BARINGS

2025 OUTLOOK

NAVIGATING A SHIFTING LANDSCAPE

GLOBAL FIXED INCOME

CONVERSATIONS

Against a shifting macro, political and geopolitical backdrop, our fixed income portfolio managers explore the future prospects for high yield, emerging markets debt, and investment grade credit.

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COLIN GORDON (MODERATOR): In thinking about the outlook for 2025 and beyond, Donald Trump's victory in the U.S. presidential election is a key factor on many investors' minds. What are the potential implications of a second Trump administration for each of your markets?

BRIAN PACHECO: A second Trump administration, at a high level, will likely mean stronger growth and less regulation—and the U.S. high yield market was very quick to price that scenario in following the election. From a sector standpoint, the effects of Trump's policies on energy will be interesting. While energy rallied following the election, it's unclear whether a so-called "drill baby drill" scenario is necessarily a good outcome for the sector, or whether it will meaningfully increase supply—especially since prices, not regulation, have been the key determinants of energy supply in recent years. And of course, there are demand and geopolitical elements that could impact the picture as well.

RICARDO ADROGUÉ: From a geopolitical standpoint, there is a perception that risks are waning now that the election is behind us. That may be true to an extent—especially regarding Russia-Ukraine and the Middle East—but I do have nagging concerns that the market may be getting overly optimistic given the vast array of complicating factors surrounding each of these geopolitical crises.

OMOTUNDE LAWAL: With regard to both emerging markets (EM) and European corporates, tariffs are a major source of uncertainty under Trump 2.0 and an issue we're monitoring closely. For EMs, China is the biggest unknown and the most material to the global economy. Under the first Trump administration, we saw a reorientation of trade from China to other parts of the world. Looking ahead, we expect there to be winners and losers across EMs in a global tariff war. Commodity exporters and countries with strong domestic economies will likely show some resilience. But the market may be underpricing the extent to which China can and probably will fight back economically.

COLIN GORDON: Despite the uncertain environment, credit spreads continue to tighten. Is there a disconnect between what you're seeing from the top down and bottom up?

BRIAN PACHECO: High yield spreads are tight relative to history, but there are reasons for this. From a macro perspective, recession and political risks, while still present, appear to be moderating—and credit loves moderation. From a fundamental standpoint, high yield issuers are in good financial health overall, despite pockets of weakness in retail and other consumer-oriented sectors. Technical forces in the form of strong demand and low supply are providing further support.

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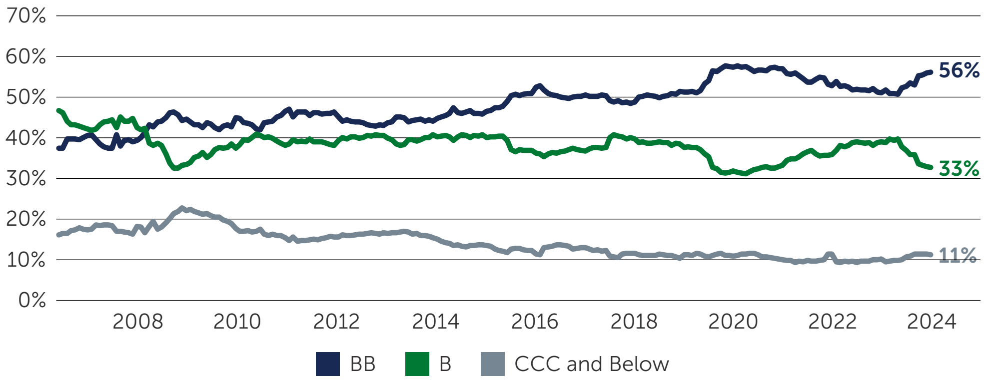
The high yield market has also structurally changed. It is as high-quality as it's arguably ever been, with the percentage of BB issuers in the global high yield bond index near all-time highs at 56%, and the percentage of CCC issuers around 11% **(Figure 1)**. Additionally, the duration of the market is around three years, which suggests there is less sensitivity to spread widening. The increase in quality, in particular, has helped keep default rates low as well. Defaults typically come from CCCs, and given how small of a percentage that CCCs account for today, we expect defaults going forward to remain within the bounds of history, even if they pick up slightly in the coming year.

