Fixed Income Insights

Macro Talking Points

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In brief

- **Reviewing the market risk list for 2025**
- **Carry set to be supportive of fixed income returns**

What can go wrong in 2025. Apparently, quite a lot. I surveyed our MFS® community of fixed income portfolio managers and asked them their thoughts on the top risks for this year. Watch out: The result is a bit scary. Overall, they flagged 25 distinct risk factors, which means that macro risk management and volatility are likely to remain major themes in the period ahead. There was a short list that clearly emerged as the most pressing sources of risk. These, unsurprisingly, included renewed inflation, the impact of a global trade war, geopolitics and a potential eurozone crisis. Besides the consensus list, some portfolio managers also expressed concerns over the downside risk to global growth, the risk of a US recession, the risk that AI may underwhelm and trigger a market correction, potential cyberattacks, the risk of a political crisis in France, the risk of surprising rate hikes in G10, the negative impacts of an immigration rollback, a shortage of funding, a volatility event, a private market crisis, the crypto bubble bursting and, finally, excessive market valuations. In other words, 2025 is lining up to be another busy year in global markets. As I see it, the backdrop remains favorable for active investing given the importance of risk management and the potential dislocations and opportunities that may arise as the result of risk-driven market turbulence.

Keep calm and carry on. Despite the daunting list of market risks discussed above, global fixed income can at least count on the positive contribution from one of the key components of its total return expectations: carry. Carry appears set to remain elevated, compliments of HFLFL, my new favorite acronym for the year ahead: higher for longer, for longer. With US 10-year rates close to 4.6%, the income bit from fixed income should indeed play a big role.[1] But to be clear, the outlook is less constructive for the other components for fixed income total returns. Specifically, falling rates because of aggressive US Federal Reserve easing now looks off the table. Meanwhile, the macro backdrop may well be in great shape, especially in the US, but it looks like a stretch to expect significant spread compression from the current level. Which brings us back to carry as the last bastion of supportive return expectations. Credit spreads may appear compressed, but it's important to remember that the total yield valuation picture looks quite favorable, as illustrated by US IG yields well north of 5%. Another source of comfort on the market insights team's radar is that the Fed's hawkish pivot is now fully priced in. Indeed, Fed rate cut expectations have been crushed. At this juncture, the future market only prices in 36 basis points of cuts — *i.e.*, much less than two full cuts — over the next 12 months.[2] That seems quite conservative, which means that it is unlikely that the Fed will under-deliver on the policy front relative to these sober market expectations. Overall, it seems that rate dynamics are likely to continue to drive the show in the period ahead, not only for fixed income but, perhaps, even for riskier asset markets. At what level of rates will the attractive carry of fixed income become a pain point for equities? The rate story also has major asset allocation implications. As the downside momentum in rates is no longer a strong market force, the correlation landscape between bonds and equities will likely be overhauled, with fixed income gradually regaining its attribute as a portfolio diversifier. In other words, the potential drivers of fixed income returns may look quite different from what they were just six months ago, but we believe fixed income is nonetheless well positioned to remain an attractive asset class.

Endnotes

[1] Source: Bloomberg. US 10-year generic treasury yields, data as of 6 January 2025.

[2] Source: Bloomberg. Based on the forward cash curve, data as of 6 January 2025.

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