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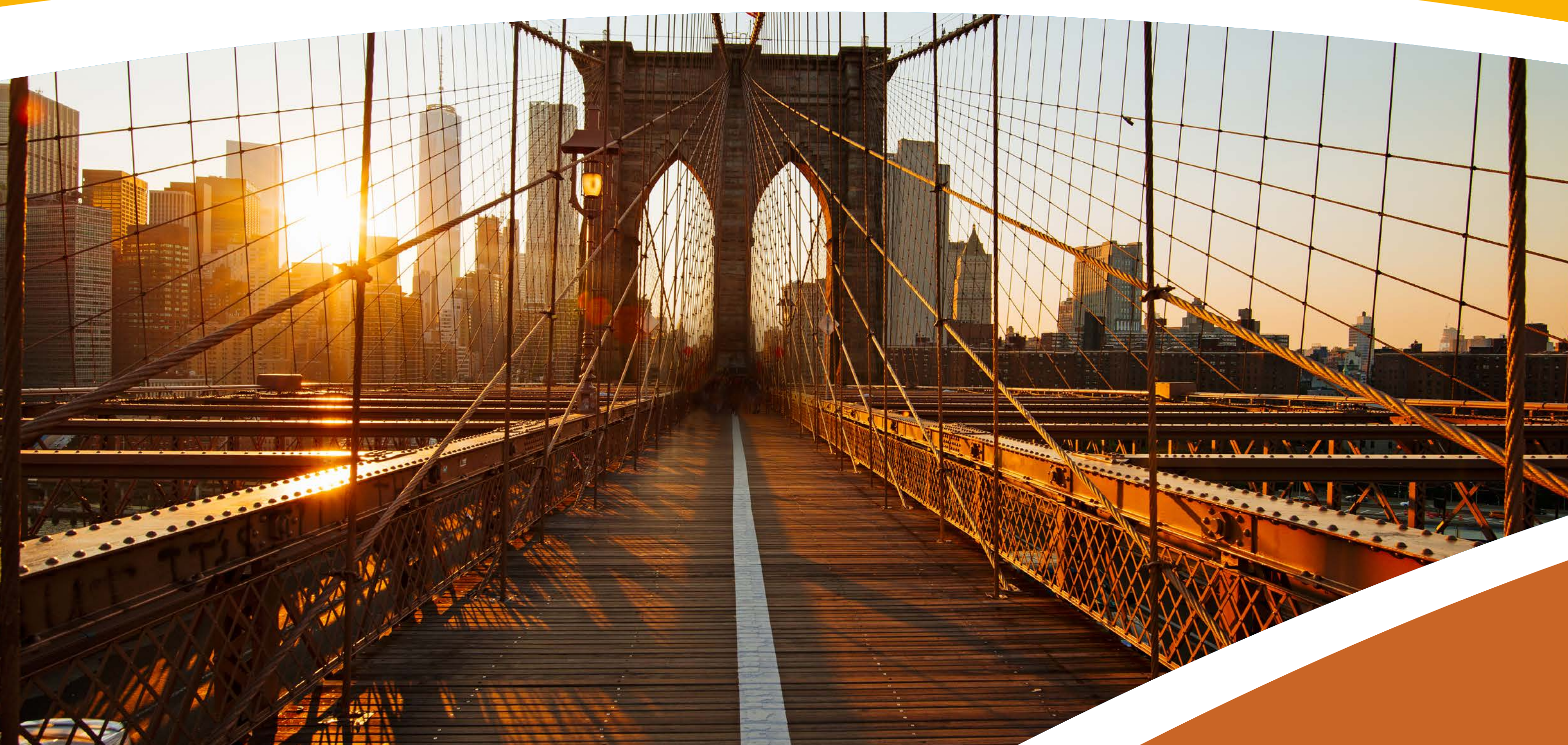
Q3 2025

Active Fixed Income Outlook:

Politics vs. economics



Q3 2025 | Active Fixed Income Outlook: Politics vs. economics

Global Credit: Getting fiscal

Could markets soon be wrestling with the consequences of fiscal dominance on the streets and debt mountains on the spreadsheets?

