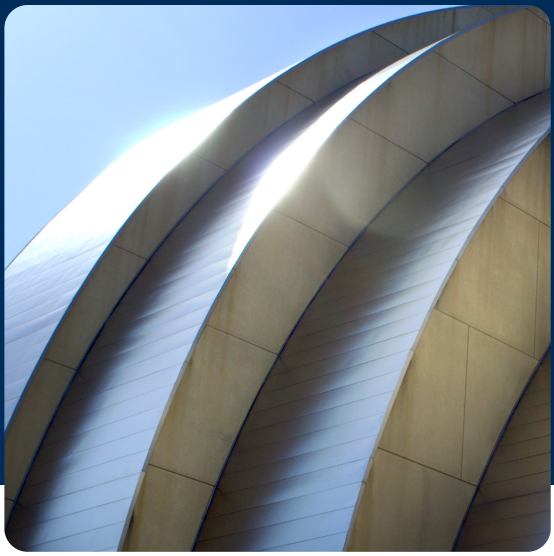
Global Fixed Income's Top 5 Investment Ideas for 2025



MacKay Shields Fixed Income Team

Fixed Income Top 5 Insights for 2025

1. Fade the animal spirits and focus on diversification and valuations
2. Securitized Assets: A Compelling Value Proposition
3. Favor high yield over investment grade corporates
4. Resilient Foundations and Select Opportunities in Emerging Markets
5. Rate Volatility Presents Opportunities Along the Yield Curve

2025—Bonds Take Center Stage

We believe the bond market in 2025 is positioned for strong performance, driven by a resilient U.S. economy, moderating inflation and a shift toward a higher steady-state interest rate environment. Fiscal policies continue to support growth while monetary conditions stabilize, creating a favorable backdrop for fixed income investments. Rising institutional and retail demand for bonds, fueled by steadying yields and reduced Fed balance sheet runoff, underscores the broad appeal of fixed income as a reliable source of income and portfolio durability. With tight credit spreads and elevated equity valuations highlighting the relative attractiveness of bonds, fixed income can offer a unique combination of yield, stability, and diversification in an uncertain market landscape.

1 Fade the animal spirits and focus on diversification and valuations

In today's market, elevated valuations and pockets of exuberance—driven by lingering "animal spirits"—call for a disciplined and cautious approach. Investors should resist chasing speculative rallies or overvalued sectors, as the current environment is devoid of easy "home runs." Instead, success in this cycle hinges on a focus on diversification and reasonable valuations, targeting steady, sustainable returns. With growth moderating, somewhat sticky inflation and policy uncertainties on the horizon, a strategy aimed at "singles and doubles" is essential. By allocating across high-quality assets, prioritizing income and avoiding concentrated risks, we maintain investors can navigate this complex market with resilience and confidence, building durable portfolios for long-term success.

2 Securitized Assets: A Compelling Value Proposition

We believe securitized assets present a compelling opportunity for 2025, offering better relative value compared to corporate credit. High-quality securitized sectors such as Agency mortgage-backed securities (MBS) and AAA-rated CLOs provide attractive carry and strong structural protections. Agency MBS spreads, historically wide relative to investment-grade corporate bonds, are poised to tighten as rate volatility decreases, bank demand returns and supply remains limited due to higher mortgage rates. Similarly, AAA CLOs offer a yield advantage over comparably rated corporate bonds backed by resilient leveraged loan performance and sound fundamentals. Growing institutional investor demand for yield is expected to further drive spread compression in these markets.