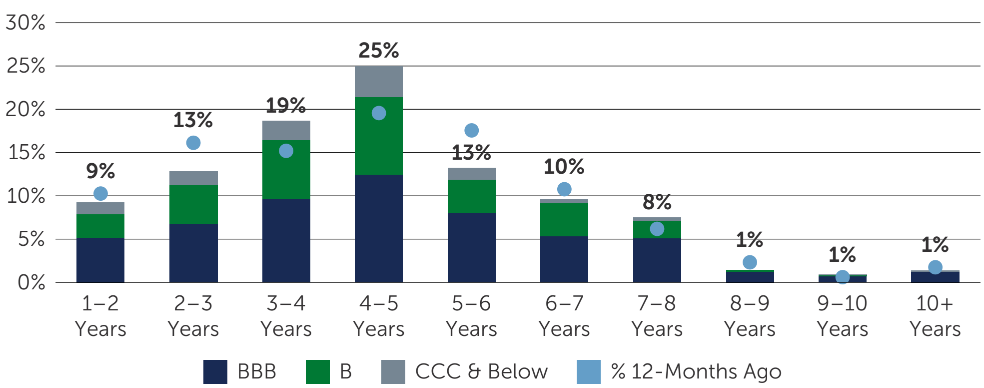
Figure 1: A Higher-Quality Global High Yield Market



Source: ICE BofA. As of September 30, 2024.

Given the high quality and short duration of the market, it is also worth mentioning that maturity walls—another looming risk—are arguably less concerning than some market participants may believe, and may even be more "asset" than "liability." Because high yield companies typically refinance 12–18 months ahead of a maturity, securities that are being refinanced early—and that are currently trading below par—are in many cases earning a higher return than their yield-to-worst would imply. There is a big portion of the market that fits this dynamic and looks fairly attractive as a result.

Figure 2: High Yield Maturity Wall May Be Less Concerning



Source: JP Morgan. As of September 30, 2024.

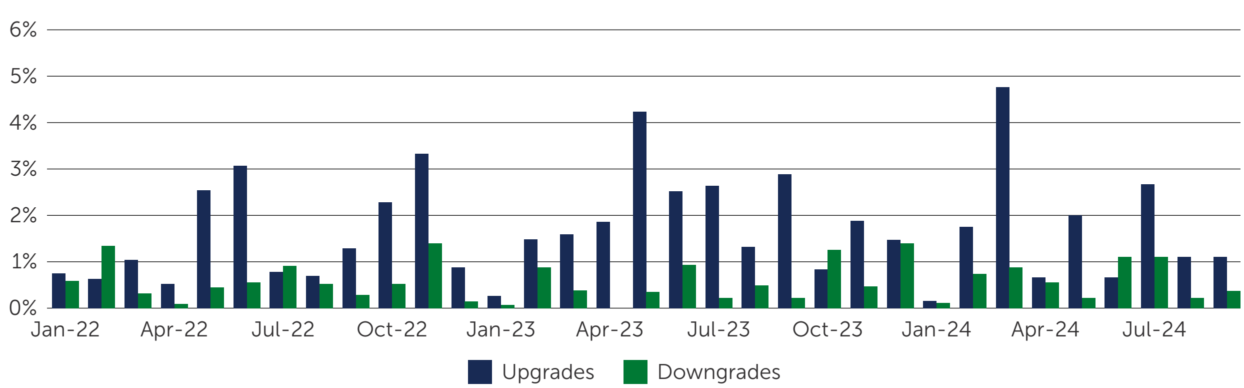
CHARLES SANFORD: The bottom-up picture is similarly positive for IG credit. Technicals are notably strong, and demand remains robust—particularly from yield-focused insurers that are seeking to match the liabilities coming from surging demand for fixed annuities. Fundamentals are also strong across the U.S. and Europe, with corporate earnings having largely recovered to pre-pandemic levels. That said, leverage continues to creep up, suggesting that the tightness in spreads may not be fully justified by the fundamental picture, particularly given the potential for volatility going forward.

COLIN GORDON: Looking at the macroeconomic backdrop, the U.S. and European economies appear to be heading in different directions. Do you agree with that, and what are the implications for your asset classes?