Colin Reedie
Head of Active Strategies / Co-Head of Global Fixed Income

Fiscal sustainability is a live conversation in financial markets.

Many of the significant themes we have been focused on since the pandemic not only remain powerful forces, but have actually been amplified by the current geopolitical backdrop.

Most now acknowledge that the pandemic was the catalyst for a seismic shift to fiscal dominance. It created both a moral and economic case for fiscal policy; developed countries in particular deployed it aggressively. Since then, we have witnessed further fiscal largesse as governments have had to respond to a number of challenges to growth and they have repeatedly turned on the fiscal taps.

For example, when gas prices spiked after Russia invaded Ukraine, governments rolled out a variety of support packages to shield consumers and industry from the full force of the impact. We also saw expansionary fiscal policy in the US in 2023 to support infrastructure construction, emergency assistance for Ukraine, and healthcare. Meanwhile, the UK implemented a mortgage interest payments scheme to help homeowners when interest rates rose significantly in 2022.

Fragility exposed

The pandemic was part of a trifecta of shocks that highlighted the fragility of the global economic system.

In 2008, the Global Financial Crisis exposed the fragility of the banking system, Covid exposed fragilities in company supply chains, and the complex network of conflict and competition in Russia/Ukraine, US/China and the Middle East has highlighted geopolitical fragilities.

Having ruthlessly prioritised efficiency in previous cycles, we now see a rebalancing away from efficiency towards resiliency. 'Liberation Day' told us that the fundamentally transactional President Trump believes in tariffs as the means of returning a manufacturing base to the US. This means that America now has to reengineer global supply chains at the same time as the rest of the world is forced to do the same, while considering whether the US can be a trusted long-term partner.

In short, systemic resilience is now receiving priority over economic efficiency and profit maximisation. A transition of this significance will be costly and could lower productivity. It could continue the trend towards a home-first approach which could further increase international tensions.

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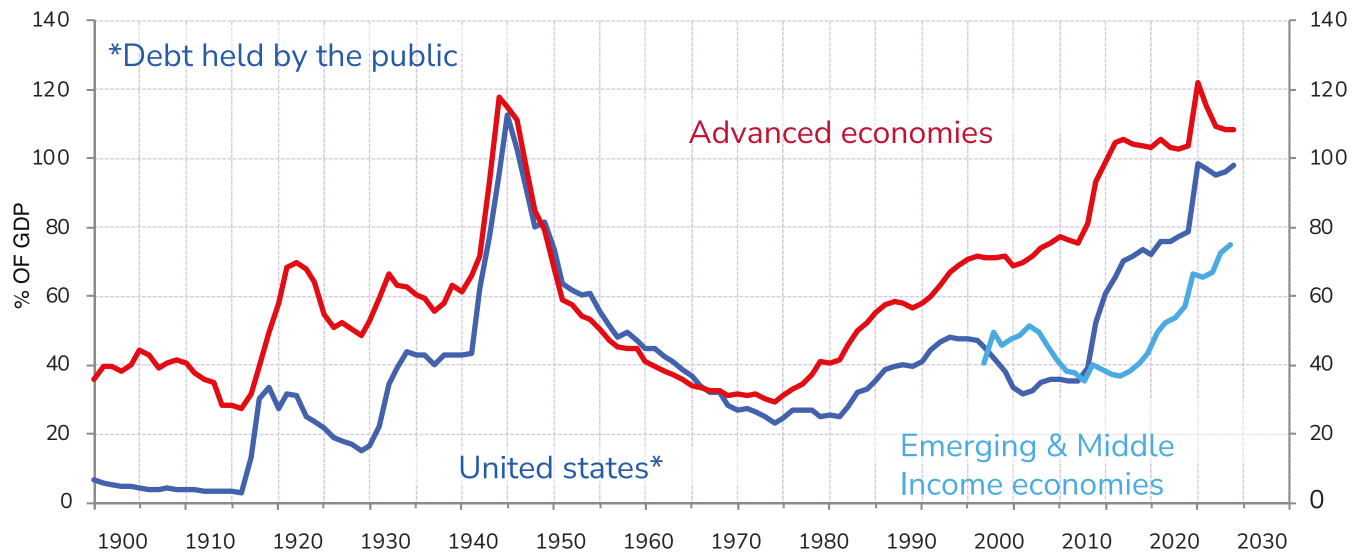
Gross public sector debt/GDP



