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CHIEF INVESTMENT OFFICE

Fixed Income Spotlight

2025 Year-Ahead: Clip Those Coupons, Be Ready if Anything Goes On Sale

December 2024

All data, projections and opinions are as of the date of this report; and subject to change.

SUMMARY

- The interest rate cut cycle has begun, while nominal and real yields look good relative to recent history, inflation and global developed market rates.
- We find concerns about deficits, tariffs or high debt loads causing a rate spike to be exaggerated and suggest investors to extend their strategic duration targets as a steeper yield curve driven by lower short rates.
- Investment-grade (IG) and High Yield (HY) spreads are at or near their tightest levels in several decades. Despite supportive macro and fundamental backdrops, we continue to believe that risk/reward is skewed negatively.
- Mortgage-backed Securities (MBS) still appear relatively attractive to other high quality Fixed Income asset classes such as IG. Key risks to our view remain higher interest rate volatility and uncertainties regarding Bank demand.
- We expect municipal bonds to remain an attractive asset class for tax-sensitive investors, despite valuations that are richer than historical averages. Technical and fundamental backdrops are expected to remain supportive.

View the CIO Viewpoint ▶ View the CIO Asset Allocation Guidelines ▶

ASSET CLASS WEIGHTINGS

Asset Class	Underweight		Neutral	Overweight	
Global Fixed Income		●			
U.S. Governments				●	
U.S. Mortgages				●	
U.S. Corporates		●			
International Fixed Income			●		
High Yield		●			
U.S. Investment-grade Tax Exempt			●		
U.S. High Yield Tax Exempt		●			

These Chief Investment Office (CIO) views relate to fully-diversified, multi-asset class portfolio and use the asset class breakdown of the CIO "High Tax/Balanced" Allocation. Source: Global Wealth & Investment Management Investment Strategy Committee as of December 3, 2024.

FIXED INCOME U.S. RATES FORECAST

(% end of period)	Spot	1Q25	2Q25	3Q25	4Q25
Fed Funds Range	4.58	4.00–4.25	3.75–4.00	3.75–4.00	3.75–4.00
2-Year T-Note	4.19	4.00	4.00	4.00	4.00
5-Year T-Note	4.19	4.15	4.15	4.15	4.15
10-Year T-Note	4.33	4.25	4.25	4.25	4.25
30-Year T-Bond	4.55	4.50	4.50	4.55	4.55

Source: BofA Global Research U.S. Rates Research; December 13, 2024; spot price as of that date. Note: Federal funds rate forecasts are model expectations; other values are for market rates. The forecasts in the table above are the baseline view from BofA Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts. **There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment outcomes.**

FIXED INCOME AT A GLANCE

Rates Markets	29-Nov	Last Month	Change
Fed Funds rate	4.63%	4.88%	-25 bps
3-month Treasury Bills	4.49%	4.55%	-6 bps
U.S. 2-year Note	4.15%	4.17%	-2 bps
U.S. 5-year Note	4.05%	4.16%	-11 bps
U.S. 10-year Note	4.17%	4.29%	-12 bps
U.S. 30-year Note	4.36%	4.48%	-11 bps
FF / 10s Curve	-46 bps	-59 bps	+14 bps
2s / 10s Curve	+2 bps	+11 bps	-10 bps
German 10-year	2.09%	2.39%	-30 bps
UK 10-year	4.24%	4.45%	-20 bps
Japanese 10-year	1.04%	0.94%	+10 bps

Credit Markets	29-Nov	Last Month	Change
U.S. Investment Grade (Spread)	+78 bps	+84 bps	-6 bps
U.S. High Yield (Spread)	+266 bps	+282 bps	-16 bps
U.S. High Yield (Yield)	7.14%	7.33%	-19 bps
Emerging Markets (U.S.$, Spread)	+222 bps	+226 bps	-4 bps
10-year AAA Municipal	2.83%	3.04%	-21 bps
10-year Muni / Treasury Ratio	67.9%	70.9%	-3.0%

