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Fixed Income Report

Federated Hermes Limited

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The view from the fixed income desk

Mitch Reznick, CFA
Group Head of Fixed Income – London &
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Is the market pricing in a 'Trump tantrum' of its own?

Key points:

- In general, credit fundamentals are sufficiently robust to bear the impact of a loss in macro momentum.
- Supply-demand dynamics (such as market technicals) remain exceptionally supportive of credit.
- Inflation trends are generally moving in the right direction for credit, however the dramatic shifts in trade and industrial policy in the US could pause or even reverse this trend.
- As we have seen recently, fiscal policy – more than monetary policy – is likely to be the driver of steeper rates curves in Europe and in the US.
- Despite the recent rally in risk assets – particularly in Europe – all-in yields remain attractive.
- Spread compression between high and low quality implies we need conviction to add lower-rated risk, particularly in the context of rising uncertainties.
- The main risks for credit markets include: elevated complacency; the effects of the US exerting its industrial and trade policies on the world (e.g., disinflation, reflation, macro); a rapid move to above 5% in the US 10-year; the nature of any agreement to end the war in Ukraine.

Our outlook for macro, fundamental and technical forces is generally supportive of credit, meaning our overall appetite for higher-quality credit risk remains sound.

Although we have been impressed with the market's resilience – or perhaps insouciance – when faced with some pretty dramatic headlines out of the US, 2025 will continue to be a year of more volatility, more often. This makes us somewhat hesitant to roll up rates and credit curves.

Credit spreads are relatively tight versus their ten-year history and versus all-in yields. This has three important implications. First, capital appreciation driven by tightening spreads, which supported total returns in 2024, will be tougher to come by in 2025. Secondly, given the relatively low proportion of spreads versus all-in yields, performance in credit will be more sensitive to changes in interest rates than is typically the case. Thirdly, despite this gap between yields and spreads, all-in yields remain attractive and would require meaningful widening to hit break-even levels of returns.

Against the backdrop of supportive macroeconomics, fundamentals, and technicals, we think it will be a decent year for credit spreads and total returns if positioned in higher-quality credits. That said, we are a little more cautious on emerging market (EM) credit predicated on concerns about the effects of US trade and industrial policies.
For strong deal structures, given the health of the structured credit market, both asset-backed securities (ABS) and collateralised loan options (CLOs) remain attractive at the right rating level. **While we don't see an obvious run in spreads, we are mindful that the market could have a 'Trump tantrum' of its own.** For potential downside protection, our options book has been deploying put options on CDS indices, which have become cheaper, as the most efficient way to protect against a violent move wider.

Spotlight

Spotlight

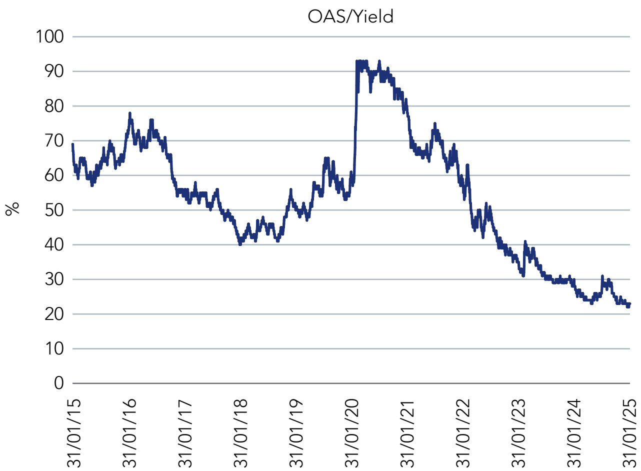
Mind the Gap!

Mitch Reznick, CFA
Group Head of Fixed Income – London &
Global Head of Sustainable Fixed Income

What do spreads as a portion of attractive all-in yields portend?

Since global credit spreads hit their wides at the start of the Covid-19 pandemic in March 2020, spreads as a percentage of yield have been collapsing as illustrated by Figure 1, below. During the pandemic, the percentage was at its widest because risk premia gapped violently on a myriad of fears. In the meantime, central banks started to cut rates to stimulate growth in response to collapsing economic activity and to reduce the cost of capital to people and corporates. Consequently, spreads comprised the vast majority of all-in yields.

Figure 1: Last ten years: Global credit spread as percentage of yield.



Source: Federated Hermes Ltd and ICE BofA Indices.

