



360°

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Fixed Income Report

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Contents

Click the text on the right to navigate to each section and use the menu at the bottom of the page throughout the report to go between sections easily.

Introduction/Commentary **2**

Spotlight **4**

Fundamentals **7**

Catalysts **10**

Credit relative value **12**



Introduction/Commentary

Spotlight

Fundamentals

Catalysts

Credit relative value

Introduction



Introduction/Commentary

Spotlight

Fundamentals

Catalysts

Credit relative value

**Mitch Reznick, CFA**

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Commentary

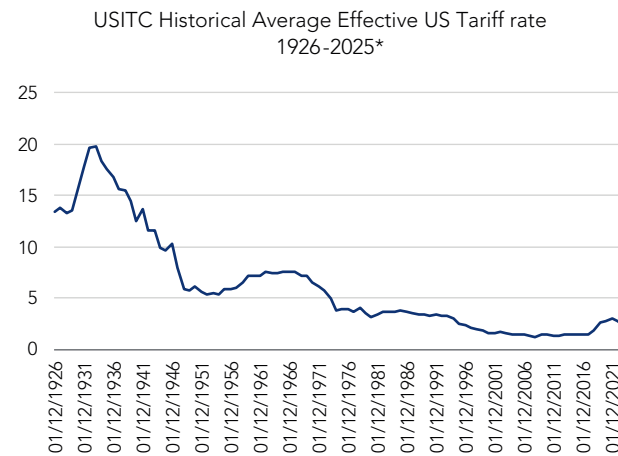
How not to be a deer caught in the ‘headlines’

By the time you read this, it could very well be out of date. This has been the case every time we’ve set out to convey our views on fixed income markets since 20 January. Since inauguration day, we have seen material changes to how the US government operates; shifts in the balance of power and influence; issuance of dramatic executive orders; reversals of those orders (and then reinstatements); the belligerent deployment of trade policy, and so on.

The pace of the news cycle is something to behold. At the time of writing (in early August) all of the below happened in the previous week:

- Europe and the US reached a trade agreement, averting a potentially chaotic situation.
- The US announced a unilateral jump in global tariff rates, codifying average tariffs levels not seen since the 1930s.
- The White House sent letters to the world’s largest drug manufacturers, demanding they cut prices.
- A US Federal Reserve governor resigned in the wake of President Donald Trump’s repeated attacks on the central bank’s leadership.
- A massive revision of US jobs data showed that hiring is slowing.
- President Trump fired the person responsible for the jobs numbers, calling them “rigged”.

It is worth noting that this list is more illustrative than comprehensive.

Figure 1: Highest tariff regime since the Great Depression

Source: Bloomberg, The Budget Lab at Yale. As at 28 July, 2025.

The headlines are relentless and dramatic, which is only compounded by the tendency of the US administration to reverse course. Wall Street has reportedly coined the term ‘TACO’ – Trump Always Chickens Out – in response to the latter phenomenon.

We try to look past the headlines in order to make strategic decisions. We focus on the forces – macro, fundamentals, rates, sentiment, technicals – that drive fixed income markets.

We regularly assess these market drivers to determine how we want to deploy capital across fixed income markets. In our most recent strategy meeting, we concluded that despite some troubling signals from the global economy and corporate fundamentals, the very worst-case scenarios have now become low-probability events.

We have seen a marginal decline in uncertainty since President Trump invoked a national emergency in order to impose tariffs in April¹ (See Figure 1). This decline in uncertainty turned sentiment so positive that, once again, it starts to resemble complacency. Strong market technicals were highly supportive of credit spreads and gave us an opportune time to rebuild our credit options book.