Index Returns	1-month	12 months	Year-to-Date
U.S. Treasury	0.8%	5.2%	2.2%
U.S. MBS	1.3%	6.9%	2.9%
U.S. ABS	0.7%	7.0%	5.1%
U.S. CMBS	1.0%	10.1%	7.3%
U.S. Corporate	1.3%	8.3%	4.1%
U.S. High Yield	1.2%	12.7%	8.7%
U.S. Leveraged Loans	0.8%	10.2%	8.4%
U.S. Municipals	1.7%	5.2%	2.5%
U.S. Municipal High Yield	2.1%	11.6%	8.1%

Bps refers to basis points. Source: Bloomberg. Data as of November 29, 2024 and subject to change. **Past performance is no guarantee of future results. Please refer to the end of the document for asset class proxies and index definitions.**

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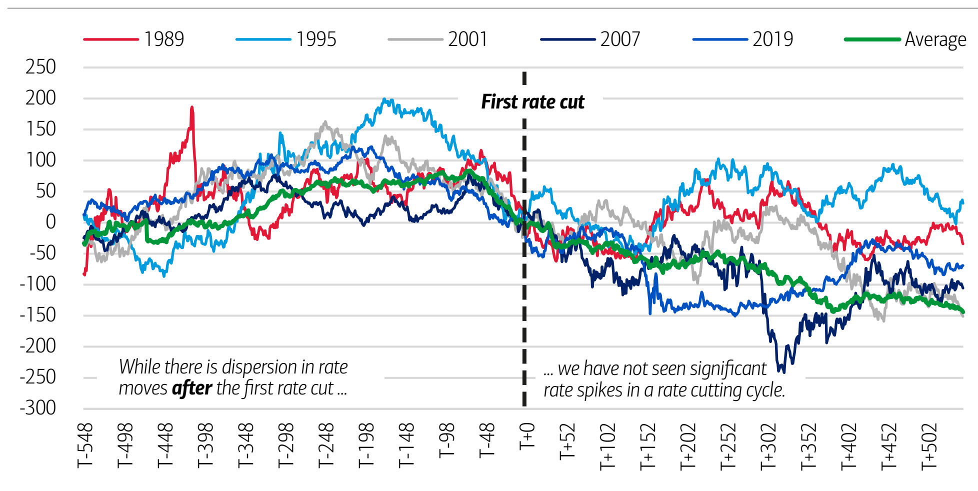
Please see last page for important disclosure information.

It's true in many respects, including high quality Fixed Income: "You get what you pay for." We believe only two things are required for acceptable Fixed Income returns: decent starting valuations and patience. We consistently suggest the second but must rely on markets to deliver us the first. Thankfully, the market currently does just that: it delivers reasonable valuations—though not outstanding, in our opinion—and therefore, for investors exhibiting patience throughout any 2025 volatility, we are constructive on overall Fixed Income returns, especially in a multi-asset class portfolio.

Several reasons support this view. First, the Federal Reserve (Fed) has reduced inflation from above 9% to below 3%, while unemployment has increased. Alongside the new administration, the Fed is now highly focused on avoiding a recession versus reducing inflation and is poised to cut rates throughout 2025. All things being equal, a rate cut cycle correctly calibrated to the economy acted as gravity on longer-term yields, usually avoiding significant rate spikes (Exhibit 1).

Exhibit 1: While Long-term Moves Vary During an Interest Rate Cut Cycle, They Generally Do Not Spike.



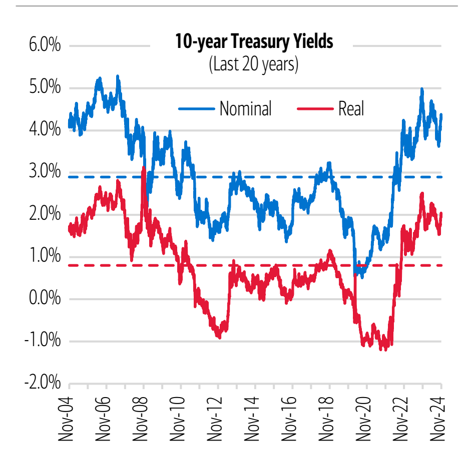
Source: Bloomberg; Chief Investment Office. As of December 9, 2024.

