# Fixed Income Allocations for 2025 and Beyond: A Playbook for Investors

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# Executive Summary

- Credit valuations appear elevated, global debt levels are high and rising quickly, and persistent fiscal imbalances risk undermining market confidence.

- Private credit has been all the rage of late, but potentially higher returns on offer come with many trade-offs versus public fixed income.

- Poor returns from traditional fixed income in 2021 and 2022 have caused some investors to reconsider the composition of their fixed income allocations.

- However, despite growing risks, rising bond yields over the past few years now provide compelling all-in yields in pockets of the bond market.

- Liquid global credit, in an unconstrained format seeks to provide investors with enhanced returns over active core and passive fixed income, without the primary trade-offs of private credit, while targeting positive returns in all market environments.

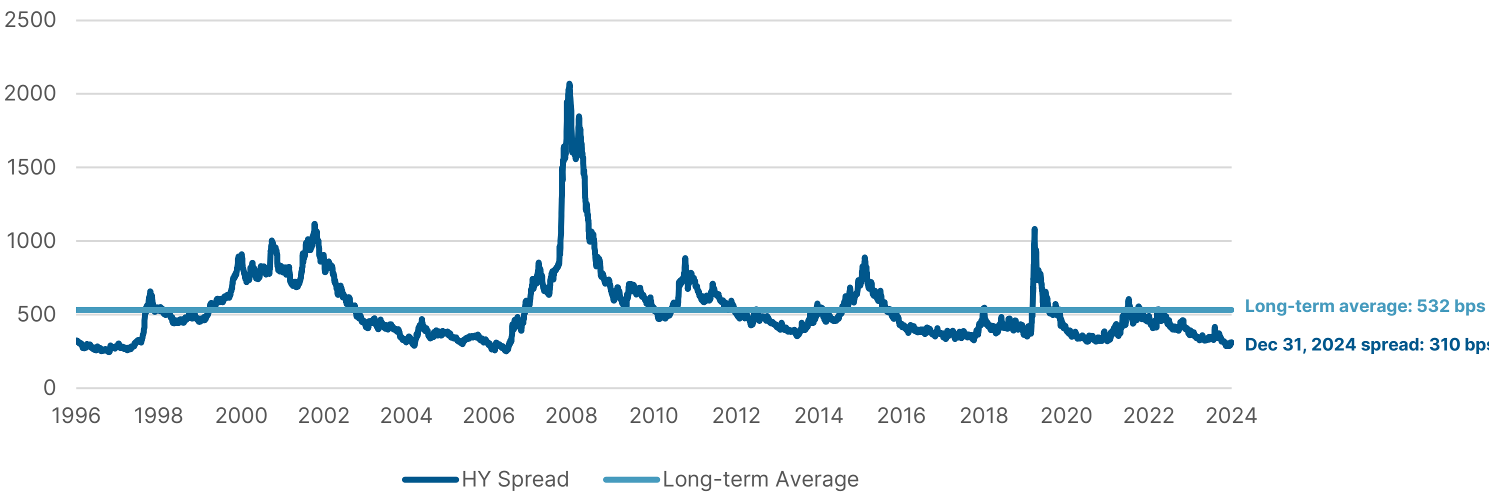
- There are benefits to making a strategic rather than tactical allocation to unconstrained global credit when constructing a well diversified portfolio.

## What are some keys risks in today's fixed income market that investors must grapple with?

### 1. Credit Valuations

The chart below shows the average high yield spread (the incremental yield you earn for lending to a lower quality corporate with challenges, think: Bombardier in Canada or Boeing in the U.S) over the last 28 years. If you rarely look at credit markets, this is the only chart you need to get a sense of whether the market is tilted in favour of lenders or borrowers (it's a borrower's market today!). Also take note that these periods in favour of borrowers can last several years, but when the tide turns, it tends to do so abruptly and in extreme ways.