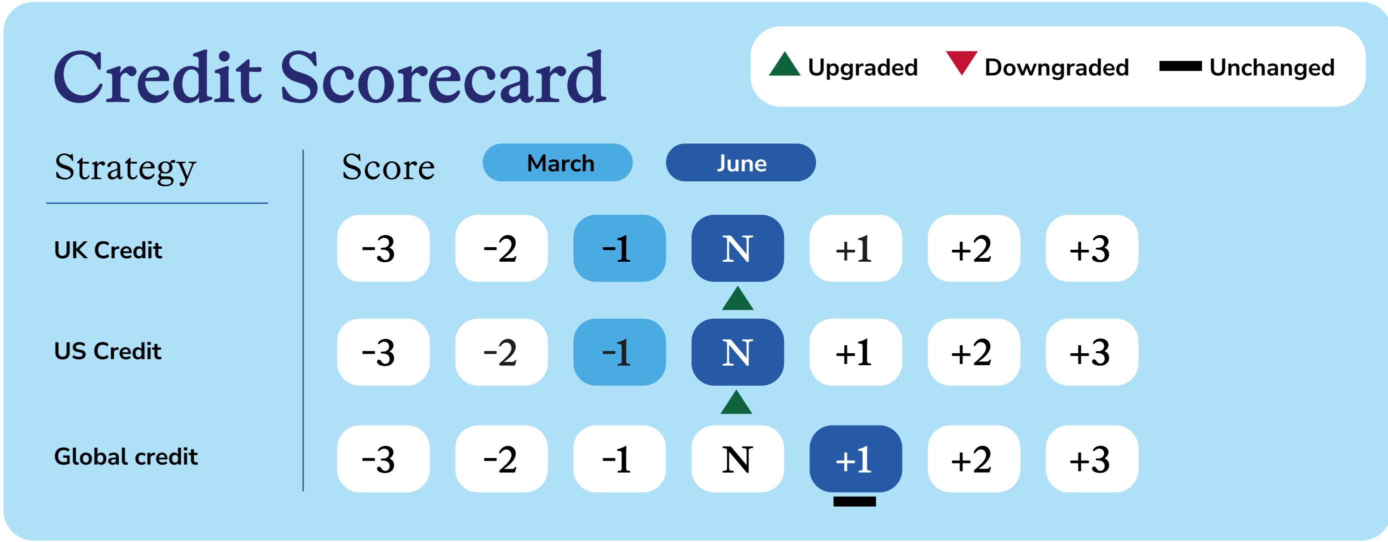
Source: Macrobond as at 18 June 2025

A debt spiral?

As we can see in the chart above, current projections of rising debt levels are unsustainable. Trump's tax-slashing 'One Big Beautiful Bill Act', the release of Germany's constitutional 'debt brake', and recent corporate tax breaks all raise the question: have those developed economies that deployed their fiscal weapons so aggressively now realised that the only way out of this debt fiasco is to focus on boosting growth?

As investors keep a watchful eye on debt/GDP ratios, the point to realise is that there are levels that are feasible now that are lower than were feasible until only recently. If you believe rates/yields could be structurally higher, then the forward-looking point is that funding large public deficits will be more difficult with structurally higher levels of investment required to re-shore, on-shore and friend-shore production in today's world. In addition, defence spending, climate risk mitigation and a global spending spree on the infrastructure powering artificial intelligence are all other areas of investment driving this trend.

We have repeatedly highlighted how powerful these forces are and the potential impact they could have on markets – not least fixed income ones. That view has not changed.



Source: L&G as at 18 June 2025 – can be subject to change at any point.

Key risk
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Euro credit: Steadying the course?

Where we situate European fiscal shifts and policy easing amid global turmoil.

Marc Rovers
Head of European Credit

Magdi Yasin
Fixed Income Investment Specialist

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The past: what just happened?