Secondly, Treasury valuations are attractive on a nominal and real basis, both absolutely and relative to other opportunities. The 10-year yields 4.20%, 130 basis points (bps) more than its 20-year average (Exhibit 2). Some argue that that average is skewed by the Fed's bond buying programs; we counter that the Fed has said absolutely nothing to imply that they will not continue to use those policies in future years. Furthermore, real rates have afforded compensation (around +2% to inflation, on average) at the high end of the historical range and have been significantly more attractive than anywhere else on the globe (e.g., U.K., Europe or Japan) (Exhibit 3).

Third, in both a positive and negative development, valuations are extended across risk assets. S&P 500 trailing, forward, and long-term price/earnings multiples are at the high end of historical ranges. IG credit recently hit levels not seen since 1997. HY bonds currently offer no additional yield after accounting for average credit losses—only municipals have offered good valuations within the Fixed Income credit spectrum. When almost everything has been expensive, catalysts are more likely to be able to cause larger price disruptions, so an up-in-quality tilt is warranted.

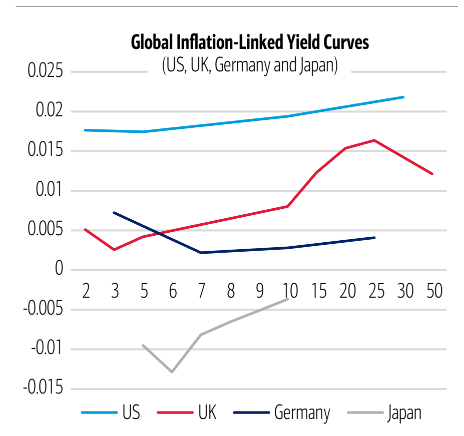
We are therefore slightly overweight Treasury and Agency MBS collateral to earn decent yields, while having dry powder and help hedge against expensive risk asset valuations; neutral on municipals for now; and willing to forego additional spread by being slightly underweight IG and HY credit. While we do not see a catalyst for wider credit spreads, we'd prefer to take macro risk in Equities and stay up-in-quality in Fixed Income.

Exhibit 2: Long-term Yields Are Back To Pre-Global Financial Crisis Levels And Are Reasonable in Today's Environment...



Source: Bloomberg, CIO calculations, December 9, 2024.

Exhibit 3: ...and U.S. Real Yields Are Attractive In A Global Context, Especially Compared to Expensive Risk Assets.



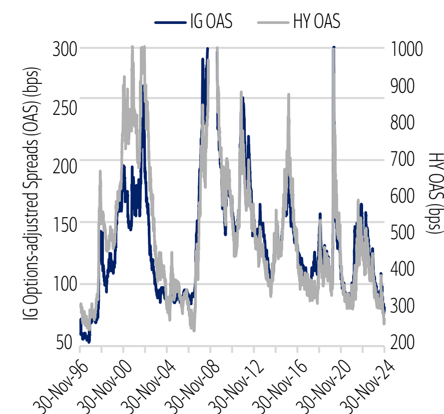
Source: Bloomberg, CIO calculations, December 2024.

In terms of duration, while rates are very reasonable, they are not outstanding, and a pro-growth executive branch and central bank increases inflation risk. We find valuations to be attractive enough to compensate for this risk, and if we see 10-year rates move decidedly back into the 4.5% to 5% range or real yields into the 2.25% to 2.5% range in 2025, we may again look for opportunities to extend duration. For now, we remain neutral duration, and our highest conviction call remains that the yield curve will normalize. Investors should therefore extend out to their strategic duration target and not be overly reliant on short-dated Fixed Income or cash alternatives. As a reference point, the current market duration of the U.S. Fixed Income market is 6.2 years.

