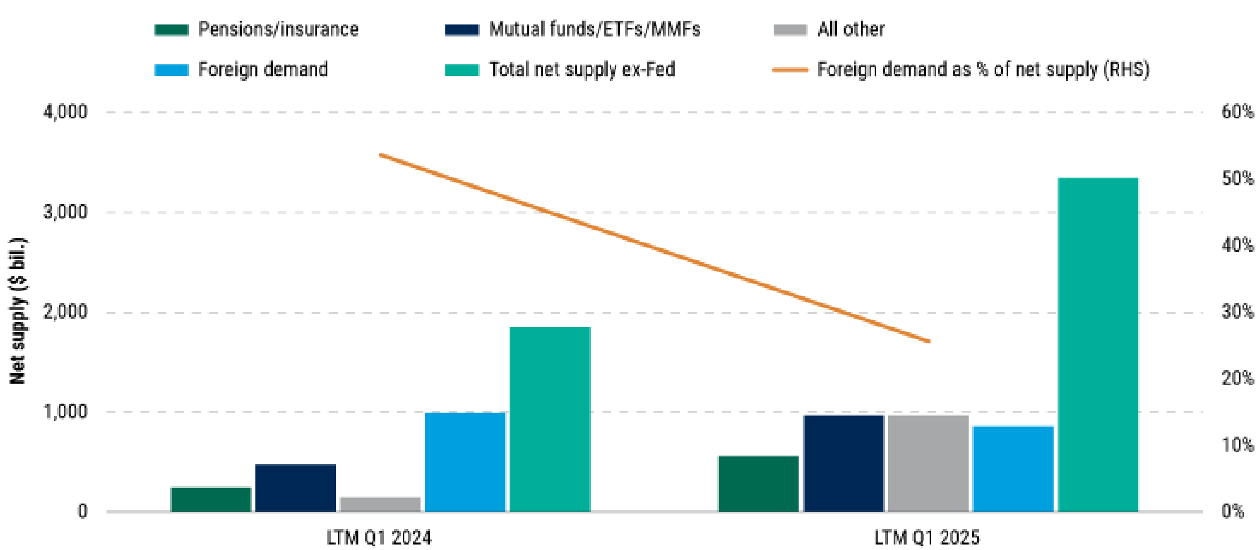
The corporate credit markets have remained surprisingly calm relative to rates and equities amid the recent tariff rhetoric and policy-related chaos, with support from a solid foundation as the economy and markets head into a potential deceleration, albeit from a period of strength.

The key questions for fixed income investors, who are grappling with head-spinning shifts in the financial world order, have turned somewhat existential: Will the US government's actions more permanently erode the long-term attractiveness of US financial markets? And if so, what does this spell for the long-established trend of US exceptionalism, which had created a massive concentration in US assets?

US credit, and its underlying fundamentals, have long been viewed as superior, but the differential is shrinking – and because of that, and given the tight valuations across financial assets, we favor reducing the substantial overweight to the US toward more neutral exposures. Therefore, we support a more global fixed income approach that considers the potential benefits of Europe, Asia, and parts of emerging markets as critical components of a diverse portfolio.

The sell-off in Treasury bonds in recent months may signal anticipation of reduced future demand from marginal foreign buyers and is likely one of the reasons for a weaker dollar. If confidence and trust in the US take a more permanent hit, the longer-term implications for demand and pricing of US assets could weigh on future growth – in terms of both corporate earnings and macro trends.

Foreign Demand for US Bonds Has Declined



Source: Federal Reserve, Barclays Research as of 17 June 2025. "All other" includes GSEs, state and local governments, banking sector, brokers/dealers, other financial companies, non-financial corporate and non-corporate business, households, and REITS. Households are estimated as a residual category.

That said, we do not expect the US to lose its prominent position in financial markets nor face an end to its exceptionalism anytime soon. Rather, we see the gap with other regions compressing – and believe investors may benefit from becoming more diversified, both globally and across asset classes and sectors.

