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Insight INVESTMENT

FIXED INCOME MARKET REVIEW AND OUTLOOK DECEMBER 2024

We summarise the key events, influences and driving factors across the markets, and provide our outlook for the global and regional economies and fixed income asset classes.

MARKET DATA[1]

Bond yields (10-year)		Monthly change (bp)
USA	4.57%	+40
Germany	2.36%	+28
Japan	1.10%	+5
UK	4.57%	+33
Bond spreads (over govts)		
Bloomberg US Corporate Index	80bp	+2
Bloomberg Euro Corporate Index	102bp	-6
Bloomberg Sterling Corporate Index	96bp	-12
Bloomberg US Corporate High Yield Index	287bp	+21
Bloomberg Pan-European High Yield Index	309bp	-22
Equities		Monthly change (%)
S&P 500	5,882	-2.5%
Stoxx Europe 600	507.6	-0.5%
FTSE 100	8,173	-1.4%
Nikkei 225	39,895	+4.4%
Hang Seng	20,060	+3.3%
Currencies		
EUR/USD	1.035	-2.1%
JPY/USD	157.2	-4.7%
GBP/USD	1.252	-1.7%
Commodities		
Oil price (Brent crude), $ per barrel	74.6	+2.3%
Gold price, $ per oz.	2,625	-0.7%
CRB Commodity Index	537	+0.1%

MARKET REVIEW[2]

Governments – Government bond markets weakened in December, as markets reflected concerns of inflation increasing and expansionary fiscal policies. The yield on the 10-year US Treasury rose 40 basis points (bp) to 4.57%. German yields also increased, with the 10-year rate rebounding 28bp to end December at 2.36%. UK gilt yields followed suit as the 10-year yield increased by 33bp to

[1] Source: Bloomberg. As at 31 December 2024.
[2] Source: Bloomberg, Barclays. As at 31 December 2024. For illustrative purposes only. The views shown are market views and don't directly relate to an investment strategy and shouldn't be relied on as recommendations.

4.57%. Yield levels also rose in Japan with 10-year Japanese government bond yields rising 5bp, ending the month at 1.10%. Yield levels in emerging markets were high as well with the JP Morgan Emerging Market Bond Index yield rising 10bp to 6.39%.

Credit – Credit markets were mixed during December, with the US seeing spreads edge higher, while in Europe they were generally slightly lower overall. The option-adjusted spread (OAS) over governments for the Bloomberg US Aggregate (Agg) Corporate Index ended the month higher by 2bp at 80bp, while the Bloomberg US Corporate High Yield Index spread was 21bp wider. The spread on the Bloomberg Euro Agg Corporate Index tightened by 6bp over the month to 102bp, as the Bloomberg Sterling Agg Corporate Index was 12bp tighter, taking the spread below 100bp for the first time. Meanwhile, the Bloomberg Pan-European High Yield Index spread tightened by 22bp.

The Bloomberg US Investment Grade Corporate Index generated excess returns of -2bp in December. Supermarkets, aerospace/defense, gaming and airlines were the strongest performing sectors generating positive excess returns. Meanwhile, health insurance, healthcare, and media entertainment were the largest detracting sectors.

The Bloomberg Euro Agg Corporate Index generated 34bp in excess returns in December as spreads tightened slightly, though the increase in government bond yields meant total returns for the month were slightly negative. Insurers and real estate investment trusts (REITs) made notable gains, as did integrated energy companies, natural gas utilities, and media entertainment. Though no sectors had negative excess returns, banking, supermarkets, and oil field service companies lagged the rest of the market.

Excess returns for the Bloomberg Sterling Agg Corporate Index were 85bp in December, the strongest single month in 2024. However, as with its euro corporate counterpart index, gilt market weakness meant total returns for the month were negative. The strongest performing sectors were utilities, diversified capital goods, and other financials. Automotives, banking, life insurers, and building materials companies lagged behind in what was overall a strong month for corporates.

ABS markets were mixed in December; with senior UK and Dutch Prime residential mortgage-backed securities (RMBS) showing some signs of fatigue as spreads widened modestly. However, the broader market rally continued, with spreads grinding tighter across in many areas. However, UK autos were modestly wider despite the headlines surrounding financing agreements.