While we do not dismiss the talk of inflationary risks, we are not overly concerned about them and think they are adequately priced into markets. The Fed is no longer buying bonds, so inflationary money supply growth is no longer a concern. Any deficit spending is now financed directly through bond issuance; this drains all the extra money injected into markets and is much less inflationary than central bank-financed deficits. While tariffs can increase prices, consumers alter behavior and higher prices can cause demand destruction, offsetting inflationary effects. Furthermore, higher debt levels in developed economies (U.S., Europe and Japan) over four decades now have reliably led to lower rates—not higher—as demographics and high debt loads are both drags on real economic growth. An appreciable allocation to long-term Fixed Income is therefore a prudent measure, balancing future risks against compounding the valuations currently on offer. We caution against expecting any capital appreciation from bond portfolios, however, unless there is a severe economic dislocation. Expect returns to approximate starting yields, and prepare to clip coupons in 2025 in case any episodic volatility in 2025 causes assets to “go on sale.”

Investment Grade & High Yield—The Rich Can’t Get Much Richer, Stay Slightly Underweight Credit Risk in Fixed Income Portfolios. Looking back across credit markets during 2024, the surprising thing about the year was the absence of big surprises. Economic data has largely come in better than expected; investor demand for high-quality Fixed Income amid higher all-in yields has been exceptionally strong; and—other than periods of elevated rate volatility and a late-summer growth scare —it has been a very benign period for risk assets, and credit markets, in particular. IG and HY spreads are on track to end the year tighter for the second consecutive year, with year-to-date excess returns of 2.6% and 5.2%, respectively, through November.

Exhibit 4: Credit Spreads Continue to Screen Rich with IG at Lowest Levels Since late-1990s and HY Lowest since mid-2000s.



Source: BofA Global Research. As of November 30, 2024.

In our view, pretty much everything in Fixed Income looks increasingly rich: IG is currently trading at its tightest level since the late 1990s, while HY hasn’t been tighter than current levels since 2007. Clearly, there are many positive elements priced into valuations. Expectations for gross domestic product growth are tracking above 2%, earnings growth is expected to accelerate next year, yields are still relatively elevated, demand remains healthy, and the Fed remains in easing mode—which, admittedly, could change quickly (i.e., Powell pivot 3.0?).

While we acknowledge that a continuation of some or all of these elements could lead to an environment where credit spreads continue to trend at tight levels or even compress modestly, we still don’t believe that the risk/reward relationship for credit investors is compelling enough to warrant an overweight or even neutral positioning in IG and HY at this time. That said, while we are hesitant to say spreads have hit a floor, it is important to understand that credit spreads are mean-reverting. Furthermore, signs of investor complacency are abound, and risks continue to look skewed to the downside with regards to forward excess returns for IG and HY markets. To be clear, outside of another inflationary spike and associated increase in interest rate volatility, or a significant escalation in geopolitical risks, we don’t see an obvious catalyst for credit spreads to move materially wider. In fact, we would argue that any selloff in credit spreads would likely be relatively contained unless we saw a meaningful deterioration in the macro backdrop.

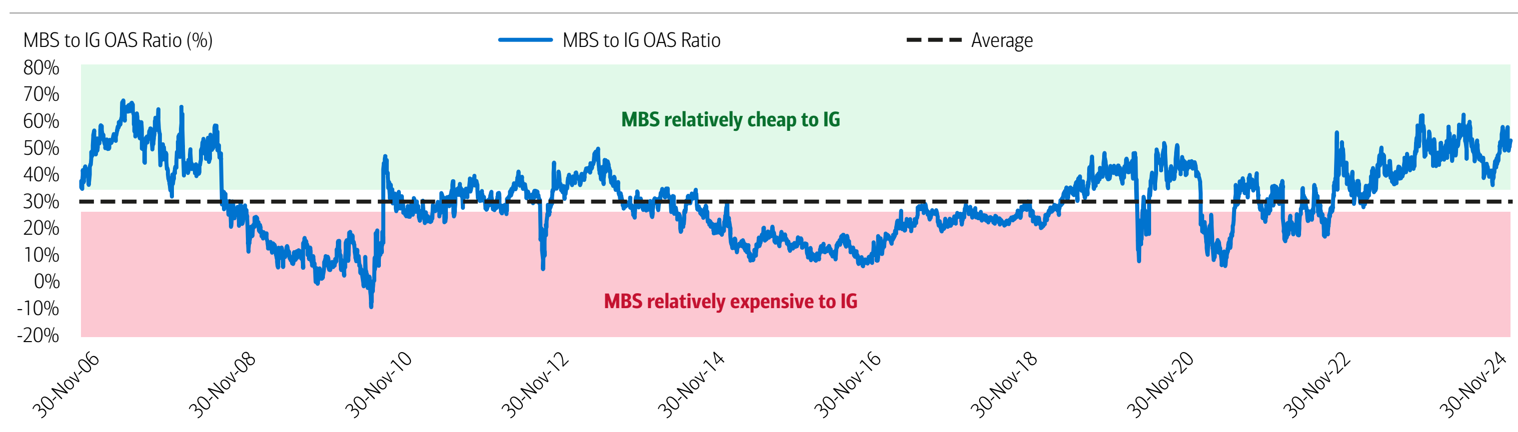
While spreads could continue to trend at low levels, we believe it is prudent to remain patient and keep risk budgets tight in an allocation to credit in Fixed Income portfolios and maintain a slight underweight positioning until a better entry point presents itself.