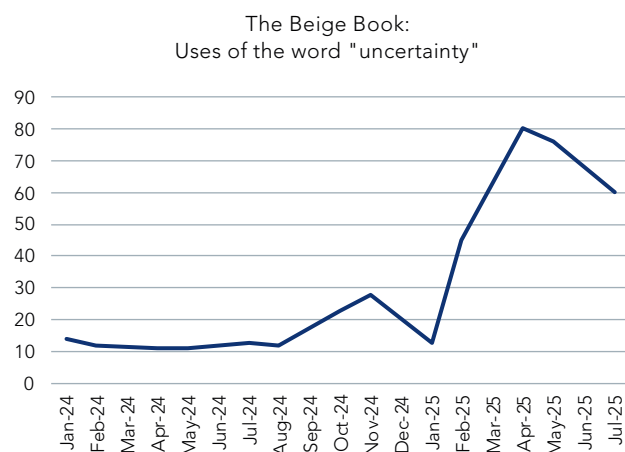
¹ Fact Sheet: President Donald J. Trump Declares National Emergency to Increase our Competitive Edge, Protect our Sovereignty, and Strengthen our National and Economic Security – The White House



Commentary

How not to be a deer caught in the 'headlines'

Figure 2: Fed officials see a dip in 'uncertainty' in recent months



Source: The Federal Reserve, Federated Hermes, Ltd.

* The Beige Book, officially titled Summary of Commentary on Current Economic Conditions, is a report published by the US Federal Reserve Board eight times per year. It summarises anecdotal information gathered from the 12 regional Federal Reserve Banks about economic conditions in their respective districts.

While we have maintained our preference for Europe over the US in credit, we likely underestimated the power of the 'de-dollarisation trade' that has benefited emerging market (EM) credit. Since April, asset-backed securities (ABS) have provided high-quality protection against volatility and we remain positive on this asset class. The collateralised loan obligation (CLO) market remains open and robust and, despite spread tightening, we still see value when investing in high-quality managers. We continue to like European banks and certain flavours of subordinated debt predicated on the strong capitalisation ratios of the sector. This follows years of repairs to balance sheets. We note that across geographies, multiple banks and financials are delivering their strongest sets of earnings.

We remain at below average spreads in a period of above-average risk. However, global high yield spreads are not as rich as they seem when controlling for the remarkable decline in duration. In fact, at three years of duration, we believe high yield credit is an excellent low-duration trade in a rate-curve-steepening market, as we discuss in the Spotlight section.

High yield currently represents an attractive harbour from the rate-volatility storm, as credit volatility is less pronounced than rate volatility right now. While we believe macro conditions are supportive of higher-quality credit, it is not necessarily the case for equity-risk-like credit. As such, we are resisting the Sirens' call to chase default risk for spread and yield. Valuations and spread compression do not yet justify this approach.

We remain concerned that erratic and confusing decisions made by the Republican administration in the US may undermine the credibility of the financial ecosystem. The constant pressure on independent institutions like the Fed is worrying. Pushing out non-partisan civil servants such as the labour statistician claiming that she rigged numbers for political purposes is also troubling. This relates to another concern of ours about the smooth functioning of the US Treasury market. Although the probability of a rupture in the Treasury market remains low, we can no longer rule it out.

Spotlight



Introduction/Commentary

Spotlight

Fundamentals

Catalysts

Credit relative value

Spotlight

Is global high yield a short duration market now?



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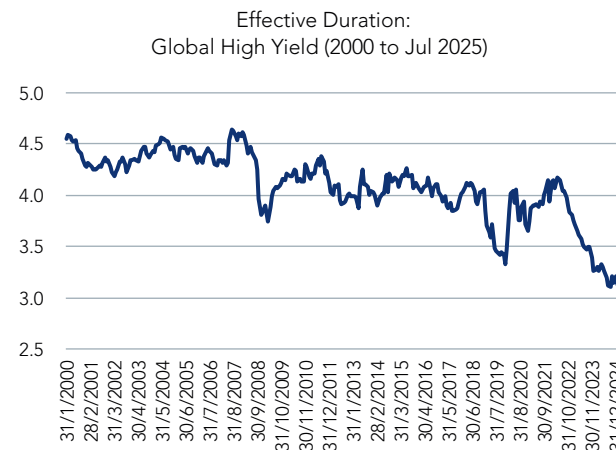
Over the duration, duration has declined

The duration of the global high yield (GHY) market is below its long-term average and quite a distance from its peak. Figure 3 shows duration at around three years, which is by far the lowest it has ever been. This compares to a long-term average of just over four years. This 25% decline in duration requires us to consider valuations in a new context.