Between March and May, European markets were shaped by global trade tensions and a notable shift in domestic fiscal and monetary policy. The most significant development was Germany's historic reform of its constitutional debt brake in March, enabling substantial new infrastructure and defence spending.

This triggered a sharp repricing in rates, with 10-year bund yields surging 34bps – the largest daily move since reunification – before reversing in April as global risk sentiment deteriorated.[1] The European Central Bank responded to weak growth and falling inflation by cutting rates twice, 25bps in both March and April, contributing to a broader bond market rally. In May, bond yields stabilised as global trade tensions eased, though concerns about US fiscal policy kept upward pressure on global yields.

European credit markets initially widened – investment grade spreads rose by around 17bps through March and April – but recovered in May as the US and China agreed to de-escalate tariffs and a UK-US trade deal signalled improving bilateral momentum.[2] President Trump's threat of a 50% EU tariff reintroduced some volatility, though a July deadline gave markets breathing room. Meanwhile, the UK, while politically turbulent with the Reform Party gaining ground, followed the ECB's lead with a May rate cut and reached a new agreement with the EU to deepen economic ties. Despite ongoing external risks, the region ended the period in a more constructive position, underpinned by easing policy and a pivot toward fiscal support.

1. Source: Bloomberg as at 16 June 2025
2. Source: Bloomberg as at 16 June 2025

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The present: Politics over economics

Credit markets are holding up well even if there are signs of unease. In our latest Euro credit scorecard discussions, the dominant concern remains the macro backdrop: ongoing trade tensions, a fragmented global political picture, and the spectre of tariffs. But there's also a recognition that recent positive headlines have delayed the arrival of harder data, whether in the form of slowing US growth, rising inflation, or broader market stress. Demand remains robust, particularly in the 3–3.5% yield space, bolstered by the continued absence of defaults or significant negative momentum. Germany shows early signs of recovery however growth remains elusive due to trade war uncertainty. The complexity of EU trade negotiations makes a near-term deal with the US unlikely. Meanwhile, valuation signals are mixed: BBBs are clearly compressed versus their A and AA peers, prompting a shift in our focus.

We're leaning toward more tariff and recession-resistant, carry-enhancing opportunities — specifically shorter-dated BBs that are less exposed to cyclical risk, and select T1 structures where the risk/reward ratio still looks attractive. Demand remains strongest in the 3 to 7-year segment, where the curve offers enough yield without excessive duration risk. Sector-wise, we're rotating away from autos – a sector that has already rallied strongly and is now one of the tightest year-to-day – and toward banks, which still offer solid fundamentals and meaningful carry. We're also paying closer attention to politics over pure economics, for instance, how US healthcare policy could affect pharma, or the potential for a withholding tax on U.S. assets — a risk that may still be underappreciated.

Overall, we maintain a neutral short-term stance – markets are showing strength, seasonal factors are supportive (especially as supply dries up in late June), and the 'buy-the-dip' mindset remains in play.

Outlook

Looking ahead, Europe enters the second half of the year with a stronger fiscal backdrop and renewed political momentum to support growth through increased public investment in defence and infrastructure. Credit market valuations have largely recovered from the volatility that follow 'Liberation Day', reflecting improved sentiment and de-escalation in some key trade disputes.

However, risks remain. Tariff policy uncertainty—particularly around pending US-EU negotiations—continues to cast a shadow, while broader geopolitical instability could still disrupt fragile market confidence. The balance between policy-driven support and external volatility will be key in shaping the credit and rates landscape in the months ahead.

Longer term, our outlook remains cautious: macro risks are still unresolved, and valuations leave little margin for error.

What could go wrong?

One of the most pressing concerns is whether we will begin to see meaningful weakness in global growth, particularly in the US and Europe. So far, markets have weathered the storm, but the delayed effects of tariffs, tighter financial conditions and waning fiscal stimulus could begin to materialise in the data. If growth falters significantly, recession fears could quickly become central to the market narrative.

Another critical factor is the trajectory of inflation. For now, inflation remains relatively contained, which has allowed central banks to maintain a dovish stance. However, any unexpected spike – whether from supply shocks, wage pressures, or geopolitical tensions – could challenge the current policy path. A shift away from the rate-cutting bias would likely have meaningful implications for both duration-sensitive assets and risk sentiment.

