What's next for bonds?

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We believe that investment-grade bonds play an important role in diversified portfolios. Today, their appeal as income generators and risk-asset diversifiers that are typically less volatile than equities is underscored by recent equity-market strength that may be hard to sustain and positive real yields that can help cushion investors against further inflation surprises.

Potential tailwinds and headwinds

In late October 2023, we wrote that the risk-reward tradeoff for bond investors had likely improved. The brutal repricing of interest-rate risk in 2022-2023 meant that investors' forward-looking total returns could now at least be protected somewhat by a decent yield cushion should inflation pressures remain stickier for longer. From November 1, 2023 to December 31, 2024 the Bloomberg Global Aggregate Index returned a healthy 7.6% (unhedged).[1] The Bloomberg U.S. Aggregate and Euro Aggregate Indexes, meanwhile, delivered returns of 9.9% and 8.9%, respectively, over the same period.

Of course, equities have delivered far superior returns over the same period, with the MSCI World Index registering an approximate 38% gain—but that would miss the point. Our premise in October 2023 was that if global growth slowed (or worse) in 2024, then bonds could do very well playing their role as protection in a multi-asset portfolio. If, however, there were upside surprises to growth and/or if inflation remained stubbornly high (which has already somewhat transpired), investors at least had a meaningful yield cushion to protect total returns.

Looking at the asset class in more detail, credit-sensitive sectors outperformed thanks to continued spread compression as the U.S. economy and labor market continued to perform well despite elevated interest rates, U.S. election uncertainty and a fragile geopolitical backdrop.

[1]The return would have been higher still but for the strength of the U.S. dollar over the period.

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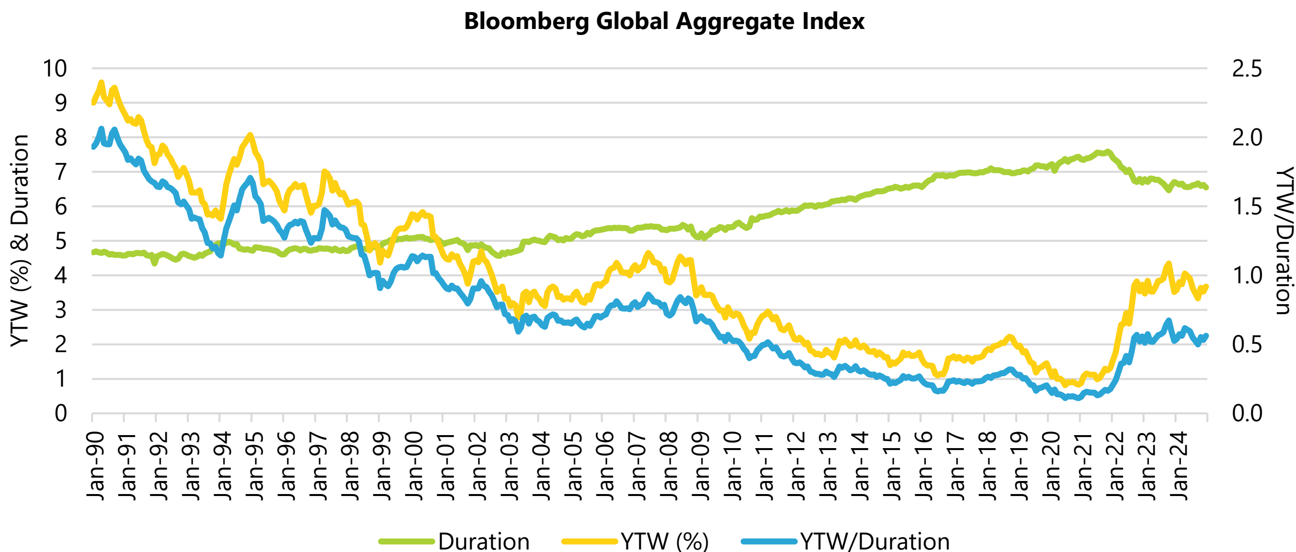
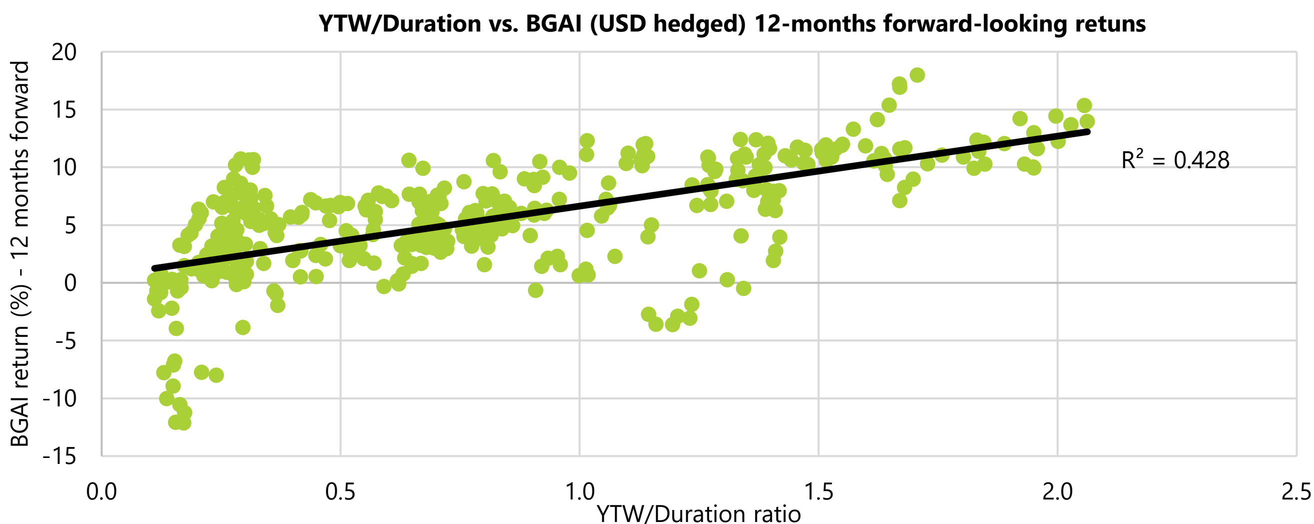
Exhibit 1: The risk-reward on bonds has improved in recent years