Against a regular market backdrop in which credit curves are positively sloped, spreads of a three-year bond should be tight to the spreads of a four-year bond. This means that we cannot compare today's GHY valuations on a pure like-for-like basis versus credit spreads when duration was much higher. The need to assess valuations normalised for duration is compounded by the improving credit quality of GHY over time. In other words, given the lower duration and higher quality of GHY today compared to a few years ago, spreads *should be tighter*.

While we believe spreads are on the rich side of fair in a historical context, we do not think they are as rich as one would think by comparing spreads to the simple long-term average. There are certain constructive aspects of GHY as a short-duration, relatively high-quality asset class: expected lower volatility and lower credit losses.

Figure 3: Global High Yield at record low duration



Source: ICE BofA (HWOC Index). For illustrative purposes only.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. Generally speaking, as interest rates rise, bond prices fall, and factors such as time to maturity and coupon rates are drivers of a bond's duration. High yield is a lower duration

market compared to investment grade. In addition to shorter maturities and higher coupons, a typical high yield bond has embedded call options. This allows the issuer to redeem the bond before its stated maturity. As such, and depending on market conditions, high yield bonds often trade as if they will mature at the call date rather than the maturity date. This happens because the rational investor assumes that the company will refinance the bond at a lower cost of capital available in lower rate and/or spread-tightening environments.

Why is duration falling?

Global high yield markets are shrinking. Since 2020, the European high yield market has been contracting at a rate of 3% per year and US high yield at 1% per year.² The drivers behind the shrinking market are affecting the level of duration.

First, high-quality issuers, which can borrow further out the maturity curve, have been leaving the high yield market and taking their duration with them to the investment grade market. So-called 'rising stars' – moving from high yield to investment grade – have exceeded the amount of 'fallen angels' – falling from investment grade into high yield – over the past few years (see Figure 4).

² Source: Calculations based on ICE BofA data on HE00 and H0A0. 31 Dec 2020 to 31 Dec 2024.



Spotlight

Is global high yield a short duration market now?

Figure 4: Net rising stars in North American and European credit markets

	2025	2024	2023	2022	2021	2020	2019	2018	2017	2016	2015
North America	20	27	7	30	40	3	22	30	22	-30	13
Europe	29	32	31	-9	33	-8	19	52	38	27	-18
Total	49	59	38	21	73	-5	41	82	60	-3	-5

Source: Bloomberg. Based in Moody's ratings. Rising Stars less Fallen Angels.

In addition, we believe the rise of other leveraged finance loan markets, such as direct lending and collateralised loan obligations (CLOs), have trimmed supply into the GHY market by taking market share.

Since 2022, we have also seen a consistent rise in average coupons within the high yield market, as older bonds issued in the lower rate environment are redeemed and new bonds are issued. The effect of this is to bring duration down on the index, as a higher coupon bond will have a lower sensitivity to changes in interest rates, all else equal.

Finally, we should add that although these factors are material in driving down duration, we acknowledge that changes in spread can accelerate changes in duration as well. For example, as spreads are tightening, refinancing becomes more likely and bonds will trade to call. This in turn can lower duration. The reverse is true: as spreads widen, bonds trade to maturity, raising duration.