The question of fiscal sustainability is also of concern. Persistently high budget deficits, especially in the US, combined with rising debt-to-GDP ratios, could eventually test the market's tolerance. If investors begin to lose confidence in fiscal discipline, we could see pressure build in sovereign spreads, funding costs, and even broader risk asset pricing.

Lastly, geopolitical risk remains a constant source of potential volatility. The wars in Ukraine and the Middle East continue to evolve, and any significant escalation – whether military or economic – could unsettle markets. These conflicts also carry the risk of second-order effects, such as energy market disruption, refugee flows, or realignment of global alliances, all of which could impact investor confidence and capital flows.

Credit Scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score						
	-3	-2	-1 (March)	N (June) ▲	+1	+2	+3
Euro credit	-3	-2	-1	N	+1	+2	+3

Source: L&G as at 18 June 2025 – can be subject to change at any point.

Key risk
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Emerging market debt: All eyes on the US

Emerging markets have proved resilient in a turbulent first half of the year – but risks remain, not least from an unpredictable US

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Head of Emerging Market Sovereign Strategy

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The past: what just happened?

Despite the extreme volatility in fixed income markets this year, emerging market debt (EMD) has delivered positive returns. At the beginning of June, year-to-date returns stood at 3.4% for EM hard currency sovereigns and 2.6% for EM hard currency corporates.[3] These returns have been primarily driven by US Treasuries, although resilient spreads have also contributed positively.

Within sovereigns, high yield issuers, particularly distressed names, continue to outperform. In the corporate sector, investment grade and BB issuers have outperformed B and lower-rated issuers. EM local markets have led the pack with total returns of 9.7% [4], benefiting from US dollar weakness.

3. Source: Bloomberg as at 3 June 2025
4. Source: Bloomberg as at 3 June 2025

The present: Implication of US policy

Since peaking in April after 'Liberation Day', EM spreads have recovered ground as the Trump administration appeared to back away from tariffs, at least momentarily. This has led markets to price in lower recession risks in the US and globally. At the current levels, EM spreads remain on the tight end compared to levels we would historically associate with periods of US/global recession. That said, all-in yields remain in our view very attractive with sovereign index at 7.9% and corporate index at 7.0%, which should help counter any spread widening from current levels.[5]

The IMF Spring Meetings have led to a flurry of updates to EM macro forecasts. The IMF has lowered global, advanced economies and emerging market economic growth for 2025 by 50bps across the board.[6] Markdowns are driven by and concentrated in countries with the largest exposures to the US, including Mexico (the only major EM to see a recession this year), China, EM Asia and MENA, the latter reflecting lower oil price forecasts.

However, these mark downs are not significant with the headline 3.7% growth in emerging markets flat to 2019 and in line with post-Covid averages. Further still, IMF forecasts were made in mid-April – at the peak of negativity – and hence there is room for upward revisions.

The latter, coupled with the resilience displayed by emerging markets – fundamentally and as an asset class – through multiple crises over the last decade, should help temper the extent of any spread widening.

5. Source: Bloomberg as at 3 June 2025
6. Source: IMF, April 2025

Outlook

In the coming weeks and months, the market's focus is likely to remain on US trade deals and tariff policies, the impact of tax cuts on US public finances and consequently the impact on the rates market and the trajectory of the US dollar.

Given uncertainties and back-and-forth on many of these issues, we remain relatively cautious in our beta, running a moderate overweight via credits and countries more insulated from tariff impact. We are also neutral on duration, focusing on the short end of EM credits where we have strong convictions. With attractive technicals and all-in yield valuations, we think idiosyncratic risks in emerging markets are manageable given the buffers available, with the primary risk factor being US macroeconomic conditions and market dynamics.

What could go wrong?

While the trade policy drama has overshadowed US inflation concerns, price pressures remain elevated, which is serving to keep the US Federal Reserve cautious for now. The potential tariff impact on the US fiscal situation has put pressure on long-term interest rates, causing curve steepening. All this could lead to further rates volatility. More positively, at least for developed market interest rates, oil prices remain weak, the persistence of which would increase macro pressures in EM oil exporters..