A combination of fiscal and monetary policies across the globe provided stimuli to drive a post-Covid-19 economic recovery, which then led to a collapse in risk premia. At the same time, inflation spiked and rates remained elevated to cool inflation. This brings us to the present day where risk premia are at, or are close to, lows versus their 10-year history as shown in the first section of Figure 2.

Figure 2: Percentile ranking: 10-year period

	OAS	Percentile	YTW	Percentile
US Investment Grade (C0A0)	82	1%	5.32	85%
European Investment Grade (ER00)	90	11%	3.15	76%
US High Yield (H0A0)	268	1%	7.17	62%
European High Yield (HE00)	302	12%	5.49	69%
Emerging Market High Yield Credit (EMHB)	351	5%	7.90	55%

Source: Federated Hermes, Ltd, ICE BofA Indices, as at 31 Jan 2025.

At the same time, rates remained wider as global central banks reversed their course with tighter monetary policy from 2022. Today, interest rates remain wide on concerns about fiscal deficits, government borrowing costs, and probability of reflation. Supportive credit fundamentals and market conditions, combined with elevated risk appetite following the US election, mean that spreads are tight relative to their past. Consequently, as shown in Figure 1, we are at 10-year lows in spread as a percentage of all-in yields.

This widening of the gap between spreads and yields is presented in greater detail across various sub asset classes in Figure 3. Compared to a 10-year history by sub-asset class, we are at tights versus yields across markets, with investment grade (IG) being the most acute.

Figure 3: Credit spread as % of yield

	OAS	YTW	OAS/ YTW	10yr Avg (OAS/YTW)
US Investment Grade (C0A0)	82	5.32	15%	38%
European Investment Grade (ER00)	90	3.15	29%	136%
US High Yield (H0A0)	268	7.17	37%	66%
European High Yield (HE00)	302	5.49	55%	98%
Emerging Market High Yield Credit (EMHB)	351	7.90	44%	74%

Source: Federated Hermes, Ltd, ICE BofA Indices, as at 31 Jan 2025.

That being said, we can also see that all-in yields are nowhere near their all-time tights relative to their past (Figure 2). In fact, yields are looking very attractive. Given supportive credit fundamentals for credit risk, we think this is why the credit asset class remains very appealing to investors.

Spotlight

Mind the Gap!

What does this mean for 2025?
Credit remains attractive due to supportive fundamentals and market conditions. However, given the relationship between yield and spread, performance of the asset class is likely to be more sensitive to changes in interest rates than it has in the past. And, given the gap between spreads and yields, for the asset class to underperform, we would have to see a sizeable move wider in credit spreads. Looking around credit markets, while we do see a likelihood that volatility will increase, predicated on aggressive formation of trade and industrial policy out of the US, we do not see an obvious catalyst for spreads to gap violently.

This does not mean we are wantonly chasing credit risk. We are hip to the complacent ways of the market at present as reflected in compression in credit spreads between low and high quality, and the near evaporation of new issue premia As such, we like being long higher-quality credit this year and, where possible, the deployment of credit options to indemnify performance in a spread-widening market. This positioning is justified by the known unknows: the prospect that belligerent trade policies from the US undermine global growth. Perhaps, over time, such trade policies, even in their most extreme forms, could reset the world for a new growth regime (although we highly doubt it). Even so, it would create such disruption that we find it difficult to be anything but cautious on lower-quality credit at these risk premia.