With limited room for upside in credit spreads and low dispersion across rating categories and sectors, portfolio diversification and a strict focus on issuer selection within an allocation to IG or HY is important. Given economic tailwinds and less regulatory scrutiny, we expect mergers & acquisitions to be a key theme across sectors

next year, which could lead to more aggressive capital allocation policies, intentional re-leveraging, and/or negative ratings actions—although earnings and fundamentals are likely to remain solid. With regards to sector positioning, we continue to see value in Banks/Financials relative to Industrials, as the former continues to trade wide on a duration-equivalent basis and could trade flat or through Industrials next year, particularly if general market spreads tighten over the next several months.

Mortgages Continue to Screen Cheap Relative to Investment Grade–Remain Slightly Overweight. Despite a difficult start to 2024, MBS spreads are on track to end the year modestly tighter with an excess return versus duration-matched Treasurys of 0.5% after a volatile Q3. MBS performance struggled in the face of several headwinds this year including periods of elevated interest rate volatility, a leveling off of demand from key investors, and continued quantitative tightening ('QT') by the Fed. The spread on the MBS index is currently around 40 bps, just inside of its longer-term average. While MBS valuations are less compelling than where we started the year, we continue to believe that MBS spreads offer attractive relative value, particularly compared to other higher-quality Fixed Income asset classes such as IG.

Exhibit 5: MBS Valuations Continue to Appear Cheap on a Historical basis Relative to Other High-Quality Fixed Income Asset Classes Such as IG.



Source: BofA Global Research. As of November 30, 2024.

Furthermore, despite continued pressure on affordability, housing fundamentals are on sound footing with U.S. employment data still healthy, positive wage growth, and healthy home equity. Looking at the technical backdrop, the story is more mixed as a slight increase in net supply next year will likely be met by potentially slowing demand with the Fed still engaged in QT, uncertainties regarding Bank demand for MBS in 2025, and the potential for a slowing in the pace of fixed Income flows which have been running near record levels during 2024. That said, several key risks for MBS, such as duration extension, have at least been partially mitigated for the majority of the MBS market. The most significant risks to our slightly overweight recommendation remain higher interest rate volatility in addition to the potential for government-sponsored enterprise privatization which could lead to wider MBS spreads over the short term.

Munis Still Provide Value, Remain Neutral. We expect municipal bonds to continue to provide value for tax-sensitive investors, despite valuations that are richer than historical averages. Seasonal technical factors should continue to be an important driver of muni returns, while muni fundamentals remain generally solid. The muni tax exemption could come under scrutiny next year within the context of tax reform, but we believe most classes of municipal issuers will maintain their eligibility to issue tax-exempt debt.

Technical Factors. This has been a record year for municipal bond issuance, expected to total over $500 billion. Muni issuance may be even stronger next year, given expectations of solid economic growth, lower interest rates, significant infrastructure needs, and depleted pandemic stimulus funds. However, outstanding municipal bonds totaled only $4.1 trillion (T) as of Q2 2024, just 6% higher than in Q2 2014, according to the Fed.