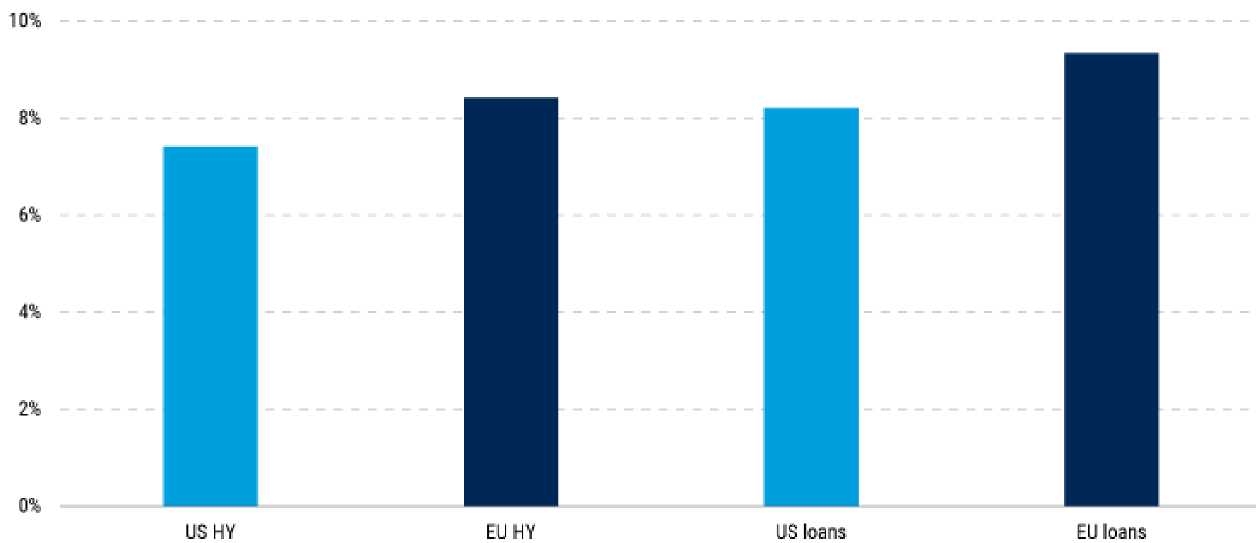
Extending into Europe, Asia, and emerging market debt

Where are we seeing opportunity today? One area where we are now more constructive is European credit, particularly European leveraged loans. Many investors are underexposed to the region, which is looking at a resurgence amid pressure to retool its fiscal expenditures on both the military and infrastructure, especially in Germany.

Europe may also benefit from a kind of forced collaboration on trade issues and spending after the bloc had previously started to fracture, leading to a more positive outcome down the road (despite some short-term pain). European leveraged loans are looking more and more like an attractive alternative to reduce overexposure to US risk assets, including mature equities and not just US credit.

EU Debt Is Looking Attractive

USD hedged yield comparisons: US and EU leveraged loans and HY bonds



Source: Bloomberg and J.P. Morgan as of 16 June 2025. US high yield is Bloomberg US Corporate High Yield Index; EU high yield is Bloomberg Pan-European High Yield Index; US loans is J.P. Morgan Leveraged Loan Index; EU loans is J.P. Morgan European Loan Index. It is not possible to invest directly into an index. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Past performance is not indicative of future results.

Parts of emerging markets are also on a solid footing, with the vast majority of EM corporates having fairly minimal direct exposure to trade to the US. Notably, the banking sector across emerging markets is generally well-positioned to withstand downside risks in the global economy, and while rate cuts have reduced profitability, these cuts factor into a stable economic outlook that supports loan quality and liquidity across the system.

We also believe recent volatility highlights Asian US dollar credit as an interesting alternative to US and European fixed income, particularly in a drawdown environment. Many investors are leery of Asia amid concerns that Trump's tariffs, while directed largely at China, could have a broader impact as China's manufacturing has shifted to other Asian countries. The underlying economies are nonetheless quite robust, however, and we see an attractive opportunity set in Asia ex China debt.

Leveraged finance: Attractive yield remains after the bounce

Credit spreads have tightened dramatically from the wide levels in April, and the primary market is coming back to life. Fundamentals for leveraged finance issuers remain robust: More companies are beating than missing earnings estimates, with help from a supportive pre-tariff stocking trend. However, more companies are guiding down than guiding up, which is consistent with heightened trade uncertainty. As recession concerns abate, the credit market has erased nearly all of its year-to-date weakness.

