TwentyFour
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Fixed Income 2025

Yields trump possibility of spread correction

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Trade tensions and geopolitical risk head a list of potential catalysts for spread widening in 2025. However, with a macro backdrop of falling rates and solid global growth, we think credit will continue to outperform government bonds and support healthy total return expectations for fixed income investors.

Key takeaways

- Falling interest rates, near-target inflation and steady global growth create a positive environment for fixed income in 2025.
- With spreads across sectors at or close to historical tights, we could see bouts of widening in response to potential catalysts such as US tariffs, sticky inflation and geopolitical risk.
- However, we don't think waiting for a correction in this environment is likely to be a winning strategy, with high yields and cash on the sidelines preserving demand for fixed income.
- We continue to see strong relative value in financials, and the high spreads and floating rate nature of European asset-backed securities (ABS) make them an increasingly attractive diversifier.

As we look to make our projections for 2025, there is no shortage of potential market drivers already on investors' radars.

Inflation is a lingering concern, President Trump is filling his second administration with loyalists not all of whom are considered experts, an economically struggling Germany is headed for elections in the new year, and the Russia-Ukraine war has entered a new phase of uncertainty after arguably the most serious escalation since the conflict began. On the plus side, the global economy looks in good shape, central banks have kicked off their rate cutting cycles, and the balance sheets of corporates, households and banks are generally in good health.

Before delving into what we think all this means for fixed income in 2025, we will take a moment to review our outlook from 12 months ago.

Not optimistic enough in 2024

Thankfully, our overall forecast of "strong returns ahead" proved correct, certainly for credit, though so did our prediction of a bumpy road to those returns.

In the US, we thought the higher rate environment would finally impact the consumer and the economy would probably experience a mild recession. We expected inflation to continue to slowly move to target, and combined with a weaker economy we thought the Federal Reserve (Fed) could ultimately cut by up to 100 basis points (bp) this year, though our base case was for fewer cuts. We also thought the US Treasury (UST) curve could experience a bull steeping, and that in general longer-dated yields would not be the headwind they had been for investors in 2023.

In Europe, we were encouraged by the rapid fall in inflation and had confidence that the European Central Bank (ECB) would cut before the Fed, with a range of 75-100bp for 2024 being our base case. In the UK, we expected 50-75bp of rate cuts from the Bank of England (BoE) based on inflation remaining higher than in the US and the Eurozone, underpinned by rising wages and the high percentage of people on long-term sick leave. Similar to the US, we didn't expect Bund and Gilt yields to rally much from their December 2023 levels over this year, despite the rate cut expectations.

For credit markets, we were correct to project strong returns but we were wrong in expecting spreads to widen materially at some point during the year. That said, we advised against trying to time any widening in spreads, since we didn't see this as a rewarding strategy given the attractive yields on offer.

In terms of total return, we saw some of the 2023 tightening in investment grade (IG) corporates being retraced but we thought returns would be strong due to attractive yields and a more supportive rates market. We saw high yield (HY) benefitting from strong technical support on falling issuance and defaults remaining low. In financials, our strong view was that yields looked more attractive than in other sectors and that returns potential for banks and insurance companies looked very attractive for 2024.

While we were confident of good returns in most areas, overall we were not actually optimistic enough. Central banks were slow to cut but this did not dampen enthusiasm for credit, spreads did not see any significant widening and instead tightened consistently during the year, allowing most sectors to deliver their attractive yields plus some capital gain.

2025: A solid macro backdrop, but with meaningful risks

From a macroeconomic perspective, the outlook is more positive than what fixed income investors have faced over the last few years. No great imbalances have been unearthed in the US economy, and the aggressive rate hiking cycle has in fact had little visible impact on growth. The Fed is confident inflation is slowly but surely falling to target (not dissimilar to its view last year), and the unemployment rate remains relatively low. While growth in core Europe, particularly Germany and France, remains weak, in other parts of the Eurozone growth is encouraging; the region is continuing to recover from the cost of living and energy crisis sparked by Russia's invasion of Ukraine, inflation continues to fall and as we approach year-end the ECB appears increasingly sure of its rate-cutting path. Overall, we think the outlook for global growth, while not spectacular, is reasonable, and it is expected to equal or marginally exceed recent growth.

