Fixed Income Asset Allocation Insights

PineBridge® INVESTMENTS

Leaning Toward Risk, But Choosing Our Spots

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Performance was mixed for fixed income asset classes during the fourth quarter of 2024, with more duration-sensitive assets seeing the most weakness as Treasury rates soared. Risk asset classes had already rallied sharply going into the November US presidential election, with economic data supporting a narrative of receding labor market concerns and robust consumer spending. Donald Trump's election victory caused a further rally in spreads as investors bet on lower corporate taxes, deregulation, and more active M&A. However, market participants have expressed concerns over potential inflationary pressures arising from some of the Trump administration's expected policy changes.

In a widely anticipated move, the Federal Reserve cut rates by 25 basis points (bps) at its December meeting, its third consecutive cut, bringing the federal funds rate to a target range of 4.25%-4.5%. However, the cut came alongside a hawkish tone, with inflation holding firmly above the Fed's target level and growth remaining solid. The "dot plot" showed just two 25-bp cuts in 2025, compared to 100 bps when Fed officials last released forecasts in September and market expectations of 75 bps before the announcement. Overall debt levels have also come back into focus as the market struggled to digest high levels of Treasury issuance, resulting in significantly higher yields.

Meanwhile, the eurozone economy faces continued challenges heading into 2025. Weaker economic data, particularly out of Germany, has led the ECB to cut its 2025 growth forecast, saying that the risks to growth remain tilted to the downside. Political upheaval also threatens the outlook for the region, and the Trump administration has created uncertainty about how swift and forceful potential trade restrictions may be. The weaker economic outlook for Europe should allow the ECB to cut rates at a steady pace, with the net outcome a stronger US dollar.

Overall, the credit market remains characterized by rich valuations with strong, but weakening, fundamentals and a supportive technical backdrop, as high all-in yields have led to robust demand. Yield and carry should be the dominant drivers of returns over the next 12 months. Ultimately, our base case remains that we are in a rare non-recessionary rate-cutting cycle in the US that should support credit performance in 2025. The US election's red-sweep outcome is expected to add to pro-growth policies and further support risk assets from a fundamental perspective, while introducing potential headwinds outside the US amid more restrictive trade policies. Despite rich valuations, we continue to have a slight bias toward risk but remain selective across industries and issuers, as opposed to broad risk-on positioning.

About This Report

Fixed Income Asset Allocation Insights is a quarterly publication that brings together the cross-sector fixed income views of PineBridge Investments. Our global team of investment professionals convenes in a live forum to evaluate, debate, and establish top-down guidance for the fixed income universe. Using our independent analysis and research, organized by our fundamentals, valuations, and technicals framework, we take the pulse of each segment of the global fixed income market.

Our Asset Class Outlooks

Investment Grade Credit

Supply, corporate earnings, and outlooks are likely to be the key factors determining the direction of credit spreads in the near term. Currently, spreads remain range-bound. Over the longer term, we expect spreads to move modestly wider due to a typical increase in supply and a focus on the ongoing risks to the economy. Domestic support should continue in the US due to higher overall yields, while foreign interest will be bolstered by lower hedging costs as the Fed moves short-term rates lower.

Securitized Products

Uncertainty surrounding Fed maneuvers has doused the exuberance from the "Trump bump." Volatility for mortgage-backed securities (MBS) has crept back as rate-cut expectations have been tempered.

Meanwhile, commercial MBS spreads are moving tighter in tandem with investment grade (IG) credit spreads, despite a lack of fundamental improvements for pre-Covid commercial real estate loans.

Leveraged Finance

We believe that defaults will remain relatively stable – trending higher but still remaining below 3%. Fundamental strength in credit metrics appears to have peaked, but started at a high level and should remain strong. Offsetting positive fundamentals are extremely tight valuations, which fully reflect hyper-bullish sentiment. We thus see a benefit in "centrist" and balanced portfolio risk positioning, targeting security selection opportunities to take advantage of divergent prospects among issuers.