While we do not expect further spread compression, and returns will be driven by yield going forward, we believe high yield bonds, bank loans, and collateralized loan obligation (CLO) debt tranches all have attractive relative return potential under these conditions. That said, front-end Treasury rates are now pricing in only two rate cuts in 2025, which we believe makes floating-rate asset classes such as bank loans and CLO debt more attractive on the margin relative to high yield bonds.

That said, the roller coaster trade dynamics and other currents will keep markets fluid, and we expect to see both positive shocks, in the form of deal announcements or teases, and negative ones, such as more aggressive policies or deal disappointments. Despite likely headline-driven volatility both ways in the coming months, we believe the risk is balanced, but tight valuations tilt incrementally toward a more defensive portfolio bias by reducing higher-risk positions.

In high yield bonds we expect positive, carry-based total returns (but muted excess returns) and believe defaults could trend a bit higher in 2026 but from current very low levels. We maintain a neutral portfolio stance following recent spread tightening.

In leveraged loans, improved forecasts for bank loan carry should compensate investors for increased uncertainty about issuer fundamentals over the near to medium term. Distressed activity could tick up in select sectors, but we expect broader measures of distress to remain relatively stable outside of a sharper economic downturn.

In CLOs, while the characteristic yield advantage has come down somewhat, higher-quality CLO debt is still offering an attractive premium at a time when asset class valuations in many areas have stepped back toward cyclical tights. CLO equity is also appealing due to its high and front-loaded income potential and embedded optionality. After outflows in April, we've begun to see inflows into CLO ETFs (mostly AAAs). We have also witnessed renewed demand from US and Japanese banks in the primary market, along with strong demand for CLO mezzanine tranches across insurers, money managers, and hedge funds, which is helping to stabilize spreads and improve equity arbitrage.

Diverse buying opportunities in investment grade credit and rates

While we don't believe investment grade (IG) credit is at significant risk from the stop-and-start tariff policies and other geopolitical risks, we think a cautious approach that looks to more diverse options, including non-US credit and rates, is warranted to help avoid overexposure to risk and to tap broader potential opportunities.

Indeed, whereas most investors had gravitated to the US recently from a rate standpoint, the US looks set to face an economic slowdown. This would point to lower rates, but the curve could be pressured by a rising future supply of Treasuries when incremental demand may be declining. Moody's recent downgrade of the US is based on expectations of deteriorating fiscal balances and debt levels, and while Federal Reserve members are indicating that they may stay on hold for longer, rate relief will be forthcoming, if at a slow pace.

This makes regions outside the US look more attractive than they had been previously – including European credit, UK sterling government debt, and long-end Japanese government bonds, where yields have risen. Similarly, parts of emerging markets, such as Brazil and Mexico, as well as Asia credit, could be attractive diversifiers as well.

Trimming risk at the tails

De-escalation of trade tensions, particularly with respect to China, has spurred a reversal in sentiment, with the market embracing risk assets once again. With the recent market rally, we've taken the opportunity to trim risk at the tails, given our view that the tariff volatility and its impact on economic growth and policy is not yet over and a slowdown is still playing out.

The market has rebounded nonetheless, providing opportunities to trim some of the highest-risk components, where prices have rallied and no longer seem to reflect any probability that volatility could return in the second half of the year. In short, we've favored reducing select triple-C rated debt and some higher-beta credits while remaining constructive on single-B credits. In leveraged finance, we think single-Bs look especially attractive given that investors have been piling into BBs and that triple-C debt has rebounded.

Valuations look to be at the low end of fair value to us at the market level, but there are securities that remain attractive. Looking ahead, we think spreads are more likely to widen than tighten given the potential for additional negative headlines to emerge and current tight valuations. The combination of shifting macro policy and rising geopolitical risks with tight valuations calls for adding an element of defensive dry powder to credit portfolios, such as high-quality CLO tranches.

Our overarching message to fixed income investors is that it's a prudent time to consider how well they have diversified their sources of both risk and opportunity. We see it as crucial to reduce concentrations in any area that could prove vulnerable down the road, while seeking exposure to regions and companies that provide diversification and improved risk-adjusted return potential.

For more insights into the trends moving markets in the second half of the year, see our **2025 Midyear Investment Outlook.**

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