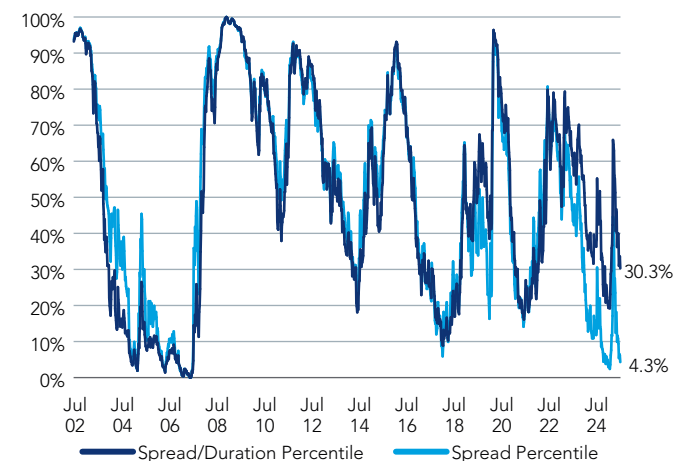
Putting on those duration-tinted glasses

In normal, functioning markets, credit curves are positively sloped. This makes sense. Investors expect to be compensated for the incremental increase in uncertainty as the ability to predict outcomes with any measure of confidence declines over time. Predicated on this universal principle, we should be paid more for four years of risk – the long-term average for duration in GHY – versus three years of risk, which is the current duration of the market.

We should expect spreads today to be lower than the long-term average (and median) because the duration is lower. In order to understand to what extent GHY markets are rich versus fair in this context, we adjusted spreads for duration over time by dividing the GHY spreads by the duration of the market over a 20-year-plus period on a weekly basis. This 'spread per unit of duration' approach normalises spreads for duration over time. We then determined to what extent the duration-adjusted spread levels of GHY are rich versus the past by creating percentile buckets.

The results are shown in Figure 5. Whereas GHY spreads on an unadjusted basis are inside of the five-percentile bucket, over a 20-year-plus period, duration-adjusted spreads are at 30%.

Figure 5: GHY spread divided by effective duration (2002 to 2025)



Source: ICE BofA, Bloomberg, Federated Hermes, Ltd.

Our view is that, on a duration-adjusted basis, GHY spreads are on the rich side of fair, but fall short of market perceptions. This point is even more salient when we consider the improvement of credit quality over that same period (see Figure 6). Over a 20-year period, higher-rated

Spotlight

Is global high yield a short duration market now?

credit in the GHY market has grown faster than any other category on an annualised basis. Based on this growth, it is now 60% of the market versus 45% two decades ago. The double-B category has taken share of the market from both single-B and triple-C, which have both shrunk over time. This is a material shift.

Figure 6: Evolution of credit quality of global high yield (2020-2025)

Global High Yield Market by Rating Bucket	Market Value (USDm)			Proportion of Market		
	2005	2025	20Yr CAGR	2005	2025	% Change
BB	341,820	1,342,722	7%	45%	60%	15%
B	309,834	704,969	4%	41%	31%	-10%
CCC	102,374	195,381	3%	14%	9%	-5%

Source: ICE BofA Indices, as at July 2025.

Beyond the credit-supportive factors that we identified at our recent Multi-Asset Credit Strategy Meeting (MACSM) – macro, fundamentals, technical – this helps to explain where spreads are on both a notional and duration-adjusted basis through this 20-year period as observed in Figure 5.

What does all of this say about global high yield valuations?

GHY spreads are on the rich side of fair. But less so when adjusted for duration. Simple averages indicate that GHY is on the cusp of 20-year tights but, on a duration-adjusted basis, we are nowhere near that.

In addition, we have seen a substantial improvement in credit quality over the past twenty years. These two factors position GHY as a high-quality, low-duration product. Given these two characteristics, GHY is a compelling product in the context of profound interest rate volatility, particularly at the long end of the curve.

Fundamentals



Introduction

Spotlight

Fundamentals

Catalysts

Credit relative value

Fundamentals

Economic outlook

The outlook for the global economy has improved slightly since our last assessment, leading us to upgrade our macroeconomic outlook score to -0.5.

This revision is largely due to the resilience of global economic data, especially in the US. Credit spreads remain tight and volatility remains low which suggests investors will be comfortable looking through any soft patches in growth as long as recession risks remain low.