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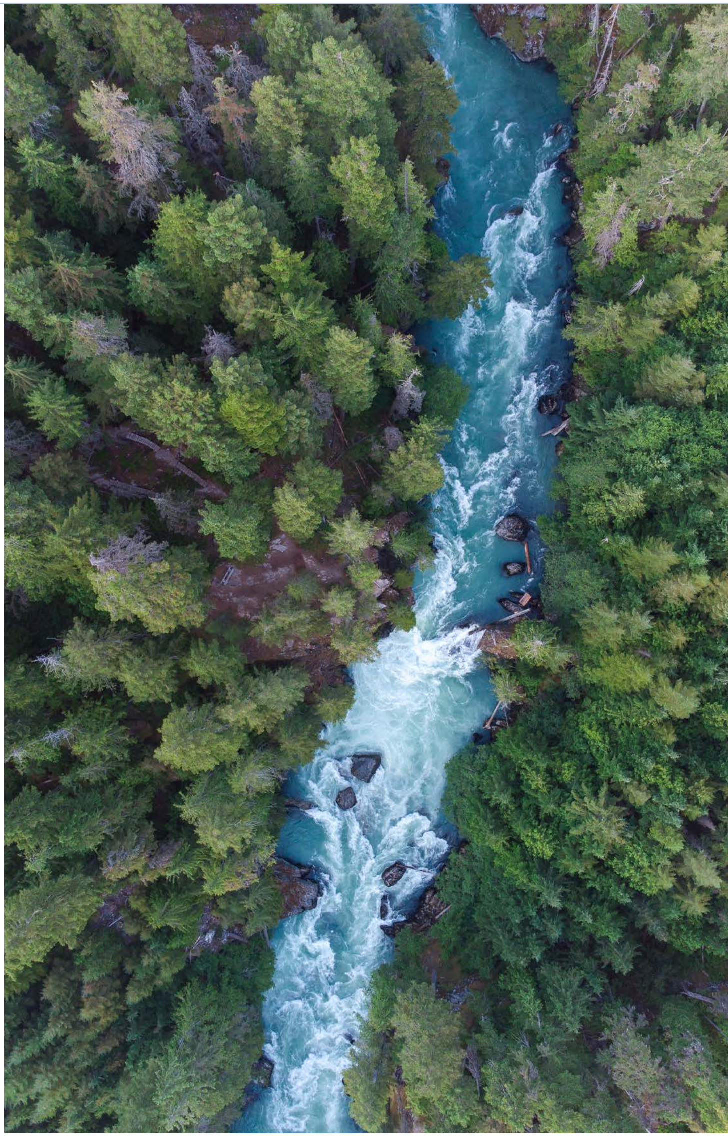


Fundamentals

Fundamentals

Economic outlook

Our base case scenario is for another year of trend-like growth in aggregate across the global economy. We anticipate China's GDP will expand at around 4.5%, the US at around 2%, while Europe and the UK will be much weaker. The main difference between 2025 and 2024 is that predictability is undermined by the unknown, lacerating effects of the US exerting its industrial and trade policy on the rest of the world, and fiscal expansion in Europe. That said, with some element of caution, we believe the macro-outlook remains supportive of credit.

Figure 4: How does the outlook for 2025 compare with 2024?

	Real GDP (YoY%)	CPI (YoY%)	Unemployment (%)	Budget (% of GDP)	Central Bank Rate (%)
2024					
USA	2.8	2.6	4.0	-6.9	4.5
Eurozone	0.7	2.4	6.4	-3.1	3.2
UK	0.8	2.5	4.3	-4.5	4.8
China	5.0	0.2	5.1	-7.3	1.7
Japan	-0.7	1.2	2.5	-2.4	0.3
Brazil	3.3	4.4	6.8	-8.5	12.3
2025 forecasts					
	Real GDP (YoY%)	CPI (YoY%)	Unemployment (%)	Budget (% of GDP)	Central Bank Rate (%)
USA	2.2	2.6	4.3	-6.5	4.0
Eurozone	1.0	2.1	6.4	-3.0	2.2
UK	1.2	2.6	4.4	-3.5	3.7
China	4.5	0.8	5.1	-5.5	1.4
Japan	1.2	2.2	2.4	-3.8	0.7
Brazil	2.1	4.9	6.7	-8.3	15.0

Source: Bloomberg.

Fundamentals

Corporate fundamentals continue to be in good shape. Maturity walls have been pushed back, default rates are expected to remain subdued, and credit metrics remain fairly healthy (especially in when it comes to European banks). Against this backdrop, we are seeing a pick-up in shareholder-friendly activity, which has a re-levering effect on balance sheets, and earnings for some smaller high-yield companies are less rosy than the broader picture portrays.