RICARDO ADROGUÉ: The U.S. economy does appear to be headed in a more positive direction than Europe, but the picture is nuanced. Europe has been subject to several negative shocks in recent years. When Russia invaded Ukraine, Europe limited the amount of oil and gas they purchased from Russia, instead opting to buy at higher prices from the U.S.—resulting in a big spike in energy costs. Europe also increased military spending during this period, and due to a lack of domestic suppliers was again forced to turn to the U.S. So, while the U.S. economy is certainly strong, the factors driving some of Europe's challenges suggest it has not become less productive as an economy. Instead, it is more likely going through a cyclical downturn that at some point will turn around. Nonetheless, this backdrop will likely result in lower rates in Europe and—assuming a backdrop of elevated interest rates in the U.S.—a wider differential between interest rates that could further strengthen the U.S. dollar against the euro.

OMOTUNDE LAWAL: I agree with Ricardo in that Europe is facing pressures that could negatively impact the European economy and European corporates in the near to medium term. But I wouldn't rule out European corporates completely. Interestingly, over the last several months, there has been a bifurcation within Europe. "Core" Europe has faced greater challenges than "peripheral Europe," where many corporates actually have been quite resilient despite downward trending eurozone PMI data—particularly larger European IG companies with a global footprint. Additionally, as Charles mentioned, the fundamental and technical pictures are solid overall. Corporate ratings actions also are trending positively, with multiple times the number of upgrades versus downgrades in recent years **(Figure 3)**. All of this is to say that while the economic differences between the two regions appear significant, the picture is more nuanced from a bottom-up perspective, and that is what will ultimately drive our allocations going forward.

Figure 3: European Corporates: More Upgrades Than Downgrades



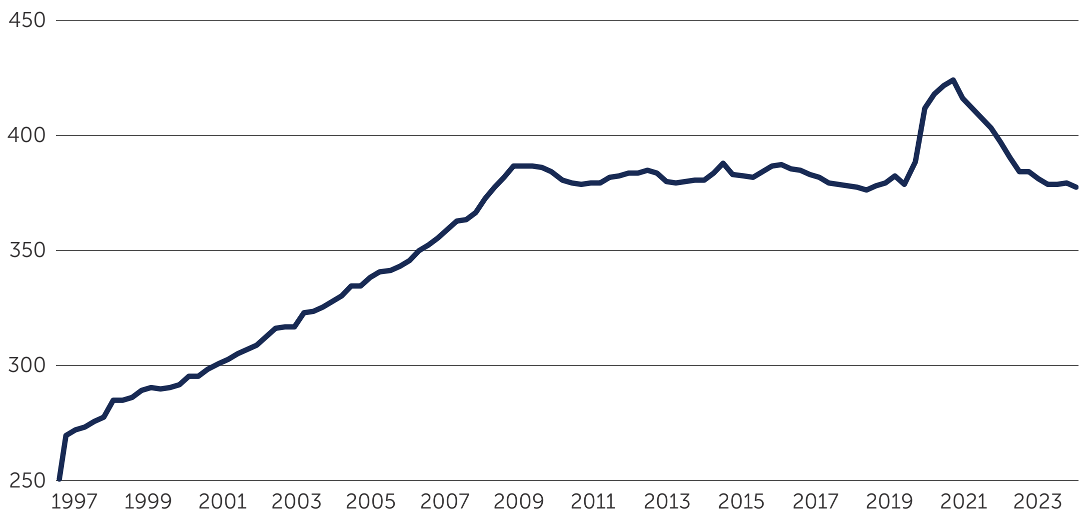
Source: JP Morgan, Bloomberg. As of September 2024.

COLIN GORDON: All of you have invested through many credit cycles during your careers. What feels different about this one?

