Western Asset
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PM EXCHANGE

Navigating Markets Amid Tariffs, Downgrades and Volatility

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Global fixed-income markets are facing heightened volatility due to tariff uncertainty, fiscal concerns and shifting US policies. US growth is expected to slow, and inflation will likely remain above target. Recession risks remain but are not in our base-case scenario. Credit markets are holding up well, with strong fundamentals supporting tight spreads, though companies are pulling back on capital expenditures amid uncertainty. Liquidity has been better than expected, helped by ETFs and portfolio trading. We believe diversification, nimble positioning and careful issuer selection are critical to managing ongoing risks and volatility. We currently see opportunities in high-quality structured credit, select EM debt and potentially long-dated USTs, given widespread bearish sentiment.

Market Outlook

- US growth is expected to slow, with sub-trend US real GDP growth and nominal growth projected at around 4.0% to 4.5% in 2025.
- Recession risk is present in the US, but it is not our base case, as ongoing fiscal support and potential central bank easing provide a buffer.
- Persistent geopolitical tensions and trade disruptions are making economic forecasting more challenging.
- Volatility is expected to remain elevated in the months ahead, creating both risks and tactical opportunities.

Central Bank Policy

- The Federal Reserve (Fed) remains cautious, balancing above-target inflation with signs of slowing growth, and is expected to cut rates modestly if data weakens.
- The European Central Bank (ECB) cut rates as inflation in the eurozone fell to its 2% target, while Asia-Pacific central banks maintain flexibility.
- The Bank of Japan is expected to continue to hike rates cautiously, with inflation remaining elevated between 2.5% and 3.5% for the next few quarters.
- Policy responses are increasingly region-specific, reflecting local inflation and growth dynamics.
- Central bank actions are critical drivers of market sentiment and cross-asset correlations.

Inflation

- US inflation remains above target, with expectations for CPI around mid-3% year-over-year in 2025.
- The debate continues over whether current inflation is transitory (driven by tariffs and supply shocks), or more structural.

- In the eurozone, inflation has fallen close to target, prompting rate cuts and a more dovish stance from the ECB.
- Asia-Pacific inflation is generally contained, with falling prices in China putting downward pressure on prices throughout the region.
- Market-based inflation expectations are stable, but consumer sentiment surveys show higher inflation fears.

US Exceptionalism and Shifting Global Dynamics

- The concept of US exceptionalism has diminished as Europe and Asia-Pacific respond to US policy shifts with increased fiscal spending and new alliances.
- Anti-migration policies and potential capital outflows could challenge US innovation and market dominance over time.
- The US dollar's reserve currency status and deep financial markets remain key strengths and are unlikely to change anytime soon.
- Europe is seeing renewed investor interest, with some capital shifting from the US to other regions.
- The global order is becoming more multipolar as regional alliances and economic partnerships gain importance.

Regional Perspectives

- **US:** Facing slower growth, persistent inflation above target and policy uncertainty, the Fed remains data dependent.
- **Europe:** Growth is sluggish, inflation is below target and the ECB is cutting rates; fiscal expansion is underway in some countries, notably in Germany, which has announced a large infrastructure and defense package.
- **Asia-Pacific:** China exports deflation, Japan faces unique monetary challenges and regional alliances are strengthening in response to US trade policy.
- Regional credit markets show resilience, but companies are cutting capital expenditures amid uncertainty.
- Diverging regional trends are creating differentiated investment opportunities.

Fixed-Income Sector Opportunities

- Agency mortgages and high-quality structured credit offer attractive yields and defensive characteristics, despite recent volatility.
- Select emerging market (EM) local debt, especially in Latin America, currently offers high nominal and real yields.
- Corporate credit spreads are tight but justified by strong fundamentals; volatility creates tactical opportunities to add exposure.
- Idiosyncratic issuer selection remains paramount, especially as overall spreads compress.
- Municipal bonds and certain sectors within structured credit are seen as attractive relative to corporates.

Portfolio Positioning

Our portfolios emphasize diversification across regions, sectors and issuers to manage risk and capture opportunities.

- We prefer yield-curve positioning (favoring steepeners) over outright duration bets, given uncertainty around both fiscal policy and US inflation.
- We favor overweights in high-quality, short-dated credit and selective exposure to EM and structured products.

- Flexibility and nimbleness are critical for taking advantage of volatility and shifting correlations.
- Current strategies focus on actively managing credit spread duration and carefully budgeting risk.

Q&A Highlights

- Liquidity in credit markets has been stronger than many expected, supported by ETFs and portfolio trading, even during periods of volatility.
- Foreign demand for US Treasuries (USTs) remains steady despite concerns about downgrades and fiscal issues, and fears of a major selloff may be overstated.
- Portfolio trading has improved market liquidity by allowing less liquid bonds to be traded efficiently as part of larger packages.
- There could be a contrarian opportunity in long-dated USTs, since most investors are currently bearish and consensus positioning can create opportunities.
- Current market pricing may not fully reflect the risks from ongoing policy uncertainty and volatility, so caution is warranted.