This is tiny compared to $27T in Treasury securities (123% higher than in Q2 2014) and $16 trillion in corporate and foreign bonds (43% higher than in Q2 2014). The restrained growth in municipal debt is due to several factors: First, states and local governments must maintain balanced budgets; therefore, they do not fund operating deficits with debt. Second, taxpayers (who vote) are often resistant to new capital projects. Third, over $1T in Federal pandemic stimulus allowed many issuers to fund capital expenditures from internal funds, without adding new debt. And finally, the Tax Cuts and Jobs Act of 2017 eliminated tax-exempt advance refundings, further constraining market growth.

While municipal supply has grown only slightly, demand for tax-exempt paper has been strong, particularly from individual taxpayers in brokerage accounts, separately managed accounts, exchanged-traded funds and mutual funds. The Republican sweep in November's elections eliminated the practical likelihood of any increase in personal income tax rates next year, but we believe demand for tax-exempt paper from individual taxpayers will remain strong.

Muni technical factors tend to be seasonal, with supply/demand mismatches at various times in the year. Municipal principal and coupon distributions are generally highest from May to August and secondarily in December and January, creating correspondingly high reinvestment demand during those periods. However, muni issuance is generally weak from November to January. Therefore, muni valuations—measured by muni-to-Treasury (M-T) yield ratios—tend to fluctuate. This year, ratios on AAA 10-year maturities ranged from 57% to 73% according to Bloomberg, providing opportunities for "crossover" investors when munis were over-valued or under-valued.

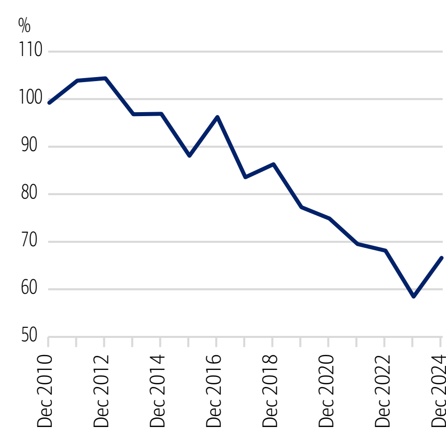
Richer Muni Valuations. M-T ratios have been declining over the last decade (Exhibit 6). We attribute this mainly to constrained supply growth and improved municipal credit quality. We do not expect a return to historically cheaper valuations while the economy remains solid. However, even at current valuations (10-year AAA M-T ratio = 66.7% on December 5), we believe munis still offer value, especially for the most tax-sensitive investors who pay a 40.8% combined federal tax rate (37% income tax plus 3.8% net investment income tax) on taxable bonds. We believe there is even more value in lower-rated, investment grade munis.

Potential Tax Reform. Policymakers are seeking ways to pay for extending current individual tax rates, which are scheduled to rise after 2025. We expect numerous proposals to cut tax expenditures, possibly including additional limits on tax-exempt bond issuance. While some municipal subsectors, e.g., private higher education, may be vulnerable to losing their eligibility to issue tax-exempt debt, we believe most municipal issuers will ultimately be unaffected. Furthermore, we believe potential pressures to municipal bond tax exemption should not deter investors from buying munis, since outstanding tax-exempt bonds would likely be "grandfathered," and any limits on new tax-exempt issuance should only increase the scarcity value of existing holdings. If the tax-exempt status of one or more muni subsectors is slated for elimination, expect a surge in bond sales from such issuers in the months before the law would take effect.

Muni Credit Remains Generally Strong. Muni credit remains generally strong, in our opinion, thanks to federal aid from pandemic-related relief packages in 2020 and 2021 and strong tax revenue growth in 2021 and 2022. As of fiscal 2022, total state Rainy-Day funds were a record 15.8% of operating expenditures, and they remain elevated, projected at 12.5% of operating expenditure by the end of fiscal 2025 (Exhibit 7). Credit rating agencies factor these improved financial positions into their ratings, and from Q1 2021 through Q3 2024, Moody's upgraded over three times as many municipal ratings as it downgraded.

