Global Fixed Income

Bonds are Back in Fashion

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Bonds are Back!

Last year, we noted that the yield on the EM bond index was 7.5%, comfortably exceeding its long-term average and offering equity-like return potential. This forecast proved accurate, with global EM bonds delivering an 8% return in 2024.. Bonds have regained their status as a safe-haven asset for investors, delivering high single-digit returns. The post-COVID years of 2021-2022 marked the worst two-year performance for bonds on

The Bloomberg Emerging Market (USD) Bond Index Yield %

Source: Bloomberg

record, temporarily disrupting their safe-haven appeal.

But 2024 marked the second year in a row of positive performance, signaling a return to normalcy. Total returns aligned with the long-term annual average based on 30 years of Bloomberg Global EM Bond Index data.. This stellar performance was driven favorable fundamentals, including disinflation, moderate growth, and rate cuts, which provided strong tailwinds for the asset class. These factors suggest continued strength in fixed income as we move into 2025.

The Fed: A friend or foe to bonds in 2025?

Interest rates are a big driver of bond returns for better or worse. Higher rates typically suppress bond returns, while lower rates support fixed income performance.. In 2025, the Fed is forecasting 100 basis points of rate cuts according to last December's dot plot. This suggests a favorable stance by the Fed toward bonds in 2025.

The Fed has good reason to be confident about reducing interest rates. Inflation is falling, growth is slowing, and the Fed is far away from its "neutral rate" of 2.5% as per its dot plot. The main caveat to this optimistic outlook is the potential for increased inflation in 2025, driven by Donald Trump's proposed inflationary policies.. Tariffs and tax cuts could push up prices to the extent that the Fed may feel forced to raise interest rates at some point during the year. However, we view this as a tail-risk event rather than a baseline scenario for bond investors. We believe that Trump is unlikely to enact punitively high tariffs that shoots the US economy in the foot. Moreover, tariffs could hurt growth, the other side of the Fed's dual mandate, leading the central bank to continue its cutting path.

Consequently, we anticipate a series of small, bond-friendly rate cuts as the most likely scenario for 2025.

Carry: A bond's best friend

Coupon income—carry—drives performance for EM bonds. Last year carry income accounted for more than 6% of the overall 8% return, and coupon income is starting 2025 comfortably above 5%. Carry is crucial for mitigating downside risks like spread widening, duration volatility, or credit events. For instance, if a bond's price declines by 5% but pays a 5% coupon, the investor breaks even.. Many EM issuers, dealing with the aftermath of the higher-for-longer rate environment, have issued bonds at elevated capital costs.

High Yield: Tight Spreads vs. Strong Fundamentals

High yield (HY) bonds outperformed investment grade (IG) bonds last year by a wide margin. HY's 16% remarkable return was four times the 4% return from IG. Top performers included Egypt, benefiting from GCC and multilateral donor financial support. Turkey's market-friendly monetary policies also played a crucial role in boosting demand for Turkish assets.

Looking ahead, we believe HY bonds are well-positioned for strong performance in 2025, supported by favorable growth, reduced inflation, and continued rate cuts by central banks.The Fed's dovish path should allow EM central banks to follow suit, boosting price returns for bonds to complement the aforementioned carry advantage of EM bonds.

Conclusion

Last year, we advised investors not to wait for a so-called 'magical' inflection point in the bond market. We wrote "Going into 2024, some investors are waiting for the first rate cut or for inflation to hit the magical 2% target as the catalyst for buying bonds. This approach risks missing the rebound. Bonds are likely to bounce back many months before the Fed's first cut." That proved sage advice last year, and we would submit a similar opinion going into 2025.

Investors should not be discouraged by potential risks, such as Trump tariffs, trade wars or geopolitical conflicts. There will always be risks on the horizon, but we know from historical evidence that bonds offer good value as we head into a new year. With high coupon income, a favorable growth-inflation mix, and central banks adopting an easing stance, the outlook for bonds in 2025 remains positive.. The outlook remains favorable for global EM bonds to achieve mid-single-digit returns in 2025.