Tariff turnaround resets the outlook for fixed income

June 2025

While tariffs have done meaningful damage to the economic outlook and raised volatility in rates markets, the softening of the US stance has restored confidence in credit returns for 2025.

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Key takeaways

- While markets have cheered the softening of the US position post-April 2, tariff uncertainty remains a serious risk to growth and the inflationary impact puts the Fed in a tricky position.
- We expect to see further deterioration in the hard economic data in the coming months, though the strength of corporate fundamentals suggest the expected US economic slowdown will not spiral into a recession.
- Europe's macro backdrop has suffered less than the US and we continue to see European fixed income markets as an increasingly attractive alternative.
- In European credit, our top picks are financials and CLOs thanks to strong fundamentals and attractive risk-adjusted yields.

Coming into 2025, we projected that while tariffs topped the list of potential catalysts for spread widening, a macro backdrop of falling interest rates and solid global growth would see credit outperform government bonds and deliver healthy total returns for fixed income investors.

The severity of the Trump administration's reciprocal tariff policy unveiled on April 2 threatened to upend that projection; a US and global recession became the widely held base case, endangering returns from credit, while the inflationary and reputational impact of tariffs meant US Treasuries (USTs) became less effective as a risk-off hedge.

Markets have since been soothed by the softening of the US stance, with President Trump sufficiently moved by the negative reaction (particularly spiking UST yields) to enact 90-day pauses that leave tariffs at 30% for China and 10% for everyone else. Fixed income markets are now largely in positive total return territory year-to-date, with equity indices also close to erasing YTD losses.

As it stands, it seems likely tariffs will end up lower than the near-worst case scenario that was unveiled on "liberation day", though they will also be far higher than expectations coming into the year.

The question is, what does this mean for fixed income, and does it change our projection for 2025?

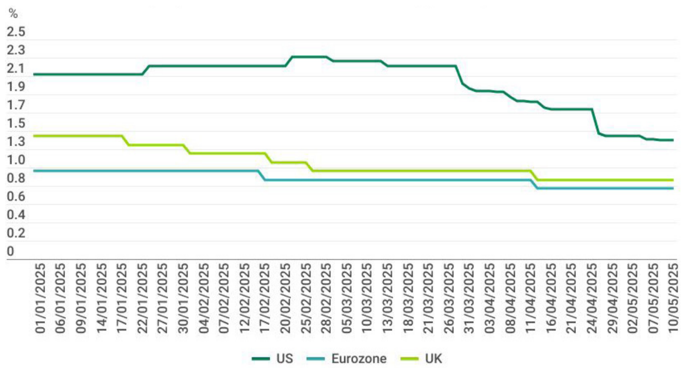
Tariffs remain a serious risk to growth

While markets have cheered the softening of the US position, the average effective tariff rate faced by US consumers now sits at 17.8%, according to the Yale Budget Lab (it was 27.6% before the deal with China on May 12).

In our view, it is reasonable to expect that negotiations with US trading partners will ultimately bring the average rate down to somewhere in the low teens. But that compares to 2.5% when Trump took office and would have been at the bearish end of forecasts coming into 2025.

As a result, economic forecasters polled by Bloomberg have cut their projections for US growth in 2025 by a full percentage point since April 2 (see Exhibit 1).

Exhibit 1: Growth projections for 2025 – Bloomberg survey



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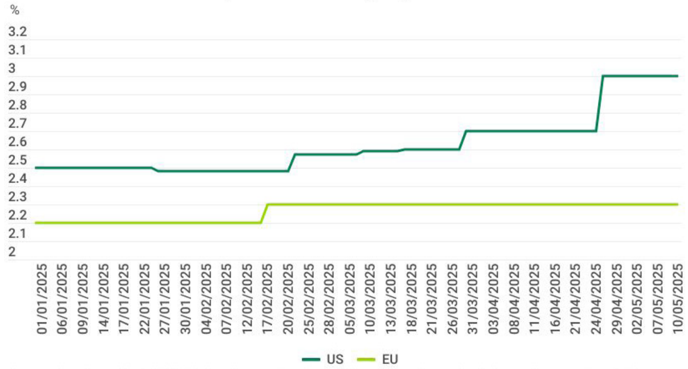
While a drop in the absolute level of growth to around 1.5% is arguably nothing to worry about, the speed of the adjustment might be a serious shock for some US companies that had made plans based on much higher growth. The ongoing uncertainty around tariffs also risks creating further economic damage down the line as businesses cannot plan ahead; a poll of 329 US CEOs in April showed business confidence had fallen to its lowest level since late 2009, with only a slight rebound in May[1].

