Fixed Income Investment Strategy
June 2025

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Market Outlook

Bond markets have faced renewed pressure over the past month, initially driven by optimism around a potential US–China trade agreement and further strained by the Moody's downgrade of the US credit outlook and broader fiscal concerns. This shift in sentiment has driven a repricing of yields, with rates rising roughly 30 basis points across the curve. Yield curves have also steepened globally, reflecting a mix of factors — including growing unease over sovereign debt levels, reduced demand for longer-dated issuance, and a rising term premium amid heightened macroeconomic uncertainty. While these dynamics have contributed to increased rate volatility, a broader perspective reveals that yields have largely remained range-bound since the Federal Reserve paused its tightening cycle in Q3 2023. Since then, the average yield-to-worst on the Bloomberg US Aggregate Bond Index has hovered around 4.83%, with the index yielding 4.75% at the end of May (see Chart 1).

From an economic standpoint, hard data has yet to show meaningful deterioration, even as soft, sentiment-driven indicators have weakened notably over the past two months. This divergence isn't unusual — the feedback loop from sentiment to actual economic activity tends to be uneven, with timing and magnitude difficult to predict. In the current environment, interpreting the data is further complicated by shifting trade rhetoric and inventory front-loading ahead of potential tariffs. Still, the broader consensus points to a slowdown, and we anticipate the US economy will hover near stall speed over the coming quarters. This subdued growth outlook should help cap yields in the medium term and likely prompt the Federal Reserve to consider rate cuts by year-end. While the Fed can afford to remain patient for now, policymakers are increasingly aware that current rate levels may be too restrictive given the evolving economic backdrop.

For core fixed income, attractive all-in yields provide a strong base for returns, and favorable relative value vs. other assets (see Chart 2). Core investment grade yields near 5% offer a cushion to rate volatility, and when compared to low historical equity earnings yield, still provide fixed income its best relative value in 15-plus years. Our game plan in 2025 remains consistent: lean into yield carry and drive returns through relative value opportunities and security selection, while keeping overall portfolio risk low. Positioning includes a modestly long duration tilt versus indices, a cautious posture in our credit allocation, and a substantial allocation in agency MBS.

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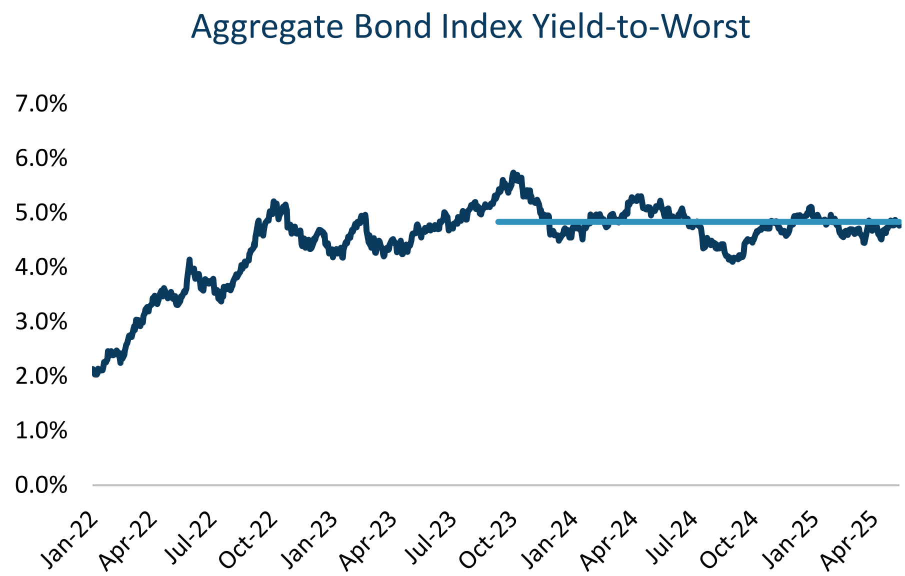
Fixed Income Allocations & Recent Changes