MBS spreads historically wide to Investment Grade Corporates

Source: J.P. Morgan

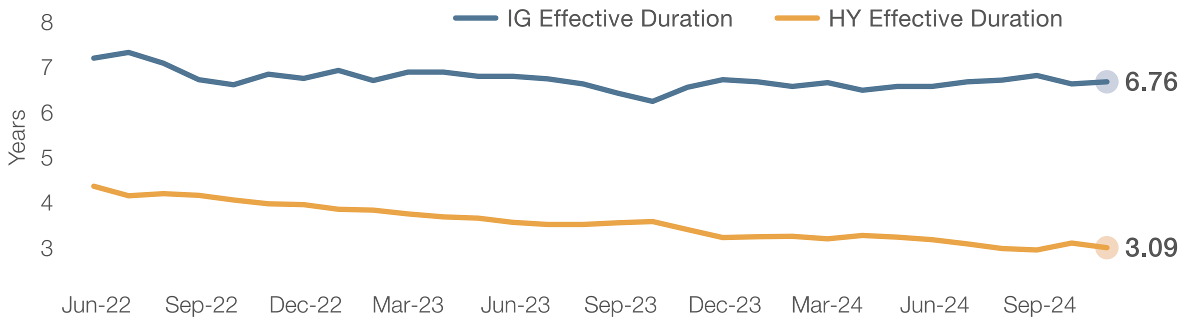
Within the securitized space, certain sectors stand out for their risk-reward profiles. Prime auto and credit card ABS deliver strong income opportunities, with stable consumer credit trends and tighter underwriting supporting credit performance. Non-agency RMBS, such as the Credit Risk Transfer (CRT) market, offers attractive relative value, particularly in senior and mezzanine tranches, backed by robust fundamentals and favorable technicals. However, cautious positioning is advised to navigate macroeconomic risks, policy uncertainties and spread dispersion across vintages. These sectors provide diversification and incremental yield in a market where credit fundamentals are expected to stay robust.

While there is cautious optimism for CMBS, it also presents opportunities for selective investors. High-quality conduit and SASB deals in in-demand sectors like multifamily, industrial and higher-end retail stand out, supported by modest cash flow growth and better sponsorship. However, risks in legacy office-heavy exposures and rising delinquency rates necessitate careful selection, particularly in subordinated tranches. With CMBS spreads offering a premium to corporate credit and improving technicals driving new issuance, this sector can provide attractive relative value for investors willing to navigate its inherent challenges.

3 Favor high yield over investment grade corporates

In our view, U.S. high yield bonds present a more compelling opportunity than investment-grade corporates in 2025, offering elevated carry and select potential for moderate spread compression. While investment-grade bonds provide stability and all-in yields around 5%, spreads are near historical tights with limited room for further tightening. In contrast, high yield offers yields of 7-8%, with BB and single-B credits benefiting from resilient corporate fundamentals, improving earnings and relatively low default rates, which are expected to decline to ~2.5%. Additionally, the shorter duration of the high yield market today compared to previous years means spreads are less tight than they appear on an outright basis, offering better compensation for credit risk. We expect spreads in U.S. high yield that are forecasted to remain range-bound, particularly in the first half of the year, as demand remains strong and economic growth continues. Periodic episodes of volatility are likely to be buying opportunities, offering the chance to earn excess returns.

The duration of the high yield market has shortened by more than one year, rendering the market less sensitive to interest rate and spread moves



Source: ICE Data as of November 30, 2024. It is not possible to invest directly in an index. See disclosures for index descriptions.

In Europe, the outlook for high yield is more cautious due to weaker macroeconomic fundamentals and slower earnings growth, which could limit broad market performance. However, opportunities may exist in defensive sectors and high-quality credits where spreads offer attractive entry points.