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Credit Scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score (March / June)						
EMD	-3	-2	-1	N ▬	+1	+2	+3

Source: L&G as at 18 June 2025 – can be subject to change at any point.

Key risk
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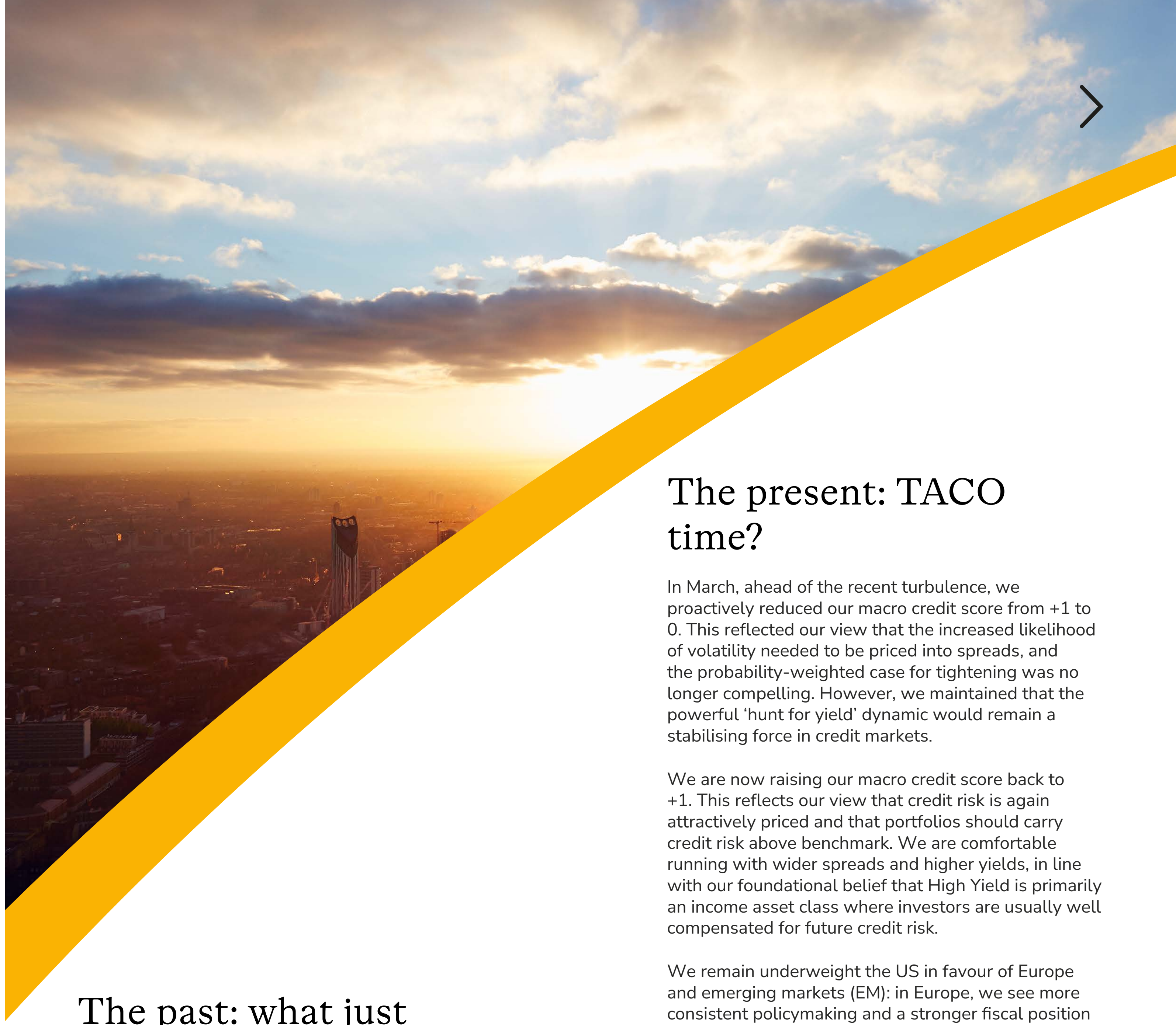
Global high yield: Pivoting to Europe

Despite US-induced volatility, the international picture for high yield appears rosy

John Ryan
Head of Global High Yield

Sophia Hunt
Senior Fixed Income Investment Specialist



The past: what just happened?