Sector	Positioning & Recent Changes
Duration/Curve	Markets are dialing back their Fed optimism — only two rate cuts are now priced in for 2025, signaling a tougher stance ahead. The House's new tax bill has thrown the federal deficit back into the spotlight, stoking fears of a flood of new Treasuries. Inflation? Still tame. But yields are climbing anyway, driven by growth and supply worries. The 30-year yield is moving in lockstep with a weakening dollar, as investors grow uneasy about foreign demand for US assets — making currency moves a bigger story than tariffs. With long-end yields near two-year highs and short-end rates reflecting a firmer Fed, the bond market has already braced for bad news. For now, expect more of the same: collecting yield in a range-bound ride since the Fed hit pause in late 2023.
Investment Grade Credit	As policy uncertainty remains a key concern, the market appears optimistic that trade agreements will materialize and that trade policies will moderate, mitigating worst-case scenarios. With most of the recent earnings season behind us, despite some downward revisions in guidance due to policy uncertainty, Q1 earnings performance has remained solid. IG spreads continue to hover around +90 bps, which is not particularly compelling. As such, we continue to advocate for a defensive approach to credit investment, prioritizing sectors with short-term tailwinds and minimal exposure to policy-related risks. Specifically, we favor large banks that are well-positioned to navigate uncertainty, regulated utilities benefiting from AI-driven power demand, and air lessors experiencing unique demand dynamics due to ongoing challenges at OEMs.
Securitized	Like other risk assets, agency mortgages sold off significantly in April, before regaining some strength in May. During that period, the current coupon spread increased from 144 bps to 164 bps, before settling at 155 bps. This move coincided with the direction of interest rate volatility during that same period. Agency mortgages underperformed corporate credit in the rally off the wides, due in part to the rhetoric regarding the possibility of removing Fannie and Freddie from conservatorship. While we believe this could be done, the hurdles are tall, with no apparent benefit to the US consumer. The recent Trump tweet confirming that the agencies would keep their government guarantee has removed some uncertainty from the market; however, their future remains in question. We expect the sector to trade in a cautious manner in the days ahead, but ultimately to tighten from very appealing levels.
High Yield	High yield spreads gapped significantly tighter along with most higher beta asset classes in May. However, lower segments of the markets continue to stay decompressed vs. their higher quality BB rated counterparts. BBs continue to lead all other HY rating categories in YTD total return, highlighting the more defensive investor positioning bias. Within sectors, noncyclical healthcare, technology, and financials remain our overweight areas. We have become more cautious as we enter the summer months as issuer earnings uncertainty has permeated through the more cyclical segments of the market. In general, spreads are still very tight to historical averages and aren't compelling at these levels.
Municipal Bonds	After a highly volatile April — marked by heavy outflows and elevated new issuance that drove significant underperformance — May was much kinder to municipals. Despite notable weakness in the Treasury market due to federal deficit concerns, municipal rates remained well anchored, resulting in strong relative outperformance throughout the month. Investor sentiment was further buoyed by the preservation of the tax-exemption in the "One, Big, Beautiful Bill," which left the benefit intact. Looking ahead, we see headline risk as the primary driver of market volatility in the coming weeks and months, though we expect this to be confined to specific sectors that have been the target of policy changes — particularly higher education and healthcare. As we move into June, municipals appear poised to benefit from a favorable technical backdrop, driven by substantial summer principal and interest redemptions. This dynamic could be further amplified if the current trend of positive inflows continues.

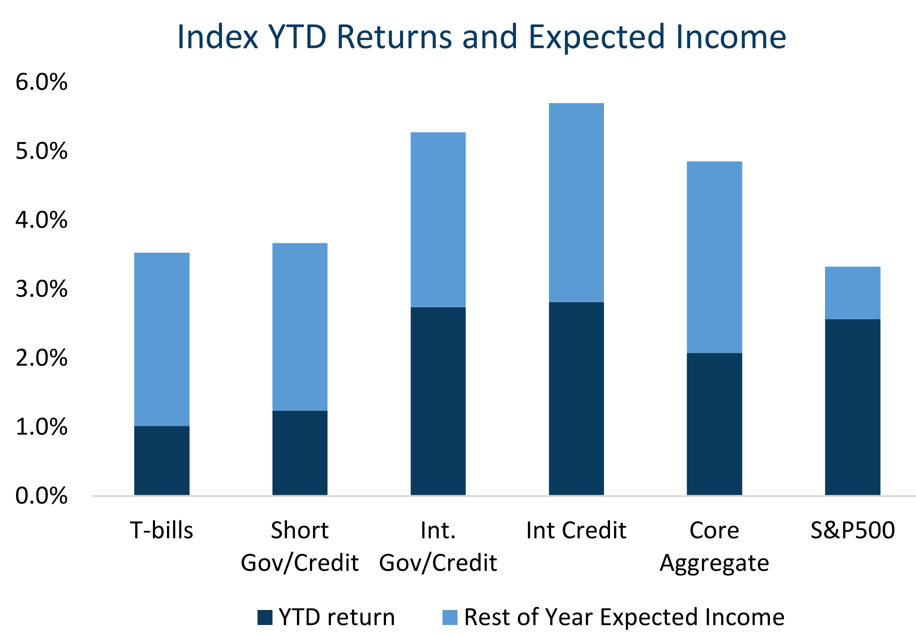
Yields Have Been Range-bound Since Fed Pause

While rate volatility has made market conditions feel more unsettled than they are, the broader picture remains relatively stable. Yields on diversified fixed income indices are still hovering near 15-year highs and have stayed largely range-bound since the Federal Reserve paused its hiking cycle in Q3 2023. As of early June, the Bloomberg US Aggregate Bond Index is trading close to its average level over that period. Although some volatility may persist, a backdrop of slowing growth and the potential for Fed rate cuts later this year should help keep yields contained — if not trending toward the lower end of the recent range.



Income Helps Hedge Uncertainty

Range-bound yields combined with attractive income carry provide a solid foundation for returns in diversified fixed income portfolios. For the remainder of the year, income alone suggests strong performance potential for core intermediate and core duration strategies. This also offers a high degree of return certainty — a valuable hedge in an environment of elevated macroeconomic uncertainty. While cash yields remain appealing, they are more exposed to downside risk if rates begin to fall, eroding income carry. Equities, on the other hand, offer limited income and will likely depend on earnings growth in a challenging macro backdrop or multiple expansion from already elevated valuation levels.



Sources on charts are Sage, Bloomberg.