**Historical High Yield Index Spreads (bps)**



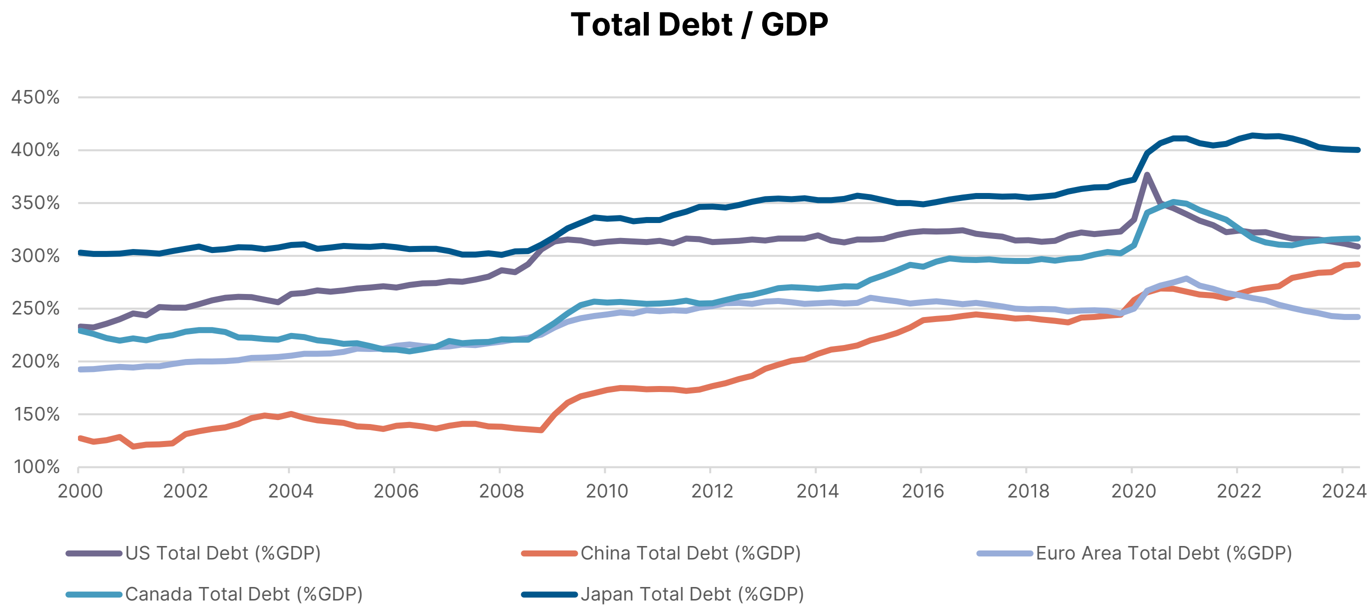

As at December 31, 2024. Source: ICE BofA.

### 2. Political Machinations

With the recent change in White House administration, the purported policy agenda with a focus on higher tariffs, lower taxes, and reduced regulation has the potential to be favourable for U.S.-based companies over time. The majority of higher revenues, net income, and cash flow (if and when they transpire) will likely accrue to the benefit of shareholders over lenders given the upside potential accruing to equity holders versus the contractual return of fixed income. Think: mergers & acquisitions, share buybacks, and special dividends—it is not going to be in vogue to deleverage. If this environment plays out, protecting capital as a lender will be more important than ever.

### 2. Elevated Debt Levels

Incentives drive behaviour, and though debt serves a useful function in society, Canada, the United States, and many other countries around the world are reaching alarming levels of indebtedness thanks in large part to years of easy monetary policy and government fiscal policy (i.e., growing deficits without the economic growth to eventually pay it back).