Markets were initially shaken by fears over the economic consequences of President Trump's tariff announcements. However, investors have increasingly interpreted the proposals as opening bids rather than firm policy, and recent legal challenges have cast doubt on the administration's ability to implement the tariffs as initially presented.

Accordingly, risk sentiment has improved, with high yield spreads now slightly tighter than they were on the morning of 'Liberation Day'. Yield-focused investors have shown a willingness to look through near-term volatility, stepping in as spreads widened and remaining engaged even as spreads have tightened. Yields peaked at 8.25% before retracing by approximately 100bps to 7.25%.[7]

The market has subsequently adopted the 'Trump Always Chickens Out' (TACO) narrative, as policymakers have walked back several initial aggressive stances – both in terms of proposed tariff levels and comments on the job security of the Federal Reserve Chair.

7. Source: Bloomberg as at 13 June 2025

The present: TACO time?

In March, ahead of the recent turbulence, we proactively reduced our macro credit score from +1 to 0. This reflected our view that the increased likelihood of volatility needed to be priced into spreads, and the probability-weighted case for tightening was no longer compelling. However, we maintained that the powerful 'hunt for yield' dynamic would remain a stabilising force in credit markets.

We are now raising our macro credit score back to +1. This reflects our view that credit risk is again attractively priced and that portfolios should carry credit risk above benchmark. We are comfortable running with wider spreads and higher yields, in line with our foundational belief that High Yield is primarily an income asset class where investors are usually well compensated for future credit risk.

We remain underweight the US in favour of Europe and emerging markets (EM): in Europe, we see more consistent policymaking and a stronger fiscal position to support upcoming infrastructure and military spending initiative, and we think EMs offer similar macro risks to the US but with higher spreads and yields.

We also maintain our underweight to the autos sector, which faces multiple structural challenges - from the transition to electric vehicles to shifting regional demand trends. Ongoing tariff uncertainty adds to this pressure.

Credit Scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score (March: N; June: +1)
Global high yield	-3 -2 -1 N +1 ▲ +2 +3

Source: L&G as at 18 June 2025 – can be subject to change at any point.

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Outlook

We expect spreads to grind tighter, supported by strong demand for yield. At current levels, we think yields remain historically attractive in the post-GFC environment. While tail risks remain, including renewed policy volatility or confidence shocks, these would need to reach a significant threshold to trigger a reassessment of default expectations.

We continue to prefer corporate risk in Europe and EM. European credit is more acclimatised to a slow-growth backdrop, and anticipated capital investment will likely support flows into the region over the medium to long term.

The broader leveraged credit ecosystem remains healthy, with public bonds, loans, and private/direct lending all contributing to balance sheet flexibility for issuers. The default outlook is subdued, and more importantly, credit loss expectations are improving. Issuers are increasingly avoiding hard defaults, opting instead for pre-emptive restructurings, or negotiated settlements. This trend is lifting recovery rates and enhancing investor outcomes.

What could go wrong?

We see two key risks to watch:

- Escalation of policy disruption beyond current expectations. Notably, a technical US recession or slowdown alone may not significantly alter the default outlook unless it drives a reassessment of broader credit conditions.
- Inflation resurgence, which remains the most direct threat to the demand for yield. In a stagflationary environment, asset allocation becomes more difficult—but high yield, with its relatively low duration and currently low default rate, could remain a competitive option.

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Research and Active Engagement: Whither the consumer?

How international patterns of consumer demand could determine performance for the rest of the year

My Nguyen
Senior Research Analyst

The past: What just happened?

Investors largely looked through first-quarter global consumer earnings, focusing instead on forward guidance, margin expectations and consumer health, as the reporting season coincided with volatile tariff headlines.