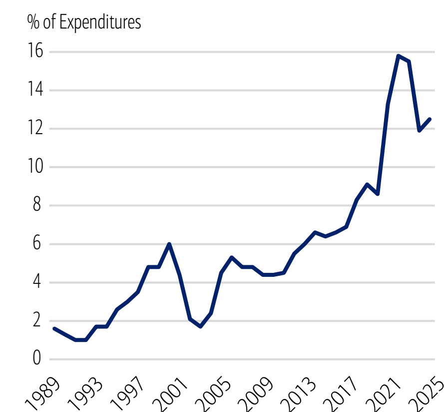
We believe the recent improvement in municipal credit quality is leveling off, but the current high levels of reserves and Rainy-Day funds should still allow most issuers to maintain strong levels of creditworthiness, even if the economy slows. Still, with over 20,000 municipal issuers, there are credit outliers to the downside, and some subsectors, such as private higher education and not-for-profit hospitals face particular challenges. Therefore, selectively on lower-rated credits is warranted.

Exhibit 6: AAA M-T Yield Ratios, 10-year Maturities.



Source: Bloomberg. As of December 4, 2024.

Exhibit 7: Total Rainy-Day Fund Balances.



Source: National Association of State Budget Officers-The Fiscal Survey of States, Spring 2024. Figures for fiscal 2024 are estimates and fiscal 2025 are projections based on governors' recommended budgets. Estimates for fiscal 2024 exclude Georgia and Wisconsin; projections for fiscal 2025 exclude Georgia, Mississippi, Virginia and Wisconsin.

Asset Class Proxies and Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in dollars.

U.S. Financials/U.S. Industrials/AA-Credit/BBB-Credit/A-Credit/ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the US domestic market.

U.S. Municipals/Bloomberg Muni Bond Index measures the performance of the Bloomberg U.S. Municipal bond market, which covers the USD- denominated Long-Term tax-exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

U.S. High Yield/BB-Credit/B-Credit/CCC-Credit/Bloomberg U.S. Corporate High Yield Index: The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

U.S. Municipal High Yield/Bloomberg High Yield Municipal Index is a benchmark that covers the high yield portion of the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Emerging Market/Bloomberg Emerging Market USD Index is a flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi sovereign, and corporate EM issuers.

Cash/U.S. Treasury/Bloomberg U.S. Treasury Index Total Return measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting.

U.S. Mortgage-backed Securities (MBS)/ABS/Bloomberg U.S. Mortgage-backed Securities Index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

U.S. Corporates/Bloomberg U.S. Corporate Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers. The U.S. Corporate Index is a component of the U.S. Credit and U.S. Aggregate Indices.

Bloomberg Capital Asset-Backed Securities (ABS) Index is composed of debt securities backed by credit card, auto and home equity loans that are rated investment grade or higher by Moody's.

Bloomberg U.S. Commercial Mortgage Backed Securities (CMBS) Index is the Bloomberg Non-Agency Investment Grade CMBS: BBB Total Return Index Unhedged.

ICE BofA Investment-grade Index tracks the performance of U.S. dollar-denominated, investment grade (IG), asset-backed securities publicly issued in the U.S. domestic market.

ICE BofA High Yield tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade and sub-investment grade corporate debt publicly issued in the U.S. domestic market.

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Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax (AMT). Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Single-state municipal bonds pose additional risks due to limited geographical diversification. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor. Investments in high-yield bonds (sometimes referred to as "junk bonds") offer the potential for high current income and attractive total return but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer's ability to make principal and interest payments. Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. For investments in Agency Mortgage-backed Securities (AMBS) and Mortgage-backed Securities (MBS), generally, when interest rates decline, prepayments accelerate beyond the initial pricing assumptions, which could cause the average life and expected maturity of the securities to shorten. Conversely, when interest rates rise, prepayments slow down beyond the initial pricing assumptions, and could cause the average life and expected maturity of the securities to extend, and the market value to decline. Most senior/leveraged loans are made to corporations with below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults.

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