The added complication is the potential for tariffs to stoke inflation, which might limit the ability of the Federal Reserve (Fed) to cut

[1] Source: Chief Executive, 12 May 2025

interest rates in response to deteriorating growth. Progress on inflation has been steady in 2025 thus far, with the Consumer Price Index dropping to 2.3% in April from 3.0% in January. However, core inflation expectations have been moving in the other direction (see Exhibit 2).

Exhibit 2: Core inflation expectations moving higher in the US



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For investors, the key takeaway from Fed rhetoric since April 2 is that, for now, the central bank is more concerned with the potential inflationary impact of tariffs than it is about the growth impact. In our view, it would take a meaningful deterioration in hard data – chiefly the unemployment rate – for the Fed to cut aggressively to support growth in 2025.

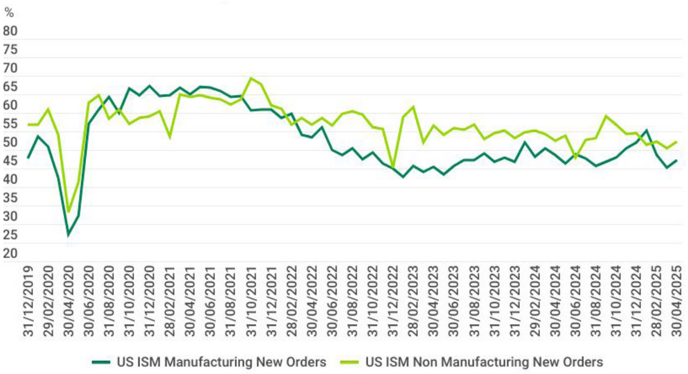
This uncertainty is reflected in market rate expectations, which are currently at odds with those of the Fed. Markets are pricing in around three 25bp cuts in 2025 and a terminal rate of 3.1% by year-end 2026, while the Fed's latest "dot plot" projections signal just two cuts in 2025 with rates closer to 3.5% by year-end 2026.

Fundamentals are a buffer to macro weakness

Despite the tariff shock, hard economic data is so far showing little sign of the sort of downturn that might precede a recession.

It is worth remembering that services, which have far less exposure to tariffs than manufacturing, account for some 90% of US economy (it is the same in the UK and around 75% in Germany). Hard data is likely to weaken as the year progresses, but it is nevertheless reassuring that, while new orders in the manufacturing sector contracted for the fourth consecutive contraction in May, overall the data doesn't suggest the dive in economic activity that many would have feared in the early days post-April 2 (see Exhibit 3).

Exhibit 3: Economic activity has not stalled



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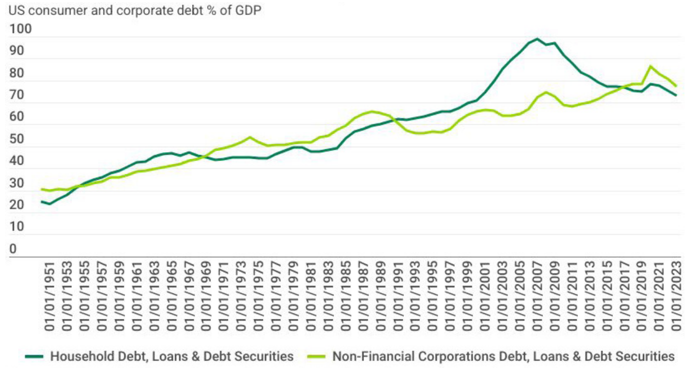
In addition, the US economy entered this period of disruption in a position of relative strength. As Exhibit 4 shows, consumer debt as a percentage of GDP is at 20-year lows. Corporate debt by the same measure has come down sharply from its Covid-era record high in 2020 and now sits at an eight-year low after a slight reversal of the previous upward trend.