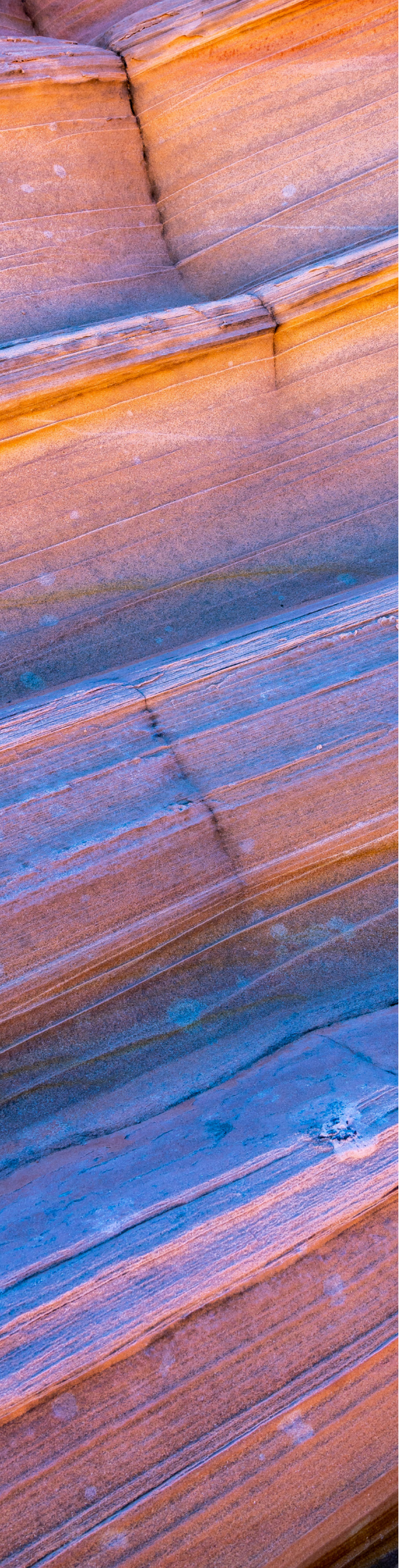
CHARLES SANFORD: I don't think we're necessarily late in the cycle, and a key reason for that is that there aren't any major built-up imbalances in the system. Prior to the GFC, for example, there was a significant amount of leverage in the system, and we similarly saw companies taking on substantial leverage during the energy crisis in 2015/2016. There have also been periods during which M&A has increased substantially, with IG corporates taking on significant amounts of leverage to acquire other companies. So, while spreads are tight and have been for a while, there are reasons to believe this cycle could continue drifting on for quite some time.

RICARDO ADROGUÉ: I agree that there may be further room to run in this cycle. As **Figure 4** shows, global debt stock has been fairly steady since 2008, with the exception of a spike in 2020. This is largely due to the fact that even as debt-to-GDP at the government level has risen, debt-to-GDP across households and corporates has fallen overall. At a consolidated level, debt-to-GDP is actually lower today than what it was at the onset of the 2008 crisis.

Figure 4: Total DM Debt Has Remained Steady (% GDP)



Source: Institute of International Finance, Bloomberg. As of June 2024.



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OMOTUNDE LAWAL: The idea that we're not yet in late innings is reflected across the corporate landscape as well. Corporate balance sheets in Europe and across emerging markets are healthy relative to history, and leverage levels—while in some cases beginning to creep up, as Charles said—have been improving overall over the last decade or so. This suggests that on the technical side, you could see spreads grind a little tighter in sectors and companies where there is room for margin expansion, especially in Europe on the back of further rate cuts. On the EM side, many EM central banks were ahead of the rate-cutting curve with the Fed, which has created headroom for companies in those countries that operate primarily in their domestic markets.

The health of the global financial sector is also much improved relative to where it was a decade ago. Looking at Europe, the banking system has recovered fairly quickly following the Credit Suisse collapse. I mentioned ratings upgrades earlier, and it's interesting to note that some of the upgrade trends in Europe have actually been concentrated in the banking sector, with several Italian and Spanish banks being upgraded recently. There's a similar theme in EM, with the banking system in better shape overall. Some EM banking systems, such as in Mexico, are as well-capitalized that they've ever been.

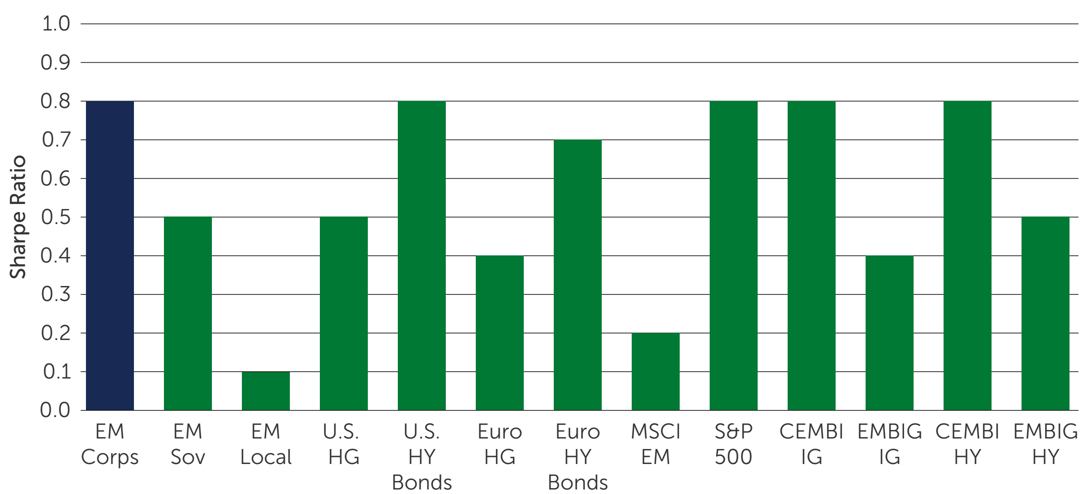
BRIAN PACHECO: We feel good about the resiliency of the high yield market, especially from a bottom-up perspective, but it's difficult to pin where exactly we are in the credit cycle given the amount of liquidity out there. Largely a function of the fiscal and monetary stimulus coming out of Covid, the liquidity in the market has made traditional recession indicators—an inverted Treasury curve, leading economic indicators, manufacturing PMIs—less reliable. At some point, when the excess liquidity leaves the market, these indicators should start working again. Until then, the view from the top down is a little hazier.