Equities – Global equity markets were mixed during a volatile month that saw some new all-time highs achieved, notably in the US, where the S&P500 Index initially almost broke through 6,100, but ended the month below 5,900, declining 2.5% in the period. Small-cap stocks were weaker still, with the Russell 2000 Index ending December 8.4% lower. Elsewhere, the Stoxx Europe 600 Index declined 0.5%, the FTSE 100 Index fell by 1.4%. Gains were more prevalent across Asian markets. The Nikkei 225 Index rose 4.4%. Hong Kong's Hang Seng Index rose 3.3% and the Shanghai Composite Index ended 0.8% higher. The broad Commodity Research Bureau Commodity Index was barely changed, ending 0.1% lower. Within that, the gold price lost 0.7% in the face of widespread US dollar strength, while oil prices were generally 2%-5% higher over the month.

Currencies – The US dollar was stronger once again despite the easing move by the Fed. It gained 1.7% against sterling to $1.25, was 2.1% stronger against the euro and gained 4.7% against the Japanese yen. The Australian and New Zealand dollars were each around 5% weaker against the US dollar, while the South African rand fell 4.4% and the Brazilian real was 3.5% lower.

ECONOMICS[3]

Global

The final month of 2024 saw further policy easing by two of the main central banks among others, despite inflation increasing slightly in some countries. Economic activity continues to remain subdued and sub-trend, but forward-looking indicators generally suggest some modest improvement ahead. Markets have been wrestling with the uncertainty surrounding the imminent return of Donald Trump to the White House, and what policy proposals may be forthcoming, including the imposition of trade tariffs, moves to deport large numbers of immigrants and how he may be able to influence Russia and Ukraine to bring an end to their war.

US

A number of economic data reports pointed to improving economic conditions. The Institute of Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) recovered sharply, while the increase in the number of new jobs created also rebounded, beating the market's expectations. The growth in average hourly earnings remained well above both headline and core inflation at 2.7% and 3.3% respectively. However, the Philadelphia Fed Manufacturing Index extended its sharp recent decline, dipping markedly further in December to -16.8, its lowest level of 2024 and well below market expectations for an increase to +3. Consumer sentiment was mixed, with a strong improvement in the perception of current conditions in the University of Michigan survey sitting alongside a deterioration in consumer expectations. Amid the mix of both stronger and weaker economic data and higher bond yields, the Fed made a 25bp rate cut, the third consecutive reduction and in line with the consensus forecasts. Projections for the future

[3] Sources: Bloomberg, Trading Economics. As at December 2024.

suggests policymakers have become more hawkish and now envisage fewer and/or a slower pace of rate cuts ahead, with potentially as few as just two further cuts in 2025. The change of rhetoric helped undercut US stock prices and send the US dollar higher.

Eurozone

Headline inflation edged up slightly in the eurozone, but the move was anticipated and did not prevent the European Central Bank (ECB) from easing policy once more. Rates were reduced by 25bp, taking the deposit rate to 3.0%. In contrast to the US Fed, policymakers appeared to become less hawkish, with ECB President Christine Lagarde admitting that some rate-setters had advocated for a 50bp reduction in rates. The euro was weaker over the month as a whole as well as in response to the more dovish comments as it fell to its lowest level of the year against the USD, below $1.05. There was some positive economic news. The ZEW Economic Sentiment Index increased to 17.0 in the month, while the HCOB Composite PMI increased to 49.5, boosted by an unexpected improvement in the services component. GDP growth in Q3 was confirmed to have been just 0.2%. Political turbulence continued in the region, with the government of German Chancellor Scholz losing a no-confidence motion that means new elections will take place in February. Meanwhile, in France Prime Minster Michel Barnier failed to pass his budget proposals and was ousted from his post by parliament. President Macron subsequently appointed former presidential candidate Francois Bayrou as Prime Minister, hoping to break the parliamentary deadlock between the left, right and centrist parties that resulted from the summer election.