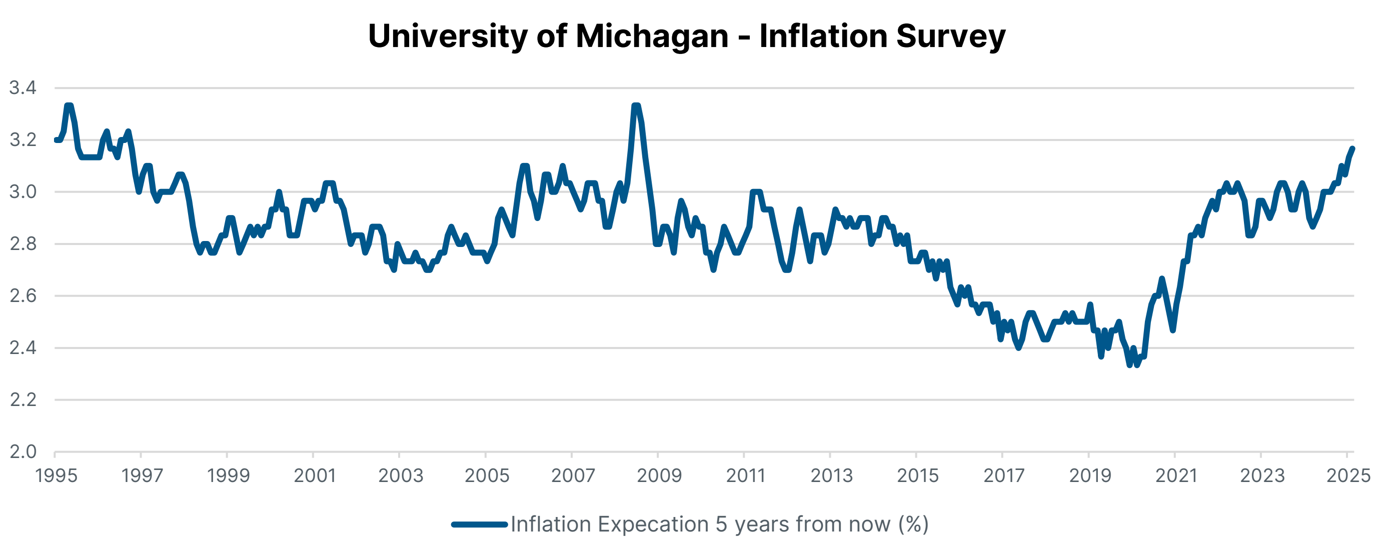



As at April 1, 2024. Source: MacroBond

### 4. An Untethering of Inflation Expectations

Bouts of inflation can be managed, at least if people expect them to be temporary or if nominal growth is higher than inflation. In fact, nominal growth consistently exceeding inflation is a method of reducing debt/GDP. However, this can be a risky process as inflation that isn't backed up by growth is stagflation, not a "beautiful deleveraging."

The coordinated worldwide government responses to COVID-19 was in hindsight highly inflationary. Pre-COVID, inflation spikes were not a great concern for central banks, if anything deflation was seen as a bigger risk. Five years post COVID-19, higher inflation expectations than in the preceding decades have been normalized, workers are demanding higher wages, and businesses are more easily able to pass on pricing increases. We're seeing signs of this normalization of higher inflation expectations in surveys and in actual inflation prints.




As at February 1, 2025. Source: MacroBond

These changes in inflation trends combined with the risks of continued government deficits globally and growing total debt levels can stoke fears of even more persistent and elevated inflation. This in turn can lead to rising longer-term bond yields as investors start demanding more compensation for lending money long-term.

If longer-term yields spike, especially if nominal growth isn't keeping pace, it becomes that much harder to pay off the existing debt stock as more of a country's income goes to paying off interest and principal on their debt, rather than productive uses in the economy.

What's the bottom line for investors? Higher inflation is typically bad for bonds, especially longer duration bonds, and inflation risks are growing. Investors with passive fixed income allocations and longer duration exposures than their liabilities require should take heed.

## Those that have non-traditional fixed income in their portfolios are often invested in private credit, but is the juice worth the squeeze?