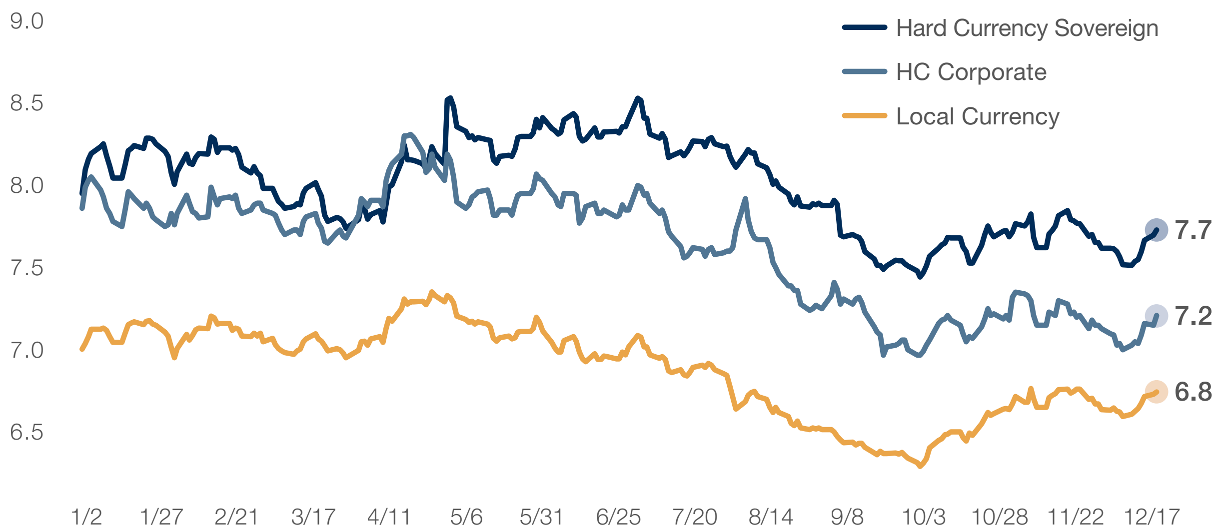
Overall, U.S. high yield stands out for its carry advantage and potential for modest spread compression, making it an attractive complement to more defensive fixed income allocations. European high yield may serve as a tactical play for selective investors.

4 Resilient Foundations and Select Opportunities in Emerging Markets

We believe emerging market debt (EMD) offers ample opportunities for investors in 2025, driven by divergent return drivers and structural advantages relative to developed market counterparts. Higher-yielding issuers outperformed in 2024, supported by resilient growth, a favorable commodity price environment and conservative leverage among corporate issuers. These structural features, coupled with a persistent risk premium, enable EMD to compound returns over time. While risk premiums have compressed compared to historical levels, the current profile still offers better compensation when adjusted for the lower duration and evolving market dynamics of the asset class. Accordingly, it is our belief that hard currency sovereign and corporate bonds are likely to deliver high single-digit returns in 2025, with selective positioning being a key driver of excess performance.

The outlook remains constructive, but external risks warrant attention. While country-level political risks are less prominent due to a quieter electoral calendar, global uncertainties such as U.S. trade policy under the incoming administration, the war in Ukraine and geopolitical tensions in the Middle East could contribute to volatility. Investment opportunities are strongest in reform-focused economies like South Africa, where productive capacity is improving, and Turkey, where economic orthodoxy has returned, enabling diverse issuers to access primary markets. As these countries continue structural reforms, EMD remains a compelling option for investors seeking diversification and attractive carry, albeit with an emphasis on careful selection and risk management.

Emerging market yields



Source: JP Morgan as of December 17, 2024. It is not possible to invest directly in an index. See disclosures for index descriptions. Past performance is not indicative of future results.

5 Rate Volatility Presents Opportunities Along the Yield Curve

The opportunity to profit from long-end rate volatility in 2025 is compelling, but outright duration risk may not offer the most favorable risk-return profile. Instead, yield curve trades and butterfly structures provide a more efficient way to capitalize on relative value opportunities while managing overall portfolio risk. Further fiscal expansion and expectations for higher issuance could widen term premia further, creating opportunities for steepening trades as long-end yields remain elevated. Conversely, flattening trades may outperform if disinflation accelerates or if global risks lead to a flight-to-quality, compressing long-end yields. Butterfly trades, such as 2s/10s/30s structures, offer convex payoffs by isolating curve volatility and mitigating exposure to outright rate moves.

These approaches minimize directional risk while taking advantage of curve dynamics, providing better risk-adjusted returns than outright duration bets. They also act as hedges against inflation or unexpected central bank actions, while their higher convexity offers attractive non-linear pay-offs. However, investors should remain mindful of liquidity constraints and potential mismatches in curve volatility. By using steepening, flattening and butterfly strategies, investors can tactically position portfolios to benefit from long-end volatility with a more balanced risk-return profile.

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