UK

Despite three of the nine policymakers voting for a rate cut, the Bank of England kept rates unchanged at 4.75% at its December policy meeting, following an unexpectedly large increase in the rate of wage growth. The year-on-year growth rate of average earnings, both including and excluding bonuses, accelerated to 5.2%, while employment growth continued. Inflation also increased at both headline and core levels, to 2.6% and 3.5% respectively, though the moves were generally expected. In other data releases, the Halifax House Price Index increased by 4.8% year-on-year in November, its fastest pace since July 2022, as mortgage demands continued to improve. However, the initial report for Q3 GDP growth rate of an anaemic 0.1% quarter-on-quarter was revised away completely, meaning that the UK economy has only expanded in two of the previous six quarters.

Japan

Japan's central bank, the Bank of Japan (BoJ), kept interest rates unchanged 0.25% following its December policy meeting, but inflation pressures increased once again. The headline rate reaccelerated to 2.9% from 2.3%, while the core rate increased to 2.7%. The BoJ has cited a preference to consider wage trends to help guide its policy decisions. The quarterly Tankan survey of large manufacturers edged higher to 14, its highest level since Q1 2022. Meanwhile, the Jibun Bank Composite PMI rose by more than the market had expected during the month, with both the manufacturing and services components increasing.

Emerging markets

Chinese headline inflation declined modestly for the third successive month, reaching 0.2% in November. However, according to the National Bureau of Statistics of China, the rate of decline in the house price index moved upward for the first time since May 2023, rising to -5.7% year-on-year in November. A further deterioration to -6.0% had been anticipated in some parts of the market. However, retail sales growth fell back sharply to just 3.0% year-on-year after two recent stronger monthly reports. The National Bureau of Statistics of China reported a slightly weaker manufacturing PMI, though the equivalent PMI for non-manufacturing was significantly stronger, and well ahead of market expectations.

In other emerging market countries, Brazil's inflation rate increased once more to 4.87%, while the rate of industrial production increased to 5.8%. However, the central bank raised interest rates once again, this time by 100bp to 12.25%, partly in a bid to take some heat out of the economy and partly to help protect the currency and preserve currency reserves. The real reached a record low against a resurgent USD during the month, partly due to market concerns about the government's stimulatory fiscal policies, which some fear will add to debt levels. Mexico's inflation eased back to 4.44%, with the central bank easing policy by 25bp to 10%, as had been widely expected. The S&P Global Manufacturing Purchasing Managers Index (PMI) increased once more, reaching 49.9, with the unemployment rate falling sharply to just 2.5%, from 2.9%. In India, inflation fell back to 5.48% as food inflation eased back slightly, while the Reserve Bank of India continued to maintain interest rates at 6.5%. After three weaker months, the HSBC Composite PMI surged back to 60.7. Turkey's inflation rate improved slightly once more falling to 47.1%, although the unemployment rate increased and business confidence, as measured by the central bank, eased back below 100. The central bank did ease interest rates, taking the policy rate to 47.5%, in the first move since March 2024. Elsewhere, Argentina's inflation rate fell back notably again, to 166% from 193%, and notably lower than its peak close to 300% in April.

ECONOMIC OUTLOOK

Global

We continue to see a stabilising growth environment, with inflation remaining above target but falling and real rates falling. On inflation, we acknowledge that the supportive base effects helping to push inflation lower are no longer there, so there is a greater likelihood of a modest rise in headline rates in coming months, with a risk of even higher spikes. The new Trump administration could also bring with it

an inflationary pulse in the US if it imposes meaningful tariffs on imports quickly. However, in most areas (outside Japan) inflation data is not an impediment to easier monetary policy. At these lower levels, inflation data may well be choppy on a short-term basis. In addition to the existing geopolitical turmoil in Ukraine and the Middle East, the new US administration brings uncertainty. Meanwhile, the political backdrop in the core of Europe is still providing markets with a lack of clarity, while in Asia, notably in South Korea, political turmoil is also a wildcard to be monitored.

