Macro Talking Points

Fixed Income Insights

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In brief

- **An uncertain world favors active managers**
- **The tight credit spread dispersion and the importance of skills as a credit manager**
- **The strategic case for EM fixed income**
- **Fixed income starts 2025 well, performance-wise**

Policy uncertainty is currently high, which requires strong vigilance and risk management. There are data on almost everything these days. That includes policy uncertainty, for which there are indices that track its level over time.[1] The current level for the US is near historical highs. Is that a major surprise? Probably not. Under Trumpilocks, the new prevailing macro regime, the spectrum of risk factors has become broader, ranging from inflation risks to fiscal concerns, to geopolitics to fears for trade wars. As we all have witnessed, headline risks surrounding trade tariffs have emerged as a prominent feature of the global market environment. Another key characteristic of Trumpilocks, especially in relation to its predecessor, Goldilocks, is that macro volatility is also on the rise. For instance, there is now uncertainty about what the US Federal Reserve is going to do. There are also questions about how material inflation risks are going to be in the period ahead. Policy uncertainty is not only elevated in the US but also at the global level, as illustrated by the global policy uncertainty index, which is at its highest reading since the COVID crisis. So where does that leave us? The higher the risks, the higher the importance of sound risk management in the investment process. Given the backdrop of challenging volatility and policy uncertainty, Trumpilocks is likely to play out as a macro regime that may favor active asset management.

Credit spread dispersion is near its historical low, but what does that mean? It is not only credit spreads that are tight at this juncture, spread dispersion within the index is quite tight, too. Spread dispersion is measured as the difference between the 10th percentile spread level and the 90th percentile one. That difference tends to vary over time, depending on the health of the credit market and the risk appetite backdrop. Looking at the US IG index, spread dispersion is as low as we have seen it in many years.[2] Why? The appetite for credit has been remarkably strong while the asset class has been supported by robust fundamentals. It's not only been reflected in the absolute level of spreads but also in the tightness of spread dispersion. Essentially, this means that there's been little differentiation priced in at the index level. Pushing that logic a bit further, it may be reasonable to argue that fundamentals have therefore been mispriced. So, what type of investor is best positioned to take advantage of a tight spread dispersion environment? Those that put a premium on fundamental research as part of their investment process. To be clear, the tighter the spread dispersion, the harder it is to generate alpha through security selection. Put differently, the tighter the spread dispersion, the more important it becomes to rely on a high-skilled asset manager with a strong security section process.

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The strategic case for emerging market debt. These days, EM fixed income might not be perceived as popular an asset class as it used to be. After all, there have been the tariff headlines under Trump 2.0, along with concerns around China's structural headwinds. But for a start, this perception has not been reflected in hard numbers, with the performance of EM debt having been more than respectable over the past few weeks — more about that below. More importantly, ignore EM debt at your peril as part of your strategic allocation to global fixed income. This is because EM debt displays compelling strategic characteristics, in our view. Looking at the past 20-year annualized returns, EM sovereign debt comfortably beats global credit and US credit's long-term performance, with a 20-year number of 5.46%.[3] In addition, that performance was achieved with reasonably low volatility, producing a compelling risk-adjusted return. Now looking at spreads per unit of spread volatility, EM sovereign debt stands at the top of the ranking across the global fixed income universe. It means that EM investors are better compensated for the credit risk they are taking than for all other fixed income segments. Taxable munis and EM Corporate Credit also feature well on that front, as opposed to Agency MBS, exhibiting the lowest spread per unit of spread vol. Meanwhile, EM fundamentals are markedly stronger than they used to be. The traditional way to describe EM used to be elevated political instability, poor credibility of macro policies and macro-stability issues. I can easily come up with a handful of countries that would fit that definition these days but are not part of the EM universe.

Global fixed income is off to a strong start. Despite a challenging macro backdrop, global fixed income performance year to date has been quite solid. Among the 17 segments we monitor, about half have produced a performance in excess of 1% since the beginning of the year, with no index showing a negative number. While the call on duration has been more complicated, the UST index has nonetheless returned 0.91%. At the top of the leaderboard stood EM fixed income, with EM local debt producing the highest number (3.03% YTD).[4] It may come as a surprise to some, but the US dollar has weakened somewhat over the past few weeks, which has been a great help to that asset class. It might be too early to call for a sustained recovery, however, as the global market backdrop, including US exceptionalism, continues to be dollar supportive. EM hard currency debt has also fared quite well, with a year-to-date number of 1.97%. EM sovereign spread compression has helped, especially for HY sovereign credits. Other notable strong performers include HY and taxable munis. Meanwhile, the laggards in 2025 have been the EUR AGG, leveraged loans and EUR IG, with performances all below 1%. Looking ahead, the attractive carry is likely to play out as the major contributor to fixed income's expected returns, which may be less compelling as a narrative than a rate compression environment, but which nonetheless sets up 2025 to possibly be a better-than-average year by historical return standards. ◢

Endnotes

[1] Source: Bloomberg, Baker, Scott R.; Bloom, Nick; Davis, Stephen J. The policy uncertainty index is an index of search results from 10 large newspapers (USA Today, the Miami Herald, the Chicago Tribune, the Washington Post, the Los Angeles Times, the Boston Globe, the San Francisco Chronicle, the Dallas Morning News, the Houston Chronicle, and the WSJ). To construct the index, the authors perform monthly searches of each paper for terms related to economic and policy uncertainty.

[2] Sources: Bloomberg, US IG = Bloomberg US IG Corporate index. Data as of 7 February 2025.

[3] Source: Bloomberg, J.P. Morgan. EM Debt = EMBIG global diversified. Returns are calculated over February 2005/ February 2025 (as of 7 February). Returns are gross and in dollars.

[4] Sources: Bloomberg, J.P. Morgan. UST index = Bloomberg US Treasury index. EM local debt = J.P. Morgan GBI-EM diversified. EM debt = EMBIG diversified. Data as of 7 February 2025.

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