Rates

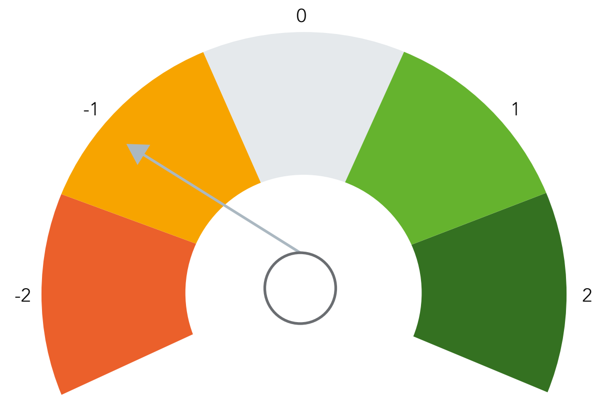
Even though the US is tottering on the brink of reflation, we expect core inflation rates to continue their downward trend albeit in a bumpy fashion. Policy has diverged meaningfully across the globe, as we now expect few rate cuts in the US, further cuts in Europe, China and the UK, and an upward trajectory in Japan. That said, we are less focused on monetary policy in 2025 than we were in 2024. This year, we believe all eyes will be on fiscal policy and domestic government deficits. This leads us to retain our bias for steeper curves with few obvious drivers for the long end to rally.

Technicals

Supply in credit markets is running behind that of a record first quarter of 2024. However, order books remain very strong and new issue risk premia have collapsed. Merger and acquisition (M&A) activity remains subdued for the moment, so the use of proceeds for much of new issue is refinancing. These conditions are very supportive of credit and the market remains wide open.

Sentiment

The data points to a very bullish market. Most risk assets – credit spreads, tech stocks (and thus equity markets), as well as crypto 'currencies' – have had a terrific run into and out of the US presidential election in November 2024. However, we have since seen a rise in the risk of economic disruptions due to tariff-driven ruptures in global trade flows, scale, and supply chains. Credit spreads remain at or close to recent tights and the low price of spread volatility is an indicator of complacency. Despite the torrent of headlines out of Washington, the market continues to 'buy the dip' . We take this to mean that either the market is in a state of denial or that it believes headline-grabbing news from the US president are simply meant to create dissonance that will eventually be resolved in a more orderly way.



Catalysts

Catalysts

Catalysts: Events that could change our view from the base-case laid out in the fundamentals section of this report.

Our catalysts section sets out some of the possible positive and negative near-term drivers of the market. We also take a look at how volatility markets are pricing risk.

Negative catalysts:

We continue to see a handful of downside risks for markets in 2025 that are not fully reflected in fixed income valuations. One of our top concerns is around government debt, as we see potential for the market to increasingly scrutinise fiscal deficits, bringing into question longer-term debt sustainability. Many countries including the UK, France and the US could be put under pressure, facing rising bond yields and tough questions around spending which would have a knock-on effect on growth.

Our second downside risk concerns tariffs. US President Donald Trump has made clear his intention to use tariffs as a tool for international negotiations. A rise in tariffs, trade wars and increased uncertainty all have the potential to weigh heavily on the global macro picture.

While a very gradual move to the US ten-year yield above five percent could be manageable for markets, spikes in rates would likely reverse the current, positive sentiment for risk assets.

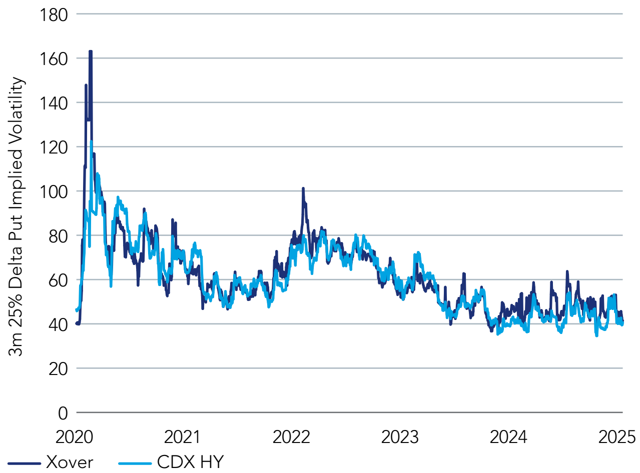
Finally, a potential unwinding of stretched risk assets could have a knock-on negative impact on consumers and growth through tighter financial conditions and worsening sentiment, while any severe escalation in geopolitical tensions has the potential to create broad risk-off moves.

Positive catalysts:

We see potential for the European economy to surprise on the upside, outperforming the weak projections for the region, possibly aided by increased fiscal spend in Germany. Other key upside catalysts include improved Chinese growth and demand led by stronger policy support, which would be especially positive for commodities. There is also the possibility of de-escalation of geopolitical tensions such as improved relations between the US and China and the potential for a more subdued, shorter-term approach to tariffs.

