OPPORTUNITIES IN FIXED INCOME AND CURRENCY

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At Insight's Summit 2025, attendees were offered perspectives on current trends in global fixed income and currency markets, as well as liability-driven investment strategies, by Insight specialists. Videos of the full sessions are available here. This paper offers a summary of the key points presented.

FIXED INCOME IN AN UNCERTAIN WORLD

Adrian Grey
Global Chief Investment Officer

Volatility could be set to rise for risk assets: There is already high volatility in government bond and currency markets, which is not present in credit and equity markets. This could reflect a degree of complacency in risk-asset pricing.

The neutral interest rate is likely to rise: We expect rising productivity, driven by technology, AI and robotics, and climate change, are going to introduce costs that lead savings and investment to skew the interest rate structures at a higher level. Inflationary pressure will also push up rates, in our view.

Regional divergence is already emerging: Japan is set to raise rates further, while other major central banks are set to cut – and for the latter, the extent and timing of cuts are likely to diverge much more significantly than in the recent past.

Yield-curve steepening is the likely result of current trends: Aside from Japan, yield curves will generally be steeper elsewhere as central banks cut rates at the short end, but are set to issue large amounts of debt, putting upward pressure on yields at the longer end.

Overall yields are attractive but spreads are tight – but asset-backed securities (ABS) are an appealing exception: Spreads in most areas of the credit market are tight compared to historical levels, and while yields are attractive, you are receiving relatively little for risk taken over government bonds. The notable exception is ABS, where spreads have not tightened in the same way as other markets.

The private credit market could be helping the public credit market: The market for private debt has been expanding at a rapid pace over the past 15 years, and as borrowers have migrated to the private market, this could arguably have been a factor in reducing observable default rates in public markets. Despite tighter lending standards in recent years there has not been a meaningful rise in high yield or leveraged loan defaults, which can be seen as proxies for private debt defaults. We are cautious about the potential for complacency in the pricing of such assets.

An M&A upswing is under way: We expect this to drive significant issuance over the year ahead, and this could present a target-rich environment for active managers.

UNDERSTANDING THE DRIVERS OF THE US DOLLAR

Francesca Fornasari
Head of Currency

In recent years, the currency markets have been dominated by the US dollar (USD). In our view, to understand the outlook for the USD, there are three broad factors to consider: structural, cyclical and tactical.

- **Structurally, the USD faces large headwinds:** The US currently has a large fiscal deficit, which historically has been associated with a much higher unemployment rate; this suggests a degree of fiscal unsustainability which we expect to be a headwind for the US economy, and the USD, in years to come. Separately, the US has a dominant share of global markets and currency reserves. There are signs that the market is looking to diversify away from US assets and USD reserves.
- **Cyclically, several factors are supporting the USD:** The USD offers very attractive carry, US equities have significantly outperformed global equities for many years, and heightened trade uncertainty has also driven demand for the USD.
- **Tactically, the market is long the USD:** Positioning of currency market traders suggests long positioning in the USD across the market is at its highest level for at least a decade, and has increased materially since late 2024 and the election of President Trump.

Looking forward, we believe the structural headwinds, set against the cyclical factors supporting the USD and current extension of long USD positions, means there is an unstable equilibrium in currency markets. We believe that against this backdrop, the USD may experience a period of underperformance. Traditional valuation models for currency valuations suggest the USD is overvalued, while the euro, sterling and Japanese yen are undervalued; and history suggests that currency markets can move substantially even without a radical change in the economic background – for example, this was apparent in the significant appreciation in the euro versus the USD in 2017, after President Trump was first elected.

As examples of factors which could have a significant impact on currency markets, we are considering the following.

- **Energy prices:** European energy prices have been much higher than US energy prices. The future relationship between Ukraine and Russia is unknown, but any deal which increases the flow of Russian fuel into Europe could have a significant impact and reduce the relative difference between US and European prices.
- **Japanese growth:** There are fundamental changes occurring in the Japanese economy: remarkably, wage growth in Japan has recently exceeded wage growth in the US. With the Bank of Japan set to hike rates while other central banks move in the opposite direction, we expect this transformation to continue.
- **UK rates:** The differential between the US and UK rates is small and therefore potentially unstable in terms of the implications for currency markets, even though it is in a much more favourable position than it was for some years. If the UK rate increases relative to the US, you could expect sterling to perform well, but if it declines it would underperform.

Conclusions

1. **In the next couple of months, US exceptionalism and trade uncertainty are likely to keep the USD supported.**
2. **But beyond Q2 2025, risks for the USD are skewed to the downside as the outlook for trade becomes clearer.**
3. **This suggests to us that 2025 will be a volatile year for currency markets, and sharp corrections in the USD cannot be ruled out.**

UK GILTS: A NEW PARADIGM

Rob Gall
Head of Market Strategy

Gilt yields rose materially in late 2024 and early 2025, prompting some concerns, then fell back. Despite initial fears, this was not a 'Truss moment', like when gilt yields rose dramatically in late 2022. The differential between US and UK yields remained relatively stable, illustrating that the recent volatility was primarily the result of global bond market moves as opposed to anything specific to the UK.

Notably, UK defined benefit (DB) pension schemes are now fundamentally different. Compared to back in 2022, they have much broader collateral pools and can live this level of volatility in the gilt market. DB schemes are now much more resilient.

However, now that demand from DB schemes for new gilt issuance is largely satiated, and the Bank of England is selling debt ('quantitative tightening') rather than buying debt ('quantitative easing'), other players have come to dominate activity in the gilt market.

The Bank of England has estimated hedge fund activity in the gilt market as accounting for almost 30% of trading in recent months, and Insight's analysis suggests overseas investor participation in some gilt syndications has risen from around 8% to 40% over the last few years. These investors have no need to remain in the gilt market, and this makes the market feel more fragile with the potential for increased volatility.

The gilt market also faces several fundamental challenges in the coming years.

- **Increased supply:** Gilts issued by the government, and gilts set to be sold by the Bank of England, will amount to £250bn to £300bn of gilts in the next five years, according to our analysis.
- **Expensive and large pool of debt:** The UK has higher interest rates (like the US), making the UK debt burden more expensive; but lower growth (like Europe) – with £2.8trn of outstanding debt.
- **Limited and shrinking fiscal headroom:** The chancellor of the exchequer has little fiscal headroom, and even this could be wiped out if UK growth is in line with market forecasts. Rising gilt yields and inflation could also have a significant negative impact.
- **Calls to increase spending:** Calls for more spending on defence could have a further impact on government finances.

Considering the levels of government bonds to swaps, UK government bonds have underperformed in relative terms since late 2022, but we are now at a point where the spread is wide enough that while this might be a cause for concern, there is also a potential opportunity for investors, in our view. There are also some specific opportunities that gilt investors might exploit to take advantage of high-coupon and low-coupon bonds.

We therefore expect that there could be significant volatility and challenges for the gilt market ahead – though DB schemes are resilient, and for active investors, there may be some investment opportunities to consider.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

The issuer of a debt security may not pay income or repay capital to the bondholder when due. The return risk to a portfolio is higher where a portfolio is highly concentrated in such an issuer.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large impact on the portfolio.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Where high yield assets are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

Property assets are inherently less liquid and more difficult to sell than other assets. The valuation of physical property is a matter of the valuer's judgement rather than fact.

The specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Also, many loans are not actively traded, which may impair the ability of the portfolio to realise full value in the event of the need to liquidate such assets.

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