Source: Bloomberg, Barclays Live data. Uses month-end data points from January 1990 – December 2024.

What are the prospects for the asset class in 2025? As a first point of reference, we like to look at the yield-to-worst (YTW)/duration ratio on the Bloomberg Global Aggregate Index; this provides a useful value gauge of how fixed-income investors are compensated for taking on duration (interest-rate) risk. The higher the ratio, the further yields have to rise before investors experience a negative return. Unsurprisingly, a higher YTW/duration ratio tends to result in better forward-looking returns. The ratio of 0.56 as of December 31, 2024, while slightly lower than it was in October 2023, is still at a similar level to early 2010. Bonds went on to deliver decent returns in the decade that followed.

Exhibit 2: Improved prospects for forward-looking returns



Source: Bloomberg, Barclays Live data. January 1990 – December 2024. BGAI is the Bloomberg Global Aggregate Index.

Does this mean that the risk-reward on investment-grade bonds remains attractive?

We have long been of the opinion that the exceptionally low yield environment of the 2010s—a product of "lowflation"—was an aberration spurred by quantitative easing and other unconventional monetary policies. Anchored inflation expectations and China's accession into the World Trade Organization in 2001 helped provide bonds with a structural disinflationary tailwind over the two decades that followed. However, the geopolitical landscape has clearly shifted in recent years. Moreover, protectionist policies seem to resonate with voters as tariffs are back in vogue. This may make central bankers' task of returning inflation back to 2% more challenging.

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Exhibit 3: The case for and against bonds in 2025.

Bond-market outlook	
Positives	**Negatives**
Traditionally a diversifier to risk assets	Fiscal overhang and potential government-supply indigestion
All-in yields are reasonably attractive	Credit spreads are tight
Real yields remain positive in most markets	Inflation still above central banks' targets
Hedge against disinflationary slowdown	Trump administration's policies may prove inflationary
Attractive pockets of value within fixed income	
Multiple central banks are in a rate-cutting cycle	

It is also concerning that the U.S. is running a budget deficit of 6% or more at a time when the economy is performing well and the unemployment rate is low by historical standards. An economic slowdown or recession would likely see the budget deficit rise further as tax receipts shrink and government transfers rise. To be sure, the U.S. is in the enviable position of having the world's reserve currency and an economy that is outperforming its peers. However, bond vigilantes remain alive and well—think eurozone debt crisis in 2011-12, the U.K. in 2022, and more recently France—and could even hold the U.S.'s feet to the fire if Uncle Sam starts to abuse its fiscal position.

Despite potential near-term risks, we remain positive on bonds.

Following a prolonged period of financial repression in the 2010s, when real yields were negative, most developed sovereign bond markets now offer a positive real return. The 10-year real yield in the U.S., for example, is currently at 2.2% (as of December 31, 2024).

Moreover, fixed income is a heterogeneous and complex asset class that provides opportunities for skillful active managers. We see one such opportunity in local-currency emerging-market debt, where real yields in a number of markets are in mid-single digits. Emerging market debt is naturally more volatile than G7[2] bonds , and it is recognized that Trump's "America First" policy will present challenges to some of these (as well as some developed) countries. Nonetheless, real yields at these levels represent attractive value for investors with a medium-to-long-term investment horizon.

Elsewhere, in the sterling fixed-income space, unrated senior secured bonds also remain a favoured play in our portfolios. These bonds typically offer higher yields than generic corporate bonds because of complexity and illiquidity premiums, even though they are often higher credit quality and backed by contractual cash flows.

However, there are also risks. Whereas 2% was a generally a ceiling for inflation in the last decade, it could now be a floor, which may limit the extent to which central banks are able to cut interest rates. In addition, fiscal profligacy remains a concern—not least in the U.S.—which we expect to be reflected in higher future term premia.

What does this mean for investors?

Our managers are cautious about owning long-dated bonds, instead preferring short-to-intermediate-duration securities. Corporate credit spreads, meanwhile, are now trading at relatively tight levels, limiting the potential for further compression. Accordingly, our managers are also wary about extending too far down the credit-quality spectrum and assuming too much spread-duration risk, notwithstanding the still reasonably attractive all-in yields.

In short, we believe that investors should remain committed to the asset class, but be selective in their exposures. Active managers should be well positioned to take advantage of value opportunities arising from any volatility-led market dislocations.

[2]The G7 countries include the U.S., UK, Canada, Italy, France, Japan, and Germany.

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