Leaving aside the macro environment, however, when debating our outlook for 2025 the TwentyFour portfolio management team acknowledged a number of smaller risks with the potential to become more significant headwinds. We anticipate a new round of trade tensions from the incoming US administration, with major global trading partners China, Canada, and Mexico being identified. The team also debated a range of strong views on the path of inflation, highlighting that the outlook remains uncertain; any new tariffs will obviously matter greatly, and floated US tax cuts could also push inflation higher even as a one-off. Geopolitical risks have also risen in recent weeks, with Ukraine's use of US- and UK-supplied missiles inside Russia, and Russia's use of a newly-developed long range ballistic missile inside Ukraine, arguably the most serious escalation of the war since it began. The development of these material risks could obviously impact the path of rate cuts in the US and by extension UST yields – a major driver for broader fixed income markets – during the year.

Despite tariffs, global growth to remain robust

We expect GDP growth rates in many parts of the world to either remain robust or improve over the course of 2025, and we expect global growth for the full year to be in line with or slightly above current growth rates. While it is difficult to accurately predict the size of any new tariffs, or how far reaching they might be, free-floating currencies should absorb much of the impact, as they did during the first Trump administration. It is also possible that new tariffs may not be as sweeping as suggested during the election campaign, with the threat of them instead being used as a negotiating tactic.

We expect US growth will continue to slow as high rates and a weaker consumer (albeit perhaps temporarily buoyed by tax cuts) impact spending, but with growth for 2025 still at 2-2.25%. In the Eurozone, growth in core economies is likely to remain weak, though we think elections in Germany could have a big positive impact if a new government was minded to increase spending. Peripheral Eurozone growth should remain robust as well, so we expect overall Eurozone GDP to average 1% for 2025. The UK meanwhile should enjoy a short-term “sugar rush” from the extra spending unveiled in October’s Budget, helping growth to improve to a range of 1-1.25% for 2025. The team had a strong debate around China, and whether there will be a sustained boost from the latest stimulus measures, but ultimately we expect growth of 4.25-4.5% for 2025.

The US and the Fed

With the new Trump administration beginning to take shape, trying to distinguish rhetoric or negotiation tactics from actual policy is difficult, but there are numerous proposed measures that could have a big impact on the year ahead.

Tax cuts, immigration curbs and deregulation are all on the agenda alongside tariffs, and all will have domestic and global implications. In addition, little progress is expected to be made in tackling the large US budget deficit; before the election, the Committee for a Responsible Budget projected a Trump victory would have a net deficit impact of around -$7.75tr. Some of the TwentyFour PM team raised concerns that a growing deficit and debt-to-GDP ratio, coupled with demand for term premium, could weigh on USTs and push yields higher during 2025, similar to the move witnessed in October 2023.

Given the range of unknowns, the path for base rates generated much debate among the team, but there was consensus that rates could be cut to 3.75-4.0% over the course of 2025. We are certainly mindful that a continuing strong economy and Trump policies slowing progress on inflation (headline inflation has only declined by 0.5 percentage points over the last year) could limit rate cuts to just one or two over the next 12 months, though this is not our base case.

As Trump’s policies become clearer, and new data becomes available on the path for inflation and unemployment, markets are likely to begin pricing in terminal base rates for the cycle, which we see helping to normalise the curve and push 10-year UST yields back above base rates. Therefore, we do not expect a sustained rally in USTs in 2025. Ultimately, we think yields will be little changed over the year, but we do expect further volatility and given the trading range we have seen in 2024, lows below 4% and highs towards 5% would not be surprising.

Europe and the ECB

We believe the ECB will be able to cut rates more aggressively than other central banks; our base case is 100-125bp of cuts in 2025 with an outside chance of more. In support of this view, we see core inflation falling to the ECB’s 2% target towards the end of next year with energy prices expected to remain stable. Wage inflation should also continue to fall from the highs of recent years, but with strong real wage growth supporting the consumer. Considering our projection of sluggish but improving growth, a weak core Europe, and political stalemate in France, we think the ECB is leaning to the dovish side and can afford to be more accommodative.

We see the German election currently scheduled for February as a potentially pivotal event for 2025 given the current Chancellor, Olaf Scholz, called the vote to secure backing for a relaxation of spending rules. An expansionary fiscal policy could have a big impact on German growth, which would benefit the Eurozone as well.