US

After a relatively strong year for growth, compared to many other developed economies, we expect 2024 to give way to a softer, though still positive year of growth in 2025, of around 2.2%. Inflation is expected to trend lower, but progress is likely to be slow and it may remain volatile for some time. The net effects of policies the incoming administration imposes create some uncertainty around that expectation. Looser fiscal policy is likely to provide a positive impetus to growth, while a mass deportation programme may do the opposite. Widespread tariffs would likely push inflation higher though. The Fed is expected to remain on an easing tack, but policymakers have indicated a slower and more considered approach, as rates move slowly toward a neutral stance around 3%. We expect the risk that inflation may be higher than forecast means the extent of rate cuts will be limited, such that rates may not decline far below 4% in 2025. The yield curve is expected to be modestly upward sloping, so we expect 10-year Treasury yields to gravitate towards 4.10% in a year's time.

Eurozone

Prospects for growth across the eurozone remain underwhelming, and any imposition of tariffs on imports to the US would likely present further challenges to growth prospects in the region. We see growth improving, though only modestly, to around 1.3% in 2025. The manufacturing sector has been under pressure for some time and remains weak. Positive real wage growth in 2025 could support consumption, but savings rates remain elevated. Consumer confidence has bounced as inflation has moderated but remains below the long-term average. Political risk remains a concern with the new French Prime Minister still attempting to achieve a stable government and Germany facing elections in February in which the right wing AfD party may gain greater influence. We see inflation gradually falling back to its target level and the European Central Bank being able to reduce rates further, to about 2%. Core/German bond yields are expected to decline slightly as 10-year yields gravitate toward 2.10%.

UK

The UK continues to struggle to achieve consistent meaningful growth. We see a similar profile to that of the eurozone, with some improvement towards a 1.5% expansion rate in 2025. Inflation is likely to remain sticky, making further improvement and a sustained return to the 2% target level challenging, particularly with wages growth remaining elevated. We see inflation remaining around 2.5% for much of 2025. The ability of the Bank of England to cut rates quickly could be compromised if the labour market remains tight, though we expect some further easing during the year ahead, taking base rates to around 4.0% in 12 months. Gilt yields are expected to decline, with 10-year yields declining to around the same level, though volatility is likely. However, a lack of progress on inflation may compromise achieving that level sustainably.

Emerging markets

Prospects for improved economic growth in China may continue and could come under further pressure if the new US administration successfully imposes harsh tariffs on Chinese imports. Chinese yields are at historically low levels, suggesting the market may not be optimistic in the path for growth ahead, or for a meaningful increase in inflation. We expect GDP to grow by about 4% in 2025, after undershooting its 5% target in 2024 also. Inflation is expected to gradually increase but we do not believe there is much of an upside risk to inflation, as is the case in much of the rest of the world, and the market, sees it struggling to meaningfully exceed 1%. We expect the People's Bank of China would prefer to conduct the bulk of any policy support via targeted lending facilities than via broader rate cuts but may have little alternative if the downside risks continue to play out.

Across other emerging markets, the uncertainty surrounding forthcoming trade policy of the incoming US administration and the associated potential for elevated currency volatility, has provided reasons for many central banks to pause and reflect before proceeding with more policy easing. Brazil's central bank could need to raise rates further if the recent weakness of the currency and increase in inflation continues. Other emerging market central banks may also need to consider how best to defend their currency, should the US dollar continue to strengthen.

ASSET CLASS OUTLOOK

Investment grade credit

The 2024 credit spread tightening occurred alongside an upward trend in government bond yields, leaving 'all-in' corporate bonds yields at levels that appear attractive relative to history. Overall, we have adopted a more cautious active stance in the near-term. We expect a significant amount of issuance in the first half of 2025 as issuers seek to capitalize on strong demand which could exert some upward pressure on spreads, creating opportunities at more favourable levels. Nonetheless, underlying corporate fundamentals remain

strong and policy easing continues coupled with resilient labour markets. From an economic perspective, major central banks are easing policy rates, US labour markets have been surprisingly resilient which should help prevent the US economy from falling into recession. The outlook for Europe is more complex, with weaknesses in core countries balanced by strengths in Southern Europe. From a valuation perspective, European credit markets remain more attractive, reflecting the softer economic environment.