Emerging Markets

Overall, high carry and robust fundamentals should support the asset class. 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 emerging markets, 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 issuers may benefit from Trump 2.0 policies.

Non-US-Dollar Currency

Foreign exchange (FX) and rates markets are pricing in our "trend/high for longer" scenario for the next three to six months, suggesting the Fed's "skip" in January could turn into a longer pause on monetary policy easing. Timing will be critical in positioning for a potential reversal in the US dollar should growth slow, but with parity vis-à-vis the euro firmly in play in the first quarter, an opportunity could present itself to take profits in long USD positions, especially amid signs that the pace for ECB rate cuts could be tempered by sticky inflation in Germany and budding signs of recovery in peripheral EU countries.

Segment Snapshots

Using our independent analysis and research, organized by our fundamentals, valuations, and technicals framework, we take the pulse of each segment of the global fixed income market.

Investment Grade Credit

US Dollar Investment Grade Credit

Dana Burns, Portfolio Manager, US Dollar Investment Grade Fixed Income

Fundamentals

Fundamentals remain firm, with good balance sheet strength and solid leverage metrics. M&A may have more of an influence on IG credit metrics in 2025.

Valuations

Credit spreads remain at the tighter end of the range despite the recent spread widening and strong supply in the first half of January. Select credits continue to offer good value.

Technicals

Demand for US IG credit remains strong despite tighter yields due to attractive all-in-yields. Looking ahead, sizeable coupons next year due to the rising rate environment will likely tamp down spread volatility. Reduced 30-year issuance continues to support the long end of the curve.

Non-US-Dollar Investment Grade Credit

Roberto Coronado, Portfolio Manager, Non-US-Dollar Investment Grade Credit

Fundamentals

Neutral. Companies in general continue to post decent results while balance sheets remain healthy and M&A activity remains low. Management teams however are providing cautious outlooks, citing limited visibility into future sales/margins as the economic outlook remains uncertain.

Valuations

Neutral. We see credit spreads close to fair value and expect the index to trade within a range in the coming weeks and months. A large index move in either direction is unlikely, in our view. For that reason, we believe sector and security selection will be the key to outperformance.

Technicals

Positive. Flows into euro corporates have been strong for the last 12 months, while supply has been well absorbed despite being higher than in previous years. Investors continue to be better buyers of credit, and new issues are performing well.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

Interest rate volatility is rising again. It had been whipsawed before and after the election, with a steady downward projection from a Trump win. The December FOMC meeting, however, has reignited uncertainty, which is a headwind for MBS.

Valuations

Given the strong rally in credit markets going into the end of the year, MBS is still in the cheap zone relative to investment grade credit spreads.

Technicals

If indeed Trump policies play out, reducing bank regulations and capital rules, banks will likely feel confident about adding MBS back onto their balance sheets in 2025.

Leveraged Finance

John Yovanovic, CFA, Co-Head of Leveraged Finance

Fundamentals

Last-12-month (LTM) default rates, with and without distressed exchanges, were 1.14%/0.34% for bonds versus 4.56%/0.94% for loans. We expect default rates to remain low in 2025, though with some uncertainty surrounding a few large liability management exercise (LME) possibilities. The EBITDA beat-to-miss ratio in the US was strong, at 2.5x. In Europe, certain sectors, including chemicals, building materials, and autos, remain soft. Non-cyclicals, on the other hand, are showing low single-digit growth.

Valuations

Certain sectors, such as autos, cable/telecom, energy, and metals and mining, experienced year-over-year revenue declines, while chemicals, healthcare, leisure, services, and transportation saw revenue gains. LTM par-weighted default rates (with and without distressed exchanges) were 1.47%/0.36% for high yield and 4.7%/0.91% for loans.