Private credit is high yield without the protection afforded by daily mark to market, with limited transparency on underlying holdings, and virtually no liquidity. Also, many private credit funds are levered which amplifies returns in up markets but adds to the damage in down markets.

Despite these concerns, there can be a place for private debt in some investor's portfolios, but the question is whether there's sufficient compensation for taking on the risks inherent in the asset class today.

In our view, if you add up all the incremental risks, all in yields on private credit should be higher on average than what's currently on offer. Today single B rated high yield spreads are +300bps, private credit (which has B rated characteristics) is pricing +500bps. So investors needs to ask themselves is an additional +200bps fair compensation for assuming all of those incremental risks?

## 2021 and 2022 were rough for many fixed income investors

After decades of falling yields provided a tailwind for fixed income returns, rising yields over the past few years proved a nasty headwind. In fact, investors experienced two straight years of losses in their traditional bond portfolios in 2021 and 2022[1], the first back-to-back negative returns since 1997/1998. People don't expect to lose money in fixed income. While fixed income retains many of its key historical benefits, losses should lead to a critical examination of the type of fixed income an investor holds. Some investors do not need as much duration exposure as a traditional bond fund provides and credit risk should be managed dynamically rather than blindly replicating a benchmark.

[1]ICE Global Bond Index

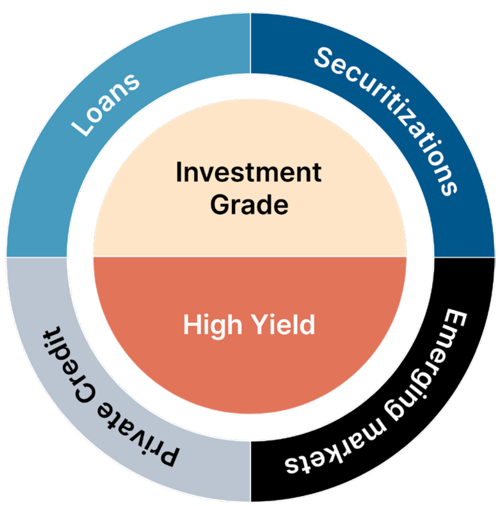
## A shift in strategy may be in order

We often say that we focus on preparing, not predicting. This means we strive to observe market signposts as part of our investment process without anchoring on one particular market outcome. Today, the signposts we see are (1) a fixed income landscape where compensation for taking on credit risk is very low by historical standards, (2) a U.S. political backdrop that might be more favourable to equity holders than bondholders, (3) staggering levels of public and private debt, (4) a risk of reaccelerating inflation, and (5) a booming private credit market where underwriting standards and credit spreads appear to both be falling.

Taken together this suggests pronounced risks in lower rated credit (both public and private) as well as risk from taking on meaningful interest rate exposure.

One potential solution is a strategic allocation to an unconstrained global credit strategy. This type of active management acknowledges and respects that credit spreads can stay tight, and yields low, for long periods. Shifting to higher credit quality and shorter duration mitigates risk in expensive and risky markets. When markets are cheap or distressed, a dynamic approach calls for taking advantage of the opportunity, rapidly and decisively shifting into lower credit quality, long-term positions.