Exhibit 4: US balance sheets look healthy



Source: IMF, 30 April 2025. Past performance is not a reliable indicator of current or future performance. Included for illustrative purposes only.

To be clear, we do expect to see further deterioration in the hard economic data in the coming months, as the corporate decisions taken (or not taken) as a result of tariffs are felt. However, the strength of fundamentals gives us comfort that provided there is sufficient progress on trade negotiations, the expected US economic slowdown will not spiral into a recession.

Positioning in fixed income

What does this mean for positioning in fixed income?

Looking ahead to the second half of 2025, there are four key themes that we expect to drive our asset allocation.

1. Rates remain unpredictable in the short term

For a number of reasons, it is hard for investors to have much conviction on the direction of government bond yields across the major markets. UST and other government bond yields have surged at various points post-April 2, initially on inflation fears and US policy uncertainty, but more recently as government deficits have come back into focus and demand for longer dated sovereign debt has cooled. As a result, government bonds have looked less reliable as a risk-off hedge in periods when market sentiment has soured.

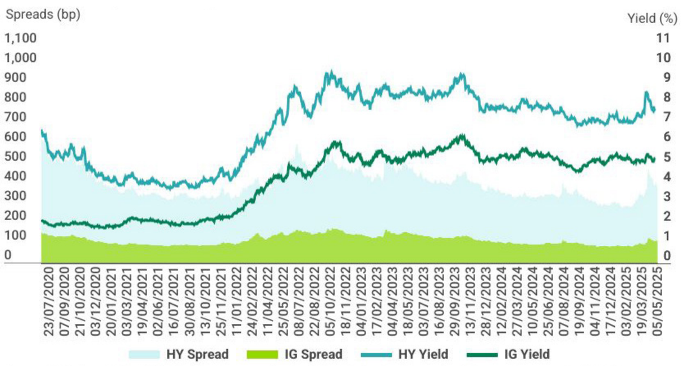
For us, this lack of conviction in rates markets means avoiding tactical allocations to government bonds, i.e. those that look to benefit from short-term rallies in yields. However, for medium-term investors we think a meaningful allocation to rates remains prudent given valuations and the severity of the tail event on tariffs (if trade deals do not materialise and growth takes a bigger hit). We believe USTs would act as an effective risk-off asset in such a scenario, and yields of around 4% in five-year USTs look attractive in that context. However, given the mix of pressures on UST yields at present, we would prefer to diversify our rates allocation with German Bunds.

2. Higher quality credit should deliver

With risk assets having been sent on a round-trip since April 2, credit spreads once again look tight relative to history and thus vulnerable to another correction given the uncertain macro backdrop. As a result, we favour higher average ratings and leaning towards shorter credit duration.

However, as Exhibit 5 shows, all-in yields (underlying rates plus credit spread) remain elevated. Among other factors, this is driving strong technical demand for fixed income which should help to limit credit spread widening in a sell-off, as we saw to some extent in the wake of April 2 in comparison to the dive in equity valuations. In our view, a low- or even zero-growth environment would be no disaster for higher quality credit given the quality of corporate balance sheets coming into 2025. We could certainly see some sector-specific issues (US retailers with large foreign cost bases and non-US manufacturers with large US exposure, for example), but high breakevens are a strong buffer to a more severe outcome on tariffs and we expect higher quality credit to deliver healthy returns for 2025.