US domestic policy uncertainty, a key theme of the first half of this year, looks set to continue in the second half. As shown in Figure 1, US tariffs are likely to remain at the highest levels in decades. We also expect US-China trade relations, a key linchpin of global growth, to gradually improve. These combined effects will potentially cause a mild slowdown in the US economy and we now expect 1.5% GDP growth this year followed by 1.6% next year. However, the tax cuts extensions and deregulation commitments that were signed into law in July could provide a near-term tailwind.

Disinflationary pressure in Europe and China should free their governments and central banks to stimulate their economies. We are more constructive on Chinese and European growth prospects and think investors should be taking advantage of opportunities to diversify their risk exposures more globally, and we expect non-US assets to continue to outperform.

Europe should benefit from greater fiscal spending, a stable consumer backdrop and potentially more rate cuts from the European Central Bank (ECB). Next year, GDP growth also stands to receive a boost from Germany's fiscal stimulus plan and broader efforts to lift defence spending in the region. We expect the European economy to grow by 1% this year followed by 1.1% in 2026.

China's economy is on track to grow by 5% this year and is being supported by policymakers' decision to help household consumption and support capital expenditures in private companies.

Catalysts



Introduction

Spotlight

Fundamentals

Catalysts

Credit relative value

Catalysts

Catalysts

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:

There are several downside risks for markets in 2025 that we believe are not fully reflected in fixed income valuations. Current spreads show investors are optimistic that the US will secure more deals with its trading partners and that these will be agreed at rates well below those unveiled at 'Liberation Day' on 2 April.

The US had only secured a handful of framework agreements by early August, including with the EU and the UK, but formal trade deals are expected to take much longer and the terms of the final agreements may look different. Tariffs have not been in place long enough for markets to fully assess the economic impact but we see potential for higher-than-average earnings misses and downward guidance revisions for the second and third quarters this year.

The tariffs are driving a significant decline in Chinese imports into the US, and we see risks around those imports being diverted to Europe. An influx of low-cost goods may somewhat offset the inflationary impacts of tariffs for Europe but will put greater competitive pressure on its key manufacturing industries like autos, electronics and industrial machinery.

Challenging growth conditions and higher spending commitments in areas like defence will bring fiscal deficits increasingly into focus for countries like the US, UK and

France. Long-term debt sustainability remains a risk and could see yields on government debt come under pressure if deficits are not brought under control.

Positive catalysts:

European capital markets stand to benefit if US market volatility drives more capital flows across the Atlantic. If the European Central Bank (ECB) brings down interest rates it could also make it easier – and cheaper – for high-risk European credits to refinance. There is the added possibility that weak economic data, or higher rates, could turn US public opinion against the tariffs, and pressure the Trump administration into a reassessment.

In terms of valuations, volatility has retraced significantly from the wides in April, though there is still some way to go, especially in the US. When we consider the low levels of underlying spreads there is a decent case to be made for continuing to own some level of hedge protection within the portfolios over the summer. We also note that volatility skew remains elevated, though it has come off the extremes, suggesting some investors may be pricing in a lower probability of a negative tail event.

Figure. 7: Three-month ATM implied volatility

Date	Current	1Y History		Percentile		
		Min	Max	1Y	3Y	5Y
CDX HY	34.50	24.55	65.64	47%	38%	23%
CDX IG	41.33	32.09	70.84	55%	53%	37%
ITraxx Crossover	36.47	30.10	64.16	48%	37%	22%
ITraxx Main	41.90	36.24	72.63	31%	31%	30%

Source: Citi Velocity, Federated Hermes, as at 19 August 2025.