While growth and competitiveness lags the US, European consumers have been more prudent than their US counterparts, which has kept savings rates high and arrears in consumer loan deals very low. The same is true of Eurozone corporates where balance sheets are generally clean and cash balances high, and with more rate cuts to come we think the case for European credit remains strong.

On the negative side, should aggressive US tariffs be placed on Eurozone goods next year, growth would obviously be negatively impacted and inflation could increase at a time when competitiveness is already weak and the bloc politically fragmented. The Eurozone also seems no better equipped than it was a year ago to deal with the war in Ukraine, or to present a unified stance, which is a more significant problem in the context of a potential weakening of US support.

It is worth noting that with the euro falling towards parity with the US dollar, the Eurozone could be prone to import inflation, which could hamper the path for rate cuts. Currency fluctuations could be a running theme of 2025 should wide-ranging tariffs be put in place; we saw sharp fluctuations under the first Trump administration, and markets are clearly expecting similar this time around with the Canadian dollar and the Mexican peso having already fallen against the US dollar.

Despite a more aggressive rate cutting policy, with much of the Bund curve already trading at yields 100-125bp below the ECB base rate, we don’t see yields falling much further across 2025. Like in the US, if curves begin to normalise then 10-year yields could be vulnerable to climbing from here, but not aggressively so in our view.

The UK and the BoE

Our UK outlook is the most uncertain given the challenges facing the economy both domestically and externally. The relatively new Labour government’s first Budget at the end of October was almost universally disliked by market participants, but did promise more spending in certain areas, particularly public healthcare. The result is likely to be a short-term boost to growth, but also a potential boost to inflation. Despite the progress made this year on inflation, which saw the headline figure fall from almost 4% in November 2023 to the BoE’s 2% target by May, the rate has since ticked up again and core inflation is proving sticky. Public sector wage rises signed off by the government are also potentially inflationary, and a number of our team voiced concern that more improvements could be slow to appear in the first half of 2025. The tightness of the labour market is also fading and we expect unemployment to increase next year. UK consumers could be more cautious as the tax raid on the private sector through increased employer National Insurance in particular takes hold, while fears of further tax hikes to come are likely to dampen business and external investment. Despite the borrow-and-spend Budget, higher tax, likely higher unemployment and higher or sticky inflation could make rate cuts difficult, although we think growth in the short term should remain resilient.

Given the range of drivers, the team’s projections for UK rate cuts across 2025 also fell in a reasonably wide range of 50bp-125bp, with the consensus being that the BoE would fall somewhere between the Fed and the ECB. Unsurprisingly given the range of views on base rates, there was also a divide on where Gilt yields would land next year. Ultimately, a more normalised curve and 10-year yields around 4% was the consensus view, with volatility high again. The off-benchmark view was that 10-year yields could climb as high as 5% on the outlook for higher inflation, which would keep rate cuts to a minimum.

More catalysts for spread widening in 2025

As mentioned above, we had expected spreads to widen meaningfully at some stage in 2024. One of the drivers of this view was that the team believed markets were too optimistic in expecting an aggressive and rapid rate cutting cycle; we expected this optimism to fade in early 2024 and it seemed reasonable that spreads would be dragged wider as government bond yields rose. This proved to be incorrect since credit markets simply ignored the rise in government bond yields as the economy remained in good shape. Spreads generally

rallied through the year, in a move that has left spreads on some indices at levels not seen since before the global financial crisis.

Undeterred, our projection for credit in 2025 is similar – we expect spreads to widen (now from much tighter levels) at some stage during the year, but timing this move will be no easier than we cautioned it would be in 2024. The ultimate trigger for a 2025 spread widening was also open to debate among the team, with the prime candidates being one of the many new Trump policies, sticky inflation halting rate cuts, geopolitical volatility, a reigniting of recession fears, and buyers simply baulking at the tightness of spreads despite the attractive yields available.

Waiting for a corporate bond correction isn't prudent

We expect corporate default rates to remain close to current levels, supported by high cash balances and high interest margins, with maturity walls also not seen as a factor. We see defaults within US HY staying in the 3-3.5% range, with our projection for European HY higher at 4-4.5%, albeit with two large expected defaults, SFR France and Thames Water, built into these numbers. There is no doubting the willingness of buyers to put cash to work currently, and we think this technical support is a strong argument to stay invested. Quite simply, yields look attractive, there is cash on the sidelines supporting every new issue, rates are being cut, and the global economy looks healthy. Waiting for a correction in this environment isn't therefore likely to be a winning strategy in our view.