In terms of valuations, despite the minor tech-led wobble in January, risk assets have remained strong with implied volatility on credit index options pricing close to the lows versus history as shown in Figure 6 . This has fed through into volatility markets, with implied volatility on credit index options pricing close to the lows versus history. When combined with the low absolute level of spreads this makes the case for owning some level of hedge protection within portfolios attractive. We also note the relatively steep volatility term structure which suggests investors are pricing higher future uncertainty and have concerns about rising volatility moving forward.

Figure 5: Implied volatility in credit is low



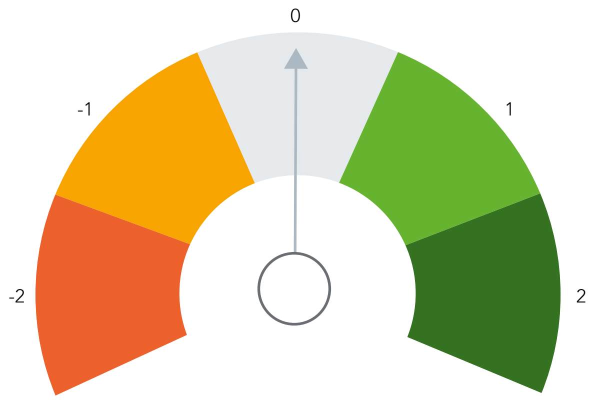
Source: Citi Velocity, Federated Hermes, as at 7 February 2025.

Credit relative value

Credit relative value

Investment grade

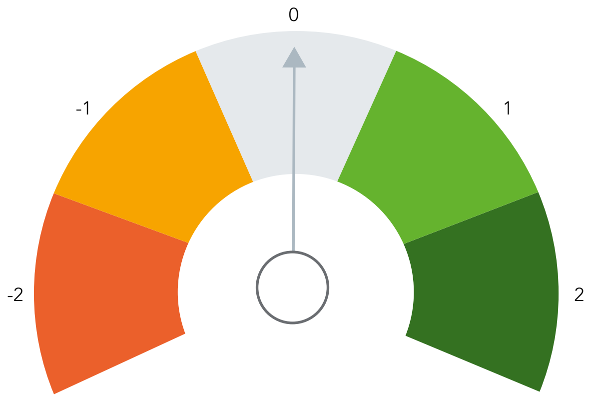
Given spread compression, out performance in 2025 will be highly reliant on sector and issuer selection. We remain overweight financials. Despite a very strong 2024, they trade wide of their median versus industrials; are supported by lower net supply; reduced regulatory; uncertainty and less direct impact from tariff pressures. Moreover, we have seen a marked improvement in credit quality over the last several years, particularly in Europe. Despite starting the year wide, euro-denominated IG credit has rallied to now be almost on top of its USD counterpart in IG territory, hence our regional conviction is far more balanced than at the start of the year. Finally, credit curves remain relatively flat and hence our preference is for more short-to-medium-term maturities to capture adequate rolldown.



Source: Federated Hermes, as at February 2025.

High yield

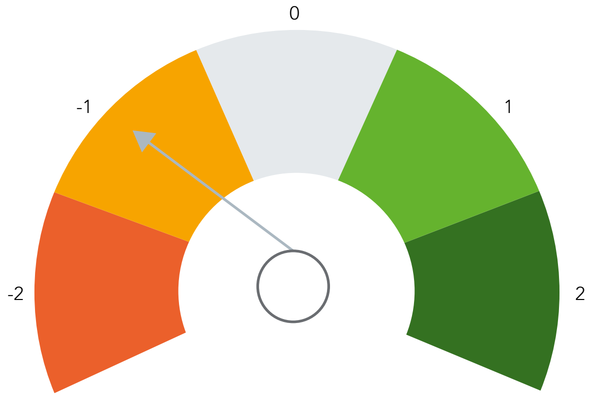
Given underlying macro risk factors and potentially higher-for-longer US dollar rates, we think it makes sense to be defensively positioned – not only in terms of sector but also capital structure – as there is minimal pick-up to gain from stepping down to more junior layers of capital in most issuers right now. Given the recent, strong out performance of European high yield spreads versus US high yield spreads we may seek to re-balance our overweight in Europe versus US. In more highly-levered European cyclical issuers a dose of caution must be applied, particularly in low-margin businesses or ones with hefty short debt maturities. Sector-wise we currently prefer financials, technology, media, and telecommunications (TMT) and healthcare over automotives, chemicals and metals & mining.