Technicals

Both fixed and floating-rate assets are still in high demand. New collateralized loan obligation (CLO) formations are robust, and retail fund flows are positive. While supply is likely to be higher than last year, we expect to remain undersupplied in general. Despite loan prices near par and high repricing activity, CLO economics are still favoring creation and still seeing record demand.

Emerging Markets

Sovereigns

Sam McDonald, Sovereign Analyst, Emerging Markets Fixed Income

Fundamentals

EM growth trends are structurally strong, supported by increasing fiscal discipline and reform momentum. The external picture is allowing for more robust current account surpluses, combined with increasing remittance and foreign direct investment/foreign portfolio investment (FDI/FPI) flows – enhancing levels of FX reserves. Political and geopolitical risks remain high.

Valuations

At 323, the EMBI is 3 bps wider month over month and 2 bps wider year to date. Spreads are now back to their March/April 2024 tights following the US election and continued robust US economic data, which has shifted market sentiment away from recession concerns. IG spreads moved 3 bps wider month over month, whereas HY moved 9 bps tighter.

Technicals

Issuance in 2025 is expected to be closer to the historical average at around $170 billion gross. Net supply will see a reduction versus 2024, with 2024 issuance coming in stronger than expected, driven by higher supply from IG names. HY has opened more, with names that have a good story (e.g., Nigeria) able to issue, in addition to new names (such as Montenegro and Benin). EM hard currency funds continue to see outflows.

Corporates

Kim Keong, Trader, Emerging Markets Fixed Income

Fundamentals

The fundamental picture remains resilient, with continued earnings beats, and our Credit Trend matrix remains positively skewed. The EM corporate credit rating trend for 2024 was at +$70 billion or +2.8% of the bond stock, which is the first net positive year since 2012. Most of the positive contributions came from broader rating upgrades rather than specific segments or sovereign-driven actions. We expect this positive trend to continue into 2025 as EM corporate fundamentals remain in solid shape.

Valuations

Over the last month, CEMBI BD STW widened by +1bp, balanced across IG and HY. In terms of regions, CEEMEA has underperformed in IG, while Asia has underperformed in HY, largely due to China and Hong Kong. In IG, the Philippines, Peru, Chile, and Qatar outperformed, while Kazakhstan, South Africa, Thailand, and Nigeria lagged. In HY, Ghana, Ukraine, India, and Nigeria outperformed, while China, Hong Kong, Zambia, and Brazil lagged. Compared to DM, we have tightened in both IG (-6 bps) and HY (-17 bps), returning to the fair value range.

Technicals

Primary activity slowed further in December, with $6 billion in deals printing. Net financing dipped further by $23 billion, from $20 billion of scheduled cash flows and $9 billion of unscheduled redemptions. January has seen an active start to the year, with $23 billion of deals priced through mid-month. Despite $36 billion of scheduled cash flows in January, net financing for the month could turn positive if the issuance pace continues. However, investors still carry elevated cash levels, and the new deals are seeing large book sizes due to ongoing additional interest from crossover investors, which remains a positive factor. In the near term, we are being neutral in Asia technicals.

Non-US-Dollar Currency

Anders Faergemann, Senior Portfolio Manager, Emerging Markets Fixed Income

Fundamentals

Rising global yields, led by the US, have driven the US dollar stronger, 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 current market moves, including USD strength.

Valuations

We have kept our 12-month EUR/USD forecast at 1.0500, premised on the view that we will end up in our "soft landing" scenario over a full 12-month horizon. However, our forecast of EUR/USD parity may come into play at least in the short term. We moved our 12-month USD/JPY forecast up to 150.00, but the short-term risk is for the yen to remain weak in a world of US dollar strength and uncertainty over the Bank of Japan's rate outlook.

Technicals

According to J.P. Morgan as of 5 January, USD net length at $30 billion is the highest level to start a year since January 2019. JPY net length is off the highs, but at a +0.9 Z-score it is still above recent levels.

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pinebridge.com

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