High yield credit

Global high yield markets continue to be characterized by strong demand well in excess of supply, a situation that intensified into year-end given receding recession concerns and generally benign corporate results. Issuance has been driven primarily by companies refinancing debt due to limited leveraged buy-out activity, leaving investors struggling to reinvest proceeds from maturing bonds and higher coupon payments. With the high absolute level of yields attracting inflows to the asset class, there appears to be little reason for this strong technical position to change in the medium term, despite spreads being tight relative to historical levels. Default rates remain subdued thanks to resilient growth, better-than-expected earnings, and improved capital market access, and we see no material signs of stress in the wider market. High yield corporates have weathered the period of higher rates well and declining interest rates should now underpin future economic activity. However, careful security selection and credit research remains critical to ensure that business models remain robust despite higher funding costs. The management teams of the companies we invest in are addressing 2026 and 2028 maturities and extending their capital structures, providing opportunities to invest in higher coupon issues.

Emerging market debt

Core rates moving higher is unfavourable for local currency rates. However, we still believe idiosyncratic opportunities remain. We favour local rates markets in selected countries such as Colombia, Peru and Brazil. Within hard currency corporates, defaults are beginning to normalise, and corporate fundamentals look healthier to us than they have done previously but policy changes and valuations could negatively affect the market. That said, when compared to US high yield, valuations are relatively more attractive than are high yield sectors of other developed markets. We are less favourable about investment grade corporates in the EM space and prefer high yield. At a regional level, we prefer Europe and Africa against Asia and Latin America, with the Middle East as our least favoured region.

Secured finance (Structured credit)

2024 was a solid year for secured finance investors, with improving macro sentiment buoying the asset class into year-end. Returns were primarily driven by high levels of income. Despite major central banks beginning to cut rates, an improving economic outlook and a gradual easing cycle would suggest that 2025 could be another promising year for returns. Throughout the year, demand consistently outpaced supply, a trend that intensified towards year-end due to the timing of the US election, resulting in tighter spreads. We anticipate some reversal of this trend at the start of 2025 as issuance picks up, potentially with some front-loading as issuers aim to capitalize on robust demand. With spreads attractive relative to similarly rated corporate credits, we expect demand to stay high. Our preference remains for issues with seniority in the capital structure and robust transaction structures that divert cash flow in the event of underperformance in the underlying asset pool. Strong underwriting and servicing policies should also act to insulate investors if the economy unexpectedly weakens. Although Prime UK and Dutch residential markets have reached relatively full valuations, there remains attractive we see attractive idiosyncratic opportunities, as well as global ones in both the Australian and US residential markets. Collateralised loan obligations (CLOs) remain attractive to us, in the US and European broadly syndicated and middle market segments.

Municipal bonds

Municipal credit conditions remain robust as we navigate an uncertain post-election period. The resilience of credit conditions in state and local tax-backed sectors is bolstered by substantial reserves and cash balances accumulated over recent years. According to Milliman, the funded status of the 100 largest U.S. public pension plans was 81.2% as of October 31, 2024, up from 72.4% a year earlier. We continue to favor revenue bond issues such as public power and water/sewer utilities, which offer stability due to their relatively predictable cash flows. Conversely, we are generally underweighting sectors that offer less yield premium, such as state and local general obligation bonds. Additionally, we see good value in airport and toll road credits, benefiting from the recovery of air and vehicular travel post-pandemic. In the short term, yield-curve steepening has provided an incentive to extend duration and capture attractive incremental yield. Looking further ahead, the prospect of higher inflationary impacts from the new administration's fiscal and tariff policies may drive a more bearish steepening environment, with long rates under pressure.

Currencies

The Republican clean sweep injects a notable amount of uncertainly in the global outlook. Looking ahead, we believe global growth is likely to struggle, particularly if trade wars become a feature. Although US growth is likely to continue to outperform other economies, President Trump's new agenda may not be immediately supportive of domestic growth. This backdrop is likely to be supportive of the USD, if it transpires that trade wars are more impactful than what is currently priced. However, short term caution may be advisable given the USD has already moved by an amount that is similar to that following the trade wars of 2018 and the market is very short EUR/USD. Also, in our view, USD valuations are more stretched than they were in either 2016 and 2018 and the US economy is in a more delicate state with higher inflation and larger twin deficits. Lastly, the strength in the USD is starting to elicit a response from Asian central banks both in the form of smoothing and jawboning, which may go some way to dampening further USD strength.

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