Source: Federated Hermes, as at February 2025.

Emerging market (EM) corporates

We do not think there is enough of a premium to step prominently back into EM corporates at the current time, particularly given the elevated risks regarding trade, growth and monetary policy. EM corporates also continue to look rich versus their sovereign counterparts. Latin America looks to offer the best relative value from a regional perspective, and we have exposure to high-quality, low-levered names with more domestic-orientated revenue streams and non-US customer markets. If EM corporate spreads do materially widen on these concerns, we will look to top-up our exposures, conscious that EM corporates generally have worse ratings for their credit profiles than their developed market (DM) counterparts meaning we can buy higher quality issuers with an 'EM premium.'

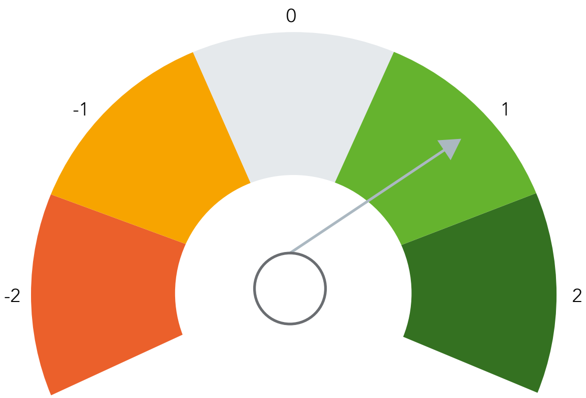


Source: Federated Hermes, as at February 2025.

Credit relative value

Structured credit

Following a record-breaking year for issuance in both asset backed securities (ABS) and collateralised loan obligations (CLOs), 2025 is shaping up to at least match the high volumes of paper available for investors, if not set new records. The strong levels of supply are being met with even stronger demand from investors, leading to spread tightening across capital stacks both in ABS and CLOs. While spreads have reached post-financial crisis tights in some cases, structured credit still provides a pickup relative to corporate credit of the same ratings and maturities, and the floating-rate nature of both ABS and CLOs affords investors a credit opportunity with more protection against rate volatility.

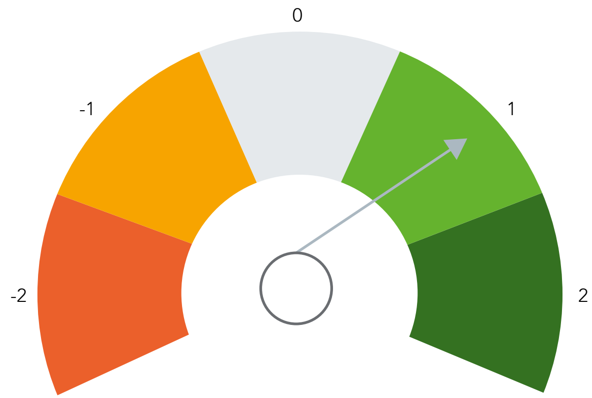


Source: Federated Hermes, as at February 2025.

Our preferred areas of focus remain BBB and BB tranches for both ABS and CLOs, although we recognise the AAA tranche of CLOs has lagged the rally in the mezzanine debt part of the capital stack. In ABS, we are more focused on consumer ABS assets such as consumer loans, auto ABS, credit cards, where the shorter-dated underlying assets lead to shorter weighted average lives on the bonds and mitigate the extension risk at these tight spread levels that come with residential mortgage-backed securities (RMBS).

Financials

Across financials, fourth quarter earnings have been strong, with large cap institutions generally increasing their outlook for 2025. The market continues to benefit from strong technicals, with almost all subordinated paper being called at the first call date and new supply accordingly well received by investors. From a relative value perspective, we continue to see better value in the subordinated layers of the capital structure. Lower coupon perpetual bonds (those with a coupon of less than 5%) have outperformed year to date, and euro-denominated bonds have generally outperformed US dollar paper, while we have seen sterling AT1/RT1 instruments lag due to some of the volatility around gilts. We think instruments with higher backend spreads have the potential to provide downside protection should we see further rates volatility in 2025 due to their lower sensitivity to rates, and we have been looking for attractive opportunities to rotate more into this segment in recent weeks.



Source: Federated Hermes, as at February 2025.