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Go Your Own Way: Capitalizing on Bond Divergence

We identify key fixed-income themes to watch in 2025, with an emphasis on how active investors can make the most of greater dispersion.

Insight from sub-adviser, Wellington Management

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Since the inflation shock first started rattling interest-rate markets around the start of 2022, we've focused on trying to understand the drivers of inflation and the policy reactions to this price phenomenon. Our expectation going into 2024 was that disinflation would dominate market narratives, paving the way for rate cuts across the globe. While we were proven right in that regard, with policy easing in most parts of the world, we believe caution is now warranted in the face of changing policies and the potential for volatile markets.

We believe this caution sets the tone for 2025, where the income earned from government bonds can help offset potential rate volatility for investors. The starting point of nominally high global growth should cushion against the impact of a potential global economic slowdown. At this stage, we don't anticipate a recession and the associated rise in downgrades and defaults. We also believe that current high yields adequately compensate investors for the heightened volatility. The notable exception to this view is the back end of the yield curve,[1] where long-dated bonds face challenges due to supply dynamics, inflation expectations, and higher nominal growth.

As geopolitical tensions heighten a sense of uncertainty in markets, policymakers' reaction functions will be tested—and our belief is that governments will continue, and indeed be forced, to respond to exogenous shocks by loosening the purse strings. In the wake of the US election, with Germany heading to the polls in early 2025 and China looking to revive its struggling economy, we can't clearly see where policies (and tariffs) are headed. However, thematically, we expect higher barriers to trade, via tariffs, and increased fiscal spending, particularly in relation to European defense. While we expect rates to be range-bound, there's a risk to the upside, as global markets become increasingly tense and react to local dynamics.

Key Points

- Expect greater interest-rate volatility and divergence ahead.
- Sectors such as European autos, materials, and consumer cyclicals are likely to bear the brunt of future US tariffs and the likely ensuing slowdown in Europe.
- The reemergence of animal spirits may reward investors able to identify winners and losers through careful research.

Testing Central Banks' Reaction Functions

The return of the growth/inflation trade-off globally has not only been an important stress test for market participants, who have had to navigate significant exogenous shocks over the last year, but it's also offered us some evidence about policymakers' reaction functions. What we've learned is that governments are eager to protect consumers from upticks in unemployment, while central banks are keen to bring policy rates back down from their current "tight" levels, even if the combination of these actions means stickier inflation.

The New Fiscal Normal: Spend, Spend, Spend

Trump's reelection will likely accelerate underlying trends around weaker labor supply and a deteriorating fiscal backdrop. While the US Federal Reserve (Fed) may slow its cutting cycle sooner than expected, we anticipate volatility in how markets price the pace of future cuts, meaning high yields in government bonds are likely here to stay, and may move even higher for long-dated bonds. Globally, we expect governments to continue tapping into bond markets for an ever-increasing laundry list of fiscal commitments, ranging from higher defense

spending to capital investments and improving climate resilience. The first 20 years of this century were dominated by secular trends that proved to be disinflationary and are now being (partially) reversed through deglobalization and aging demographics.

- *In the US*, the start of the second Trump administration should give us greater clarity on how much of his proposed policy mix of tariffs, taxes, and curbing immigration will be delivered. In the meantime, we're watching the appointments list in key areas such as the National Economic Council (NEC), the Treasury Department, the Commerce Department, and the Office of the US Trade Representative. While the Fed will likely continue cutting rates, as the US has perhaps made the most headway in tackling inflation, there's a real risk that reflationary policies will slow progress, necessitating rates staying higher for longer.
- *In the euro area*, after a brief period of remarkable unity and urgency around the twin challenges of the COVID-19 pandemic and the energy shock, we expect the policy response to immediate exogenous shocks (such as tariffs) to return to a familiar pattern of lengthy decision-making and compromises. With the reintroduction of the European Commission's fiscal rules, we expect there to be limited scope for euro-area and other European Union (EU) countries to meaningfully counter incoming tariffs with significant government spending or a cohesive response across the currency bloc. This comes at a time of perceived fragility for some of the larger countries in the EU. Contrary to the US, we see downward pressure on European yields, where the European Central Bank may need to intervene and cut rates at a faster pace than markets are pricing in.
- *In the UK*, persistent inflation and an expansionary budget deficit have already caused markets to reduce rate-cut expectations. Should the cycle continue to demonstrate resilience through a strong labor market, sticky core inflation, and renewed housing activity, there's a real risk that UK government bonds (or gilts) could de-anchor and move higher than their European peers.
- *In Japan*, we expect front-end yields to climb steadily toward the Bank of Japan's target of 1% by the summer, as deflation risks have now firmly given way to a reflation story driven by positive wage growth, imported inflation, and changes in consumer behavior.
- *In China*, a market that's continued to diverge from the rest of the world, policymakers haven't yet decisively addressed a significant balance-sheet recession, so we expect rates to remain low. The focus, thus far, has been on deleveraging local-government balance sheets, making housing less of a speculative asset, and focusing on growth driven by exports. China could be a potentially global deflationary force.

