



## The known unknowns for fixed income

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[· 2025 has been a year of surprises with many certainties predicated at the start of the year erased by the mid-point.](#)

- The known elements of market conditions should be rather supportive for the asset class. How markets will react to the current list of uncertainties is harder to assess.
- These unknowns could create opportunities however as they become known entities for investors.

Over the last few years, returns for bonds has been good and helped investors progressively recover from 2022's challenging environment. However, it has not been a straight line. Indeed, today we have entered a phase of higher structural volatility, mostly due to higher rates volatility.

This volatility reflects the higher level of uncertainty we have faced since central banks enacted the largest shift in monetary policy ever experienced. Markets were also not expecting this volatility: The outlook at the start of 2025 seemed to offer quite a number of certainties: US exceptionalism was going to be strengthened by the Trump Presidency's plans to deregulate and

cut taxes; Europe growth would remain subdued, potentially dampened by a global trade war, and inflation was not expected to be a concern.

All of these certainties have been erased. Instead, it looks like we have never faced so many headwinds. So many headwinds that, despite higher structural volatility, markets seem to have frozen, staying range-bound and unable to assess what is the correct direction for rates over the medium term.

When things go sideways, it usually makes sense to look at what we know and what we don't know.

### **What we know**

- Yields are attractive from a historical perspective with 10-Year bund yield still close to 2.60% and US Treasury 10-Year yield at 4.30%.
- The gap between overall yield and equity dividend yield has never been this thin.
- Yield curves have steepened significantly making bonds competitive versus monetary funds.
- Recent risk aversion phases have reclaimed duration positions as a good hedge for risk asset losses.
- Spreads are tight, close to 10 year lows when looking at investment grade (IG) and high yield (HY) credit. The pickup of HY to IG debt is also at its lowest, reflecting that investors are not well rewarded for taking additional risk in the current environment. Yet, absolute yield levels continue to drive appetite for the asset class.

All of the above should be rather supportive for the asset class, however there is significant uncertainty lying around.

### **What we don't know**

#### **Geopolitics**

Tensions across the Middle East have taken over. Despite a recent ceasefire announcement between Iran and Israel, only half of previous ceasefires in the region have truly held in the past. Meanwhile the Russia-Ukraine war

continues and has the potential to divide the US and its European allies. This division may see the need to accelerate defence spending, further weighing on the fiscal outlook and supply, hence higher rates.

Alongside this, increasing oil prices could push rates higher on the back of renewed inflationary pressure.

### **Trade tariffs**

The tariff trade war rumbles on and the outcomes of any deal discussions mean it is hard to predict with any certainty what it could mean from a rates and growth perspective. On the one hand, any trade deals could support risk assets and take rates higher on the prospect of better growth and higher inflation. But the opposite is also true with lower rates and wider spreads due to lower expected growth. Even if deals are signed, it remains to be seen if they are respected.

### **World de-dollarization**

The US seems to have lost its status of trustworthy ally. This could weigh on its ability to conduct constructive partnerships both economically and geopolitically in the future. It could also drive investments out of the US more broadly as a precautionary approach, supporting euro rates vs US rates.

### **Fiscal outlook**

Both Europe and the US could see further deficit slippage on the back of respectively higher defence spending or tax cuts. Even if this is something well flagged by market participants, it could still drive rates higher.

### **Central bank monetary policy**

The European Central Bank and the Federal Reserve (Fed) both look comfortable with where they stand on rates given current data. However, both central banks are also ready to act in this highly uncertain environment. Any deterioration in employment could trigger a Fed reaction, just as a spike in inflation could affect forward guidance.

The output of all of the above geopolitical risk, trade war, fiscal slippage could force central banks to take action.

Meanwhile, another challenge to confidence could come if Trump announces an early Fed Chair replacement. He has been criticising Powell and the Fed and while the Supreme Court has prevented any early replacement, future involvement by Trump shouldn't be discounted. Even if this should not impact current policy, it can add a dovish tilt to the market, and potentially drive inflation expectations higher thus further steepening the curve.

Most of what we know makes us comfortable with fixed income as the universe remains attractive from a historical perspective as well as in relative terms. Yet, tight spread levels combined with high uncertainty advocate for a diversified approach. In addition, the reason for uncertainty often leads to the same source: the US becoming less and less reliable. This makes euro fixed income particularly relevant.

Most of the unknowns can have a divergent effect, making them hard to assess. But as long-term investors, one could be looking at these short-term unknowns as potential opportunities to seize as these unknowns become known. Yet this will not be a straight line and showing agility and flexibility in terms of duration and allocation within the fixed income universe is likely to be a significant plus.

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