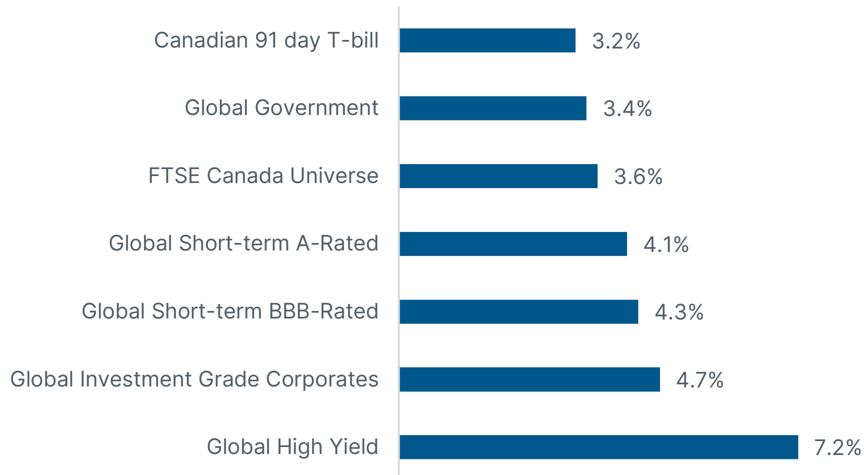
There are many different flavours of unconstrained credit strategies, but the common ingredients include a broad corporate investment universe, a dynamic investment approach (both credit and interest rate positioning), an absolute return focus, and an enhanced awareness of risk. A sample of the breadth of credit securities includes many fixed income sectors.




Periods like the Great Financial Crisis of 2008 and COVID-19 in March 2020 can lead to substantial short-term volatility but offer the potential to reap significant long-term profits, rewarding investors who dynamically increase exposure and risk after credit selloffs and patiently hold on during the recovery phase of the cycle. At the same time, we believe the ability to take advantage of periods of dislocation follows directly from preserving capital in frothier markets while still aiming to generate positive returns while patiently waiting for better valuations.

Today, we see good value in shorter dated, high-quality investment grade corporates. The all in yields are attractive versus money market and government bonds.

