AXA Investment Managers

Investment Institute *Asset Class Views*

The view from the Core CIO Office

February 2025

Chris Iggo
Chair of the AXA IM Investment Institute, CIO of AXA IM Core

Alessandro Tentori
CIO of Europe AXA IM Core

Ecaterina Bigos
CIO of Asia ex-Japan AXA IM Core

KEY INVESTMENT THEMES

Bond income returns potentially higher in 2025	Confidence in US growth should sustain performance	Asia's economy has become increasingly challenging

CIO Office: Opinions

Chris Iggo, CIO AXA IM Core

Steady income should not be overlooked

Many investors have been enjoying higher income returns as the average market-weighted coupon on bond indices has been rising since 2021 – and are likely to continue to do so as lower coupon bonds issued before 2021 mature. Over the last 10 years, the compound income return from a typical US dollar investment-grade index has been around 4%, and in Europe, the equivalent has been just over 2%. For US dollar high yield, it has been close to 6.5%. Given the rise in average coupons, income returns should potentially be higher going forward.

Of course, bond prices can be volatile. Unless bonds are held to maturity, losses can be incurred from shifts in interest rate expectations or credit spreads. To manage this risk, investors may choose strategies that have inherently less price volatility – like short-duration credit strategies. Or they can employ active managers who seek to maximise income and minimise price volatility, through hedging and other active decisions. Investors can also aim for income above the average index level through an allocation to higher-coupon bonds. Income returns are unlikely to match pre-2008 levels but are becoming more attractive given the broad increase in bond yields since 2021. With uncertainty surrounding the macro outlook, steady income returns should not be overlooked when building balanced portfolios.

Alessandro Tentori, CIO Europe

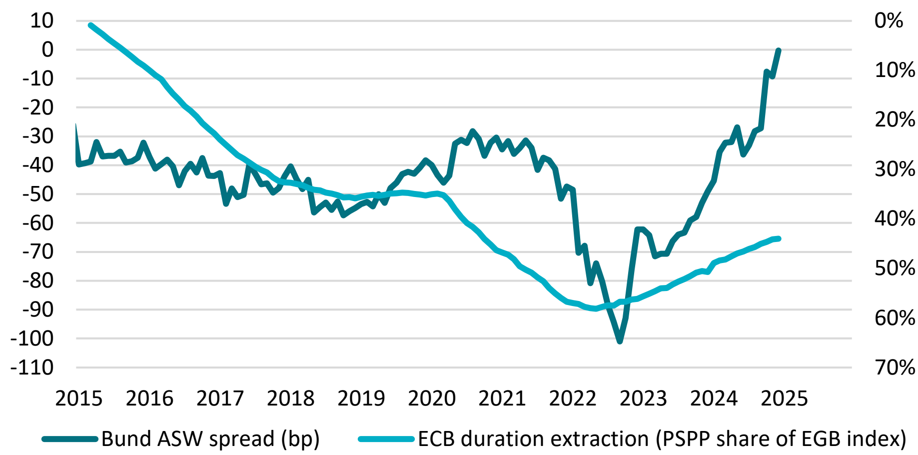
European government bonds: Liquidity-driven valuations

Fixed income investors might have noticed the rather large swing in the valuation of German government bonds (Bunds) relative to interest rate swaps in the post-COVID-19 period. In the two years to September 2022, Bunds became expensive relative to the interest rate swap curve. Since then, there has been a 100-basis-point (bp) cheapening of Bunds versus swaps. This has erased the 'natural margin' that risk-free bonds should have relative to risk-bearing bonds.

Looking at the Bund swap spread from a microeconomic perspective opens the door to variables like excess demand and collateral scarcity. These variables are linked with the activity of the largest bond player during the past decade: the European Central Bank (ECB). The chart below shows the relationship between the ECB's footprint on the European government bond market and the Bund asset swap spread. The post-pandemic quantitative easing impacted the perceived scarcity of Bunds, thus raising liquidity concerns for Europe's benchmark bond and pushing relative valuations to extreme levels.

Similarly, the ECB's decision to dial back its unconventional monetary policy operations from July 2022 put a lid on the liquidity spectre and reversed the course of Bund spreads. Indeed, other European government bonds have cheapened against swaps as a result of the reduction in ECB buying and concerns about increased supply. For some investors, this will have made European government bonds a more attractive fixed income asset relative to both swaps and corporate bonds.