COLIN GORDON: Looking ahead, what are your best ideas for fixed income investors in 2025?

OMOTUNDE LAWAL: EM corporate debt is certainly coming off a challenging several years, but for investors who are allocated to the asset class and questioning whether the returns are justifying the risks, I would point to a few considerations. For one, EM corporate debt's Sharpe Ratio, at 0.8x, is attractive relative to both history and other fixed income asset classes despite all the perceived headline noise **(Figure 5)**. Given the solid fundamental backdrop, default rates are now trending back toward normalized levels. Coupled with the sheer diversity within the EM corporate universe and lower correlation to some other asset classes, we believe it can serve as an effective diversifier in an asset allocation model.

All of that said, 2025 will likely be a year of uncertainty, which means rigorous, bottom-up credit analysis will be key to uncovering the idiosyncratic stories—the "winners"—that are positioned to benefit. EM businesses with U.S.-based operations, for example, look well-positioned amid what we expect to be near-term exceptionalism. In the likely event of a stronger U.S. dollar, EM exporters that have hard currency revenue streams could benefit. Defensive sectors also look compelling given the prevailing uncertainty.

Figure 5: EM Corporate Debt has Delivered High Risk-Adjusted Returns vs. Other Asset Classes



Source: JP Morgan. As of September 30, 2024.

RICARDO ADROGUÉ: 2025 also looks compelling for EM sovereign debt. Now that the U.S. Federal Reserve has transitioned from quantitative easing to purely using interest rates, we believe global commercial banks will increase their lending to levels more in line with history. Given the diversification potential and other attractive characteristics underlying EM, we expect direct investment flows into EM to return as well—something we believe the market may be missing.

Against this backdrop, high yield sovereign hard currency looks particularly attractive. Spreads have rallied in this segment, but in many cases, they remain significantly wider today than before the pandemic. The reason for this is that during the pandemic, multilateral institutions like the International Monetary Fund and the World Bank recommended that some of these sovereigns should stop paying their debts, and instead default and start the debt restructuring process. A number of the countries did end up doing this, and, as a result, their prices were trading at very distressed levels. It took a long time for some of these credits to come back to the market, and some of them are still renegotiating their debts. We continue to believe the risk-reward profile is particularly compelling in BB sovereigns with strong fundamentals.

BRIAN PACHECO: Heading into 2025, we see benefits to being long U.S. loans with an overlay of Treasury futures. There is not much excess return in spreads at the moment—rather, we're in a carry environment, and loans offer substantial carry. In the event that we see a step-change in interest rates, particularly if rates decline more than expected, Treasury futures offer some protection. In the context of a short duration and high-quality market, we believe this is a combination that should fare well under different scenarios.

CHARLES SANFORD: Depending on an investor's needs, there are compelling opportunities across any pocket of the credit markets. For insurance investors, particularly annuity buyers, elevated rates present compelling opportunities along the front end of the curve, whereas the long end of the curve looks more attractive for whole life buyers. For relative return investors, although spreads have compressed, there are interesting opportunities in less followed/less liquid issuers, especially in the financial sector, with aircraft lessors, business development companies, and select BBB insurance companies offering value.

> "Depending on an investor's needs, there are compelling opportunities across any pocket of the credit markets."

This piece has been adapted from our 2025 Global Fixed Income Outlook. Watch the full webinar here.

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**As of September 30, 2024*

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