Exhibit 5: US yields and spreads



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3. Europe's macro backdrop has suffered less than the US

In our view, European and UK credit are an increasingly attractive alternative to US credit. Their underlying economies are simply less exposed to tariffs, largely because they are negotiating with one (very significant) trading partner rather than dozens at once. In addition, the prospect of increased government spending, both on infrastructure and defence, has increased confidence that growth will pick up. As a result the downgrades to European and UK growth forecasts have been less severe (look back at Exhibit 1).

Importantly, Europe's inflation outlook looks more benign than that of the US, with the smaller impact from tariffs offset by a stronger euro (though the UK inflation outlook is more uncertain). The European Central Bank (ECB) is therefore in a more comfortable position than the Fed, with its 25bp rate cut on June 5 having taken its monetary policy rate to 2%, bang in the middle of the ECB's 1.75%-2.25% estimate for the neutral rate. A more predictable monetary policy environment, on top of an improving growth story less impacted by tariffs, is a positive backdrop for European credit.

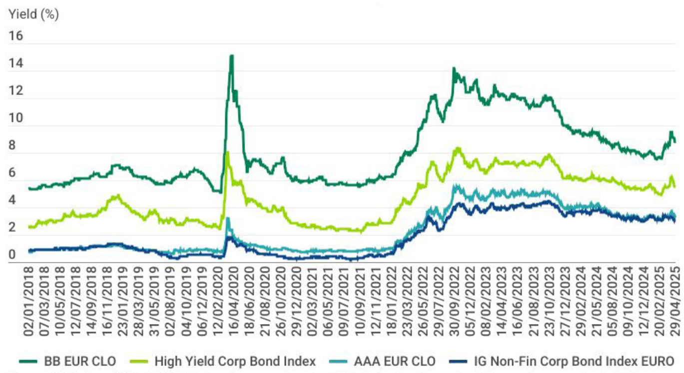
4. Financials and CLOs stand out for relative value

Within European credit, our top picks are financials and collateralised loan obligations (CLOs).

European banks recently concluded a strong reporting season for Q1 2025, with most sticking to their full-year guidance and some upgrading their projections despite the uncertainty over tariffs. This contrasts sharply with the corporate sector, where many firms have been forced to suspend guidance in response to the uncertainty around their trading conditions. While banks are certainly not immune to broader economic weakness, the fact that executives continue to see bullish full-year targets as attainable highlights their advantage over corporates, and the sector's fundamentals are also supportive for bondholders – European banks' average Common Equity Tier 1 (CET1) capital ratio remains close to its post-crisis record at just shy of 16%, and the average non-performing loan ratio has been flat below 2% for the last three years [2].

When it comes to CLOs, we continue to think this asset class offers some of the most attractive risk-adjusted yields in all of global fixed income. As Exhibit 6 shows, BB rated CLO notes offer a substantial yield pick-up to the European high yield bond index (average rating BB), while AAA CLO notes offer a slimmer pick-up in yield but to an investment grade (IG) corporate bond index whose average rating is just BBB. In our view, European CLO yields continue to overcompensate investors for what is an excellent historical performance record; since 2002, the annual default rate for sub-IG CLOs has remained below 1% (it is 0% for CLOs issued post-2013), comparing favourably to the long-term average default rate of around 4% for high yield bonds.

Exhibit 6: CLOs look more attractive than corporate bonds



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Revisiting our 2025 outlook

Let's revisit our projection coming into 2025, which was that a macro backdrop of falling interest rates and solid global growth would see credit outperform government bonds and deliver healthy total returns for fixed income investors.

Despite the tariffs shock, we believe that projection requires only minor revisions. Provided trade negotiations progress as expected, then compared to the beginning of the year we expect marginally fewer interest rate cuts (at least in the US) and lower global growth (driven by the US). In addition, while growth forecasts in Europe have not suffered major revisions, those in the US have been negatively impacted. As a result, we have increased our already marked preference for European fixed income over US.

However, we believe the macro backdrop remains strong enough for credit to outperform government bonds and deliver healthy total returns for fixed income investors in 2025.

[2] Source: European Banking Authority, latest data available as at 30 April 2025.

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