Setting the Course

2025 Outlook

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With risks centered around the US election now in the rearview mirror and year-end fast approaching, it is time to look toward the 2025 outlook for fixed income markets.

Bumpy Rate Paths but Ultimately Lower

Rates remain the most topical driver of bond markets, so let's start here. Central banks have seemingly shifted their attention from taming inflation to maintaining healthy growth and employment. This shift is more apparent in Canada and Europe, where both economies exhibit more vulnerability than the US.

We believe the path for front-end rates is ultimately lower as central banks focus on reaching more neutral monetary policy conditions, but the path could be bumpy and may diverge across global geographies. Overall, we aim to maintain higher levels of duration across our portfolios and prefer to source interest rate exposure from the front end, given our expectation of steeper yield curves, particularly in Canada.

Even if rates do not move as expected, the silver lining is that investment grade bond yields are likely to begin 2025 at a level higher than they started in 2024, despite already seeing 100 basis points of cuts from the Fed! This provides a strong income cushion if we are wrong. Meanwhile, the potential reward of being right and rates falling faster than expected could provide attractive capital gains for our investors.

Buy the Dip if Spreads Widen

Geopolitical risks continue to be heightened, but economic and growth-centered risks are far less apparent to start 2025. The absence of significant imbalances in the US economy and the surprisingly resilient growth momentum alongside fortified corporate balance sheets provide a strong fundamental foundation for the continuation of tight spreads.

From a valuation perspective, spreads are undeniably tight. Granted, this implies that any hiccup in the anticipated perfect landing could cause spreads to widen. However, unless these events are driven by a significant (and new) negative external factor, this could very well be a tactical buying opportunity. We think the most significant risk to widening credit spreads today is materially lower all-in yields, which could reduce the powerful demand for credit that is currently underpinning the market.

Credit Technicals are Your Friend

Four critical factors that could drive spreads tighter or keep them range-bound in 2025 are:

1. **The insatiable demand from yield-sensitive investors** like pensions and insurance companies for USD investment grade bonds that yield between 5-5.5% for nearly any desired term.
2. **The attractiveness of corporate bond yields** relative to the dividend yields offered by equities, which could incentivize investors to shift exposures more heavily into credit.
3. **The reallocation of record-high money market assets** that will need a new home as short-term rates fall, and the yield curve steepens.
4. **A decrease in net supply** driven by internally generated funds, such as coupon payments being redeployed into credit markets.

Hedges are Cheap and Valuable

The widespread appetite for risk assets has driven risk premiums to all-time lows, making hedges extremely cheap. Accordingly, we are more than willing to sacrifice modest amounts of yield premium to embed dynamic downside protection in our alternative mandates. Employing these hedges enables our investment team to confidently take advantage of opportunities, especially during spread-widening events.

Please feel free to contact us if you would like to discuss these themes further or learn more about how we could help you meet your investment objectives.

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