| ECB balance sheet's impact on the EGB market



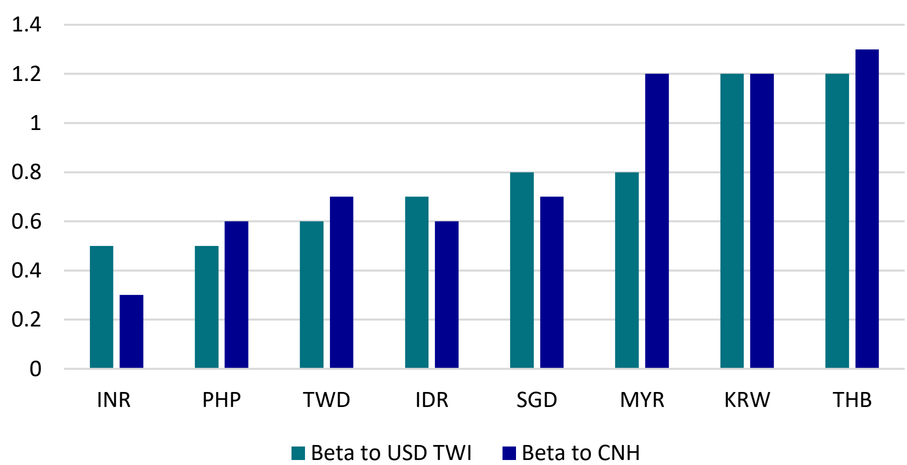
Source: Bloomberg, ECB, January 2025

Ecaterina Bigos, CIO Asia ex-Japan

Region in waiting

Asia's macroeconomic environment has become increasingly challenging from a growth, monetary policy, and currency perspective. Trade tariffs, the Federal Reserve's (Fed) interest rates path and US dollar strength make up the overarching headwinds. The US policy agenda on tariffs is the biggest direct vulnerability given many Asian countries run some of the largest bilateral trade surpluses with the US, but also indirectly, due to relatively high economic interdependency with China. While inflation eased in most Asian economies in 2024, the average remains above most central bank targets, hence the region's low real rate relative to a stronger US dollar and higher core rates add to its challenges. Fed policy path remains critical as it could intensify capital outflows from countries that ease rates too aggressively. Even in an environment of more measured tariff hikes, investor flows are likely to maintain a dollar bias. Most Asian currencies have depreciated against the greenback, particularly in the fourth quarter of last year, driven by the potential for fewer Fed interest rate cuts. Currencies will likely be the pressure valve for adjusting to any growth shock from tariffs, with intra-regional correlations likely higher initially, before policy choices, domestic imbalances and relative fiscal space in the various economies drive divergence.

| Asian currencies' sensitivity to US dollar and China yuan



Source: Deutsche Bank, Bloomberg Finance LP, Jan 2025. Betas calculated over last two years, except for INR where betas are calculated during the peak of trade wars during President Donald Trump's first term (and before the low FX policy volatility regime since late 2018)

Asset Class Summary Views

Views expressed reflect CIO team expectations on asset class returns and risks. Traffic lights indicate expected return over a three-to-six-month period relative to long-term observed trends.

Positive	Neutral	Negative

CIO team opinions draw on AXA IM Macro Research and AXA IM investment team views and are not intended as asset allocation advice.

Rates		Budgetary concerns and US politics suggest higher volatility even if rates in fair-value range
US Treasuries		10-year yield likely to stay below 5% unless view on direction of Fed policy changes
Euro – Core Govt.		German Bund yields reflect weak growth outlook and lower ECB rates
Euro – Peripherals		Spain continues to be preferred; French government bonds subject to ongoing political risk
UK Gilts		Bank of England expected to cut rates in February; market anticipating fiscal update in March
JGBs		Bank of Japan’s January rate hike reflects inflation concerns; negative on JGBs
Inflation		While real yields are attractive, the break-even rate does not fully reflect inflation risks

Credit		With growth resilient, investor confidence in credit remains strong
USD Investment Grade		Credit yields are attractive; elevated valuations create vulnerabilities if rates keep rising
Euro Investment Grade		Modest growth, alongside lower interest rates support credit’s income appeal
GBP Investment Grade		Returns supported by cooling inflation and deeper rate cuts than what is priced in
USD High Yield		Stronger growth, resilient fundamentals, and higher quality universe are supportive
Euro High Yield		Resilient fundamentals, technical factors and ECB cuts support total returns
EM Hard Currency		Attractive income from higher quality universe than recent history

Equities		Growth backdrop supportive but risks of tariffs hitting global trade
US		Earnings growth supportive; performance more balanced as AI bubble somewhat deflates
Europe		Valuations are attractive; low return expectations could be exceeded by positive surprises
UK		Markets need to see how government can improve growth prospects; lower rates will help
Japan		Solid combination of valuations and expected earnings growth
China		Signs of improving confidence but foreign investors need to see more policy support
Investment Themes*		Competition in AI to create more opportunities for beneficiaries of technology

*AXA Investment Managers has identified six themes, supported by megatrends, that companies are tapping into which we believe are best placed to navigate the evolving global economy: Technology & Automation, Connected Consumer, Ageing & Lifestyle, Social Prosperity, Energy Transition, Biodiversity.

Click here for more from the ***Investment Institute***