Companies broadly noted that US consumers remain under pressure, Chinese consumer spending recovery is stalled and European consumers held up better on a relative basis — mainly due to easier year-over-year comparisons. Firms cited several headwinds during the quarter: cumulative inflation over the last several years, higher interest rates, equity market volatility, unfavourable weather and tariff uncertainty. These dynamics aligned with a sharp decline in sentiment since the beginning of the year.

The present: Tightened belts?

While companies are not yet counting out the US consumer, recent behaviour shows rising price sensitivity, value-seeking and a shift toward needs-based spending. In packaged food, this has translated into weak volumes, heavier promotions and private-label share gains.

Consumer product firms also flagged retailer de-stocking as a headwind, with inventory management and working capital control taking precedence. At the point of sale, consumers are shopping more frequently with smaller baskets, focused on immediacy—yet still responsive to value and newness. Channel dynamics are shifting in favour of online, big-box, and club retailers, while drug and convenience channels lag. April and May commentary suggests modest improvement, as higher frequency sentiment indicators stabilised.

Outlook

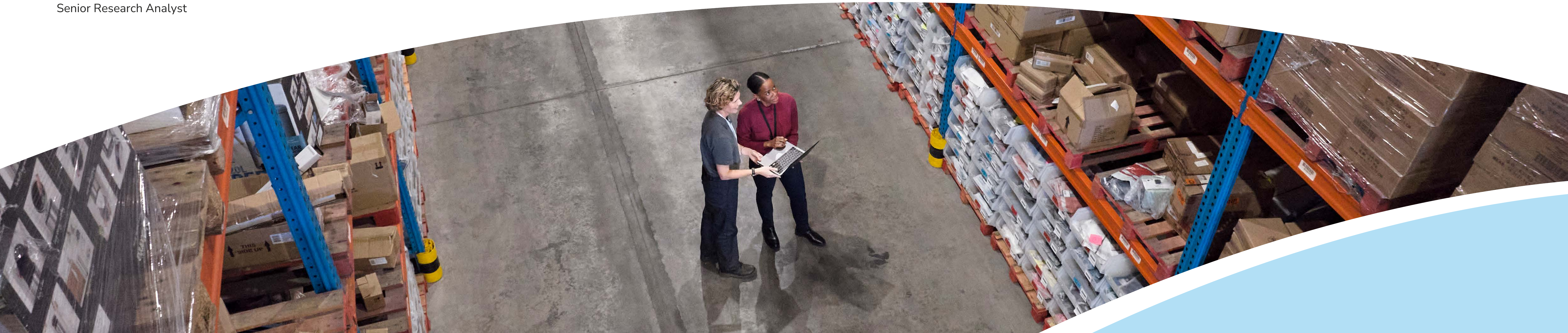
Guidance varied as companies responded to a fluid tariff environment. Procter & Gamble and Kimberly-Clark, for example, lowered forecasts due to input cost pressures but offered some margin visibility. Sysco and Kraft Heinz also cut expectations due to weaker demand expectation that were not explicitly linked to tariff.

Meanwhile, Hasbro, Mondelez and O'Reilly maintained guidance on an ex-tariff basis, while more discretionary companies with greater sensitivity to demand and higher costs withdrew guidance entirely. Most companies are avoiding aggressive inventory pull-forward but are maintaining flexibility. Given the current pause for a portion of tariffs, we could see some incremental inventory build. Supply chain diversification remains a focus – Home Depot, for example, plans to ensure no single country accounts for more than 10% of inventory within 12 months. Price increases are expected to be surgical, balancing margin needs with demand sensitivity.

What could go wrong?

Despite de-escalated tariff risks in recent weeks, expectations for a second-half rebound may prove optimistic. Many companies are still forecasting margin recovery and demand acceleration, but these assumptions may be fragile.

Key risks include prolonged consumer strain, ongoing tariff volatility and declining pricing power amid inflation fatigue. Should tariffs further impact input costs or squeeze disposable income, consumption could slow more meaningfully. If topline assumptions fail to improve, the current guidance trajectory may require a reset lower particularly as we head into the all important back-to-school and holiday spending seasons.



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Key risk

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