Importantly, some of the team argued that spreads could see more sustained widening based on the view that the strong economy and stubbornly high inflation would force rates to stay higher for even longer. In that scenario, refinancings would be more expensive and fears of rising default rates would likely drive spreads wider. Interestingly, however, even with wider spreads and less benign government bond markets, proponents of this view still thought the high yields on offer would preserve positive returns over a 12-month period.

Corporate bonds: TwentyFour 12-month return expectations

	Bull	Base Case	Bear
Investment Grade ($)	6.0%	4.7%	2.5%
Investment Grade (£)	7.0%	4.9%	3.2%
Investment Grade (€)	4.0%	3.2%	2.0%
High Yield ($)	8.0%	7.0%	5.0%
High Yield (£)	8.3%	7.7%	6.0%
High Yield (€)	5.8%	5.5%	4.1%

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Value in financials with premium set to narrow

We have argued consistently this year that European bank and insurance company bonds offer attractive premiums to corporate bonds, and this has indeed driven the outperformance of respective indices for those sectors year-to-date. Our fundamental view on financials remains very favourable; capital levels are at or close to all-time highs, non-performing loans are below 2% on average, the high yield environment has kept net interest margins healthy and profitability is strong – all of which has helped the Euro STOXX Banks equity index to gain 25% year-to-date.

We doubt it will be entirely plain sailing for the sector from a spreads perspective in 2025, given the tightening this year. However, European banks have been prudent in keeping lending standards high, and we do not expect any significant weakening in fundamentals. Spreads will probably widen at some point, but our view is that they could ultimately grind tighter than they are now by this time next year. If we do see a spread widening for financials, we expect it to be less severe than in corporate bonds; overall we expect the spread differential between banks and corporates to narrow further.

Financials: TwentyFour 12-month return expectations

	Bull	Base Case	Bear
Senior Banks (€)	6.0%	4.7%	2.5%
T2 Banks (€)	7.0%	4.9%	3.2%
AT1s (€)	4.0%	3.2%	2.0%
Sub Insurance (€)	8.0%	7.0%	5.0%

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European ABS an increasingly attractive diversifier

We remain constructive on the European ABS sector. We expect strong returns across residential mortgage-backed securities (RMBS) and collateralised loan obligations (CLOs), helped by continuing attractive yields and strong performance from the underlying collateral, while the slower pace of rate cuts being priced should maintain strong demand for floating rate assets. For investors who are more nervous about certain industries, sectors or even geographies heading into 2025, ABS can offer exposure to discrete pools of high quality assets with income derived solely from the pool's cashflows, making ABS far less exposed to broader market volatility than mainstream corporate bonds.

Demand for ABS has certainly grown over the last few years, with strong performance increasing interest among investors who had greater allocations to more traditional areas of fixed income. As a result, and similar to the financials sector, we have long argued that CLOs offer a very attractive premium versus corporate bonds, and though this premium has compressed, we continue to think it remains compelling. Given the very attractive yields on CLOs, spread compression is not necessary here to achieve returns well in excess of corporate bond markets.

ABS: TwentyFour 12-month return expectations

	Base Case
RMBS AAA (£)	4.8%
RMBS BBB (£)	6.0%
CLO AAA (€)	3.9%
CLO BB (€)	9.0%

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Winning the tug-of-war between yields and spreads

While the anticipated pace of rate cuts is less clear for the US and UK than it is for the Eurozone, our expected macro backdrop of falling rates and global growth at a similar level to 2024 would be a benign environment for fixed income investors.

Credit should continue to outperform government bonds in the medium term. We have to acknowledge that valuations have compressed and there is a tug-of-war of sorts between high overall yields and low spreads for asset allocators. In our view, the fact that yields are high, both in nominal and real terms, should keep demand for fixed income robust and any meaningful sell-offs in credit spreads are likely to be met with a strong bid.

At the same time, as is typically the case when spreads are below their long-term averages, there is not much premium on offer for moving down the ratings spectrum to lower quality credit. Similarly, there isn't much additional spread on offer for venturing into longer dated credit compared to shorter dated credit.

As a result, we think the best risk-adjusted returns in 2025 will be found in portfolios with an overweight in credit but a high average rating and relatively low credit spread duration.

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