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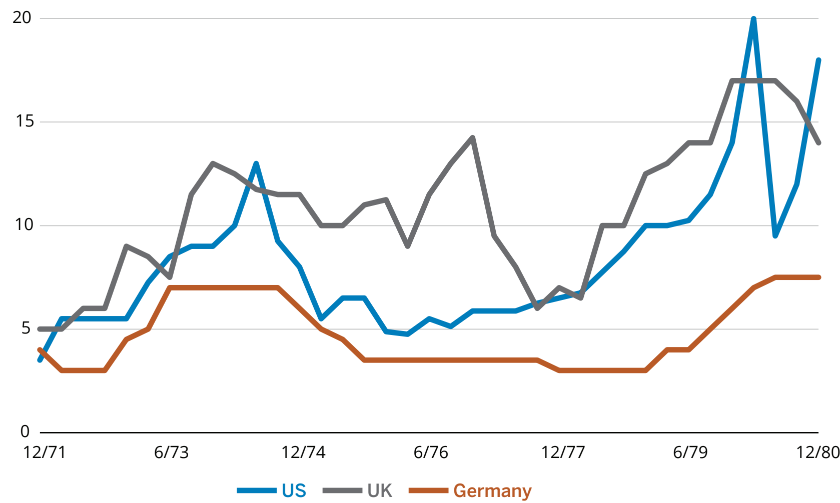
Divergence: Implications for Investors

Amid increased volatility, the theme of divergence could become entrenched in policymaking too. While this hasn't been the case for decades, there's a precedent (the 1970s) for extended periods of time when central banks didn't set rates in sync with one another (**FIGURE 1**). As the growth/inflation trade-off acquires increasingly local dimensions, rate markets may become increasingly sensitive to national cycles rather than the global cycle. We don't think investors have yet priced this in.

FIGURE 1

A Lesson from the Past: Policy Convergence Is Not a Given

Central Bank Policy Rates (1972-1980) (%)



Source: Bloomberg Finance L.P.

> Investment-grade corporate earnings growth remains stable, labor markets are still tight, and consumers continue to show signs of strength.

An Extended Cycle—What Next?

In our view, the current environment also remains supportive from a credit-investor perspective. Companies and consumers have proven resilient to higher interest rates, driven by a private sector that's been reducing leverage since the Global Financial Crisis. Investment-grade corporate earnings growth remains stable, labor markets are still tight, and consumers continue to show signs of strength. Although we consider corporate-bond valuations relatively elevated on a spread[2] basis, they remain attractive from a yield perspective. Historically attractive yields have enticed a resurgence of yield-motivated buyers to the market, providing strong technical support for the asset class. Taken in aggregate, we're constructive on the cycle and see benefits for credit investors in an environment in which we expect rates to remain range-bound. Looking ahead, we see value in a nimble approach and have identified three potential areas of opportunity for investment-grade investors in 2025.

1. **Elevated interest-rate volatility**
   As highlighted above, expect greater interest-rate volatility and divergence ahead. In our view, the rate of change in government bond yields is likely to be a key driver in risk-asset valuations. Investors who are able to dynamically adjust the credit exposure of their portfolios over the cycle should be well-positioned to weather volatility and take advantage of the potential opportunities that sudden market adjustments tend to create.

2. **Divergence across developed markets**
   Given likely continued divergence in growth and inflation across developed markets, we think credit investors should be selective about where they take risk. For instance, sectors such as European autos, materials, and consumer cyclicals are likely to bear the brunt of the tariffs that the Trump administration may impose and the likely ensuing slowdown in Europe. On the other hand, the US may benefit from increased fiscal easing, domestic demand, and deregulation, which could continue to support US corporate fundamentals. We see this divergence as a meaningful opportunity for those investors who can combine local macro expertise with deep, bottom-up, fundamental sector and issuer research.

3. **The return of animal spirits**
   Years of extreme accommodative monetary policy suppressed volatility and dispersion among credit sectors and individual credit issuers. Dispersion is returning and is likely to increase as global growth steadies and companies become more willing to explore avenues for expansion beyond organic growth, including debt-financed mergers and acquisitions. This will likely lead to increased issuance, credit-rating changes, and, as a result, higher credit-spread volatility. The reemergence of animal spirits may reward investors for identifying winners and losers through careful bottom-up research.

Overall Focus on Resilience and Security Selection

We believe that the current credit cycle remains robust, supported by strong fundamentals, technicals, and attractive all-in yields. As a result, we think investors can benefit from a pro-credit tilt while exploiting potentially compelling bottom-up sector and security-selection opportunities. However, we recognize the potential for bouts of credit-spread volatility. We believe this warrants a focus on resilience and ensuring that exposures to more cyclical sectors continue to offer adequate compensation. We anticipate that credit-spread volatility may present further opportunities in 2025 to rotate portfolio exposures and add risk at attractive valuations. Against this backdrop, we believe a dynamic, research-driven approach to credit management remains key.

Talk to your financial professional to learn more about fixed-income opportunities.

[1] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[2] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

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