Credit relative value



Introduction

Spotlight

Fundamentals

Catalysts

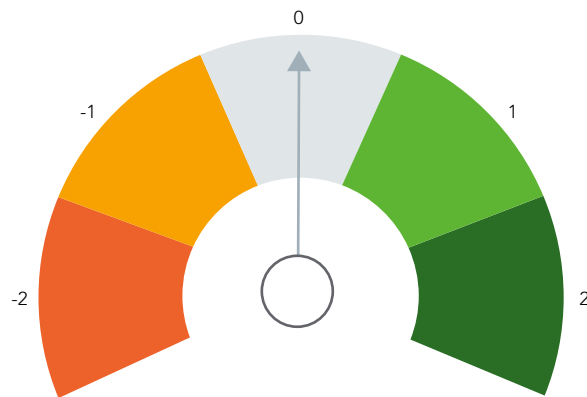
Credit relative value

Credit relative value

Investment grade

Elevated all-in yields are driving strong and sustained investor demand, marking investment grade credit as an attractive asset class at the current time. Demand has consistently outpaced supply, leading to shrinking concessions on new issues as deals are heavily oversubscribed. In this environment, technicals remain supportive and valuations compressed.

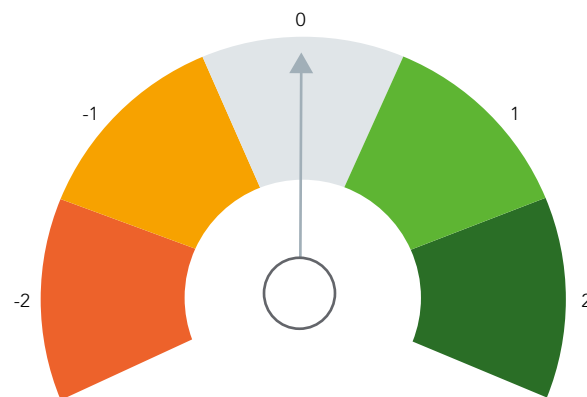
Given the macro backdrop – marked by rate normalisation and geopolitical uncertainty – we maintain a preference for defensive, non-cyclical sectors such as healthcare as well as an up-in-quality approach with A-rated paper offering value versus their BBB counterpart. Despite tight spreads, we favour euro-denominated debt, as the European Central Bank's (ECB's) policy normalisation is further along than the Fed's. Our positioning leans toward medium-term maturities, where the credit curve is steepest and offers the most attractive risk-adjusted carry.



Source: Federated Hermes, as at February 2025.

High yield

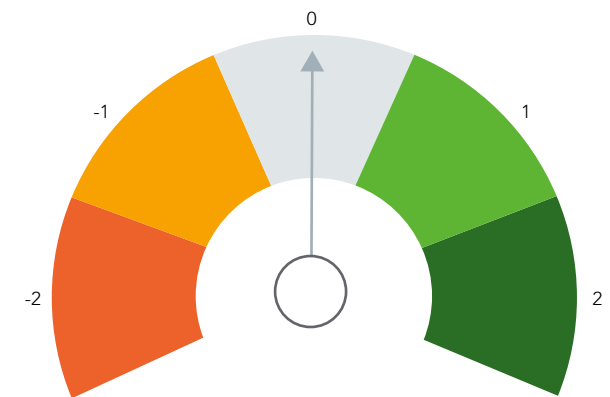
The high yield bond market has shown notable resilience and strength through the first half of the year, rebounding from early-year volatility driven by tariff uncertainty and geopolitical tensions. This market is experiencing a notable supply-demand imbalance due to a limited amount of issuance (most of it being refinancing activity) and persistent investor demand leading to a shrinking size of the high yield universe. Therefore, we maintain a constructive view on the asset class. We also note that leveraged buyout (LBO) activity has picked up. Despite a global spread tightening trend, Bs have recently lagged and now seem attractive against BBs. Finally, we see value in euro-denominated paper from US-based companies.



Source: Federated Hermes, as at February 2025.

Emerging markets (EM)

Emerging market credit has demonstrated impressive resilience over the past six months, supported by a favourable macro backdrop and structural tailwinds. Our initial view of tariffs meaningfully impacting EM economies is yet to fully play out. We continue to monitor the situation given EM's importance to global supply chains and commodities. The ongoing trend of de-dollarisation has boosted hard and local currency EM fixed income assets, attracted broader investor interest and reduced vulnerability to US rate volatility. Meanwhile, Chinese growth continues to tick higher, providing a stabilising anchor for regional economies and supporting corporate fundamentals.