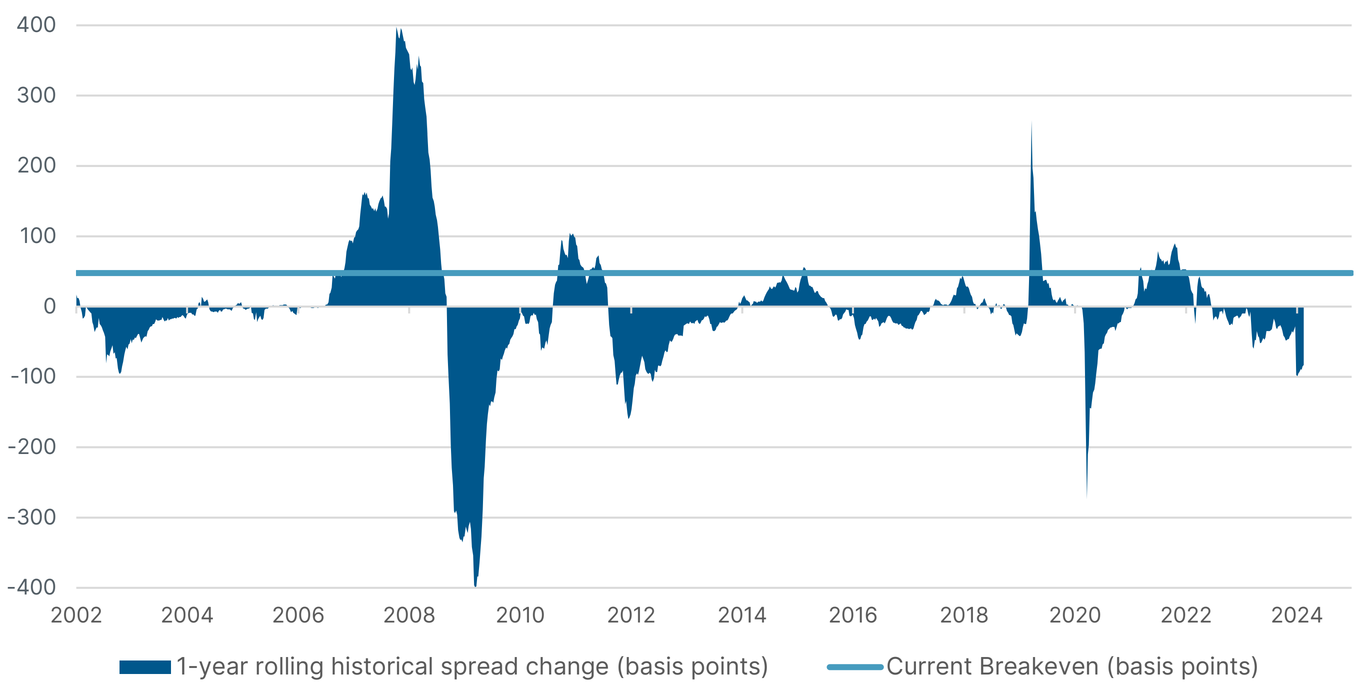
**Global Bond Yields**




As at December 31, 2024. Source: ICE BofA.

At the same time, the spread breakevens on shorted dated investment grade corporates (the level of spread widening that has to occur before the spread advantage of a corporate bond over a government bond is nullified) is much higher today than the typical one-year average of spread widening and compares favourably to all but the most acute credit markets downturns.

**Historical Spread Widening of Global Short Investment Grade Corporates Versus Current Spread Breakeven Level**




As at December 31, 2024. Source: ICE BofA.

## Unconstrained global credit seems predicated on being opportunistic. Why should this be a strategic allocation instead of tactical?

Markets can remain expensive and credit spreads remain tight for long periods of time. But the periods of dislocation offer tremendous opportunity for capital appreciation. Those periods are getting shorter as central banks and governments are intervening more rapidly when there are crises. In our view, it’s extremely difficult to market time credit; rather you need to always be in it but positioned properly to take advantage.

Investors may be tempted to say this strategy sounds opportunistic and they’d be right! But why shouldn’t investors also be “opportunistic” and move in and out of the strategy to coincide with those major market moves, e.g., global financial crisis, the pandemic, etc.? A few points to be made here:

1. **Shorter market dislocations.** If you go back to the pandemic, the most recent significant credit market dislocation, the window to buy really cheap securities was measured in days, not months. If you weren't buying in the middle of March 2020, you missed the best opportunities. Therefore, an investor needs to move very quickly and not having the unconstrained credit allocation in place ahead of time means a high likelihood of missing the best opportunities, in our view. This is particularly likely for institutional investors that typically need investment committee approval before making a new allocation.

2. **Behavioural forces.** In a market panic, it can be hard for investors to buy an asset as pricing is cratering. Most people won't pick up the phone to move money into this type of strategy—an unconstrained credit strategy—when they think the world is ending. That's just natural human behavior. When investors are nervous, they’re less likely to make a move and therefore more likely to miss the opportunity if they haven’t planned ahead for this eventuality.

3. **Funding the trade.** Even if an investor can move quickly and decisively, they need to fund the switch into unconstrained credit, and unless they had a pile of cash sitting on the sidelines (which has its own opportunity cost), they’re likely to be moving money out of a strategy that has itself already corrected. So, in a sense, they've already missed the opportunity because they’re just trading that position that has already traded down to buy something else that is down significantly, too.

   An unconstrained credit strategy is absolute return-focused, meaning it aims to generate positive returns in all markets. In expensive markets it preserves capital so there is dry powder ready to exploit market dislocations while still aiming to generate a return that’s better than cash in the meantime. We believe there is a low opportunity cost to being a long-term investor in this type of strategy and undoubtedly a much higher opportunity cost to trying to market time it.

## Conclusion

Amidst the uncertainty and risks in the market today—and fresh off a multi-year drawdown in traditional fixed income—we think investors should consider alternative approaches to managing their fixed income allocations, particularly strategies that aren't predicated on sacrificing liquidity to generate attractive returns when possible.

Unconstrained credit strategies can be selective about when and how much risk to take on and can avoid certain risks entirely if the compensation is deemed insufficient. Many traditional fixed income strategies and private credit do not have this flexibility. In our view, regardless how the world unfolds, unconstrained global credit is likely an under-allocated but useful component of a well-structured portfolio.

# Disclaimers