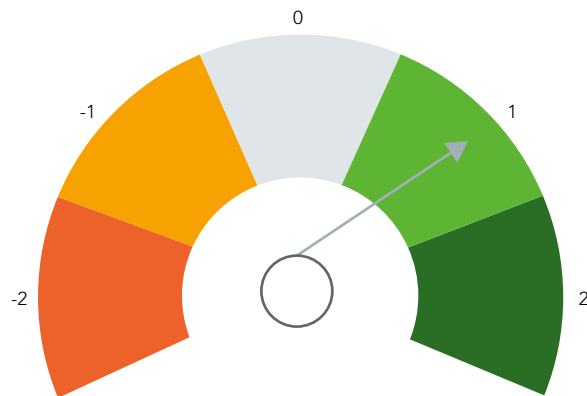
Source: Federated Hermes, as at February 2025.

Our outlook scores run from -2 to +2 and reflect the views of our investment professionals, expressed at the regular Multi-Asset Credit Strategy Meeting (MACSM). A negative score reflects headwinds for credit markets, while a positive score indicates a more constructive outlook.

Credit relative value

Financials

The supportive macro environment has continued to benefit financials, and this has come through in strong second-quarter earnings, with many large-cap institutions increasing their outlook for FY 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. Due to their lower sensitivity to rates, we think instruments with higher backend spreads have the potential to provide downside protection should we see further rates volatility. We have been looking for attractive opportunities to rotate more into this segment in recent weeks.



Source: Federated Hermes, as at February 2025.

Structured credit

Structured credit currently exhibits some familiar characteristics. Spreads are arguably tight, and in some cases are the tightest in years. However, demand remains high and the supply, especially in European asset-backed securities (ABS), is falling well short of investor appetite. This supports the outlook for technicals.

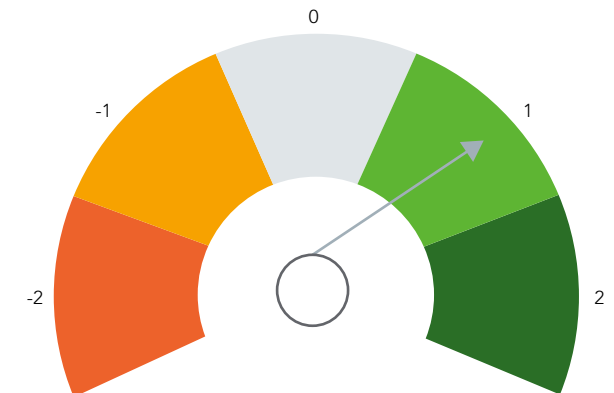
Despite the almost continuous spread tightening trend we've seen since Q4 2022, structured credit still provides investors with a pick up in spread and yield when compared to corporate credit for any given level of risk.

The US tariff announcements on 2 April provided an interesting case study in how the structured credit market reacts to bouts of volatility. While collateralised loan obligations (CLOs) moved along with corporate credit, ABS held steady, contributing a carry trade during that turbulent period and proving a useful dampener to volatility.

ABS and CLOs issuance this year has been robust. Year-to-date European ABS issuance is slightly behind where we were this time last year. However, 2024 was the best on record since the global financial crisis. For CLOs, US issuance this year is running in line with 2024, while in Europe we are significantly ahead on a year-to-date basis compared to last year.

The number of open warehouses – which are an indication of the supply to come to the CLO market – are meaningfully above the long-term average, suggesting there is substantial issuance to come. Despite this view on supply, the technicals

remain firm for mezzanine tranches as the depth of the investor base has grown in recent years. However, the volume of paper coming to the European CLO market means the AAA and AA tranches are not trading as tight as the rest of the stack when considered on a five-year basis.



Source: Federated Hermes, as at February 2025.

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