1Q 2025

Investment Highlights

Western Asset US Investment-Grade Credit Sector

This is a marketing communication.

Key Takeaways

- *The Bloomberg US Credit Index returned +2.36% for the quarter. A bull-steepening UST yield curve more than offset the negative impact of spreads leaking wider.*
- *Credit spreads widened in the back half of the quarter as policy uncertainty from the White House rose. The OAS for the Bloomberg US Credit Index closed the quarter 12 bps wider at +89 bps. The index generated 76 bps of negative excess returns (i.e., underperformed duration-comparable USTs by 0.76%).*
- *Investment-grade credit valuations (spreads) have cheapened a little, but at these levels they are still likely pricing in economic optimism reflective of resilient underlying fundamentals.*
- *The technical backdrop remains supportive as demand continues to be robust from yield-based buyers (index YTW as of March 3, 2025 is still north of 5% at 5.09%) even as supply has surprised to the upside.*

Market Review

During the first quarter, US Treasury (UST) yields fell and the yield curve bull-steepened during a risk-off period. The S&P 500 Index declined and credit spreads widened. The S&P 500 posted its worst quarterly performance since 2022, and the significant market decline was largely attributed to escalating trade tensions and economic uncertainties.

Diverging signals in the market between "hard data"—quantifiable metrics—and "soft data," which includes surveys and sentiments, persisted throughout the quarter. Hard data (retail sales, durable goods orders and the unemployment rate) suggests that the economy remained resilient. However, several surveys indicated that policy uncertainty was weighing heavily upon consumer and business sentiment, which could lead to slower activity in the coming months. Policy uncertainty remained elevated as the US announced that 25% tariffs on imports from Mexico and Canada (though a one-month reprieve for most goods was announced soon thereafter), an additional 10% tariff on Chinese imports, a 25% tariff on steel and aluminum imports and a 25% tariff on auto imports, would become effective in early April, when reciprocal tariffs were also scheduled to be announced.

In the US, job growth showed an upward trend, with nonfarm payrolls increasing by 151,000 jobs in February, up from a downwardly revised 125,000 jobs in January. The three-month payroll average of 200,000 jobs was above the fourth-quarter average of 182,000 jobs, which included weak numbers in October due to a severe storm and a labor strike. The unemployment rate remained steady at 4.1%. Inflation data was mixed; over the last three months, core Consumer Price Index (CPI) data year-over-year (YoY) declined from 3.30% to 3.10%, while the Core Personal Consumption Expenditures (PCE) Price Index targeted by the Federal Reserve (Fed) remained steady at 2.80%, indicating persistent inflationary pressures.

The Federal Open Market Committee (FOMC) maintained the target range for the fed funds rate at 4.25% to 4.50% at both its January and March meetings. The post-meeting statement in March announced that the monthly pace of UST balance sheet reduction would decrease from $25 billion to $5 billion beginning in April, while the cap on agency debt and agency mortgage-backed securities (MBS) would remain unchanged at $35 billion. During the press conference, Fed Chair Jerome Powell described the economy as "strong overall," but noted that recent policy changes in trade, immigration, fiscal policy and regulatory policy complicate the reliability of near-term forecasts.

In the UK, the Bank of England cut the Bank Rate by 25 basis points (bps) in February to 4.50%. The voting pattern was dovish, with two dissenters voting for a more aggressive cut. Meanwhile, the Bank of Japan hiked policy rates by 25 bps to 0.50% in January, the highest level since 2008. Japanese government bond yields rose during the quarter due to strong growth and inflationary pressures, supported by higher wage growth and a structurally tight labor market, leading the market to anticipate further rate hikes over the coming year. In Germany, following February's election, incoming Chancellor Friedrich Merz announced a significant fiscal plan, including a special €500 billion off-budget infrastructure fund to be spent over 12 years, exempting defense spending above 1% of GDP from the constitutional debt limit, and allowing states to borrow up to 0.35% of GDP.

Throughout the quarter, credit spreads widened and emerging market (EM) local yields largely rose. The S&P 500 Index returned -4.59%, and the US dollar weakened versus most EM and developed market (DM) currencies. As noted earlier, UST yields declined, leading to a bull-steepening of the curve. Specifically, 2-year UST yields fell from 4.25% to 3.89%, 5-year yields fell from 4.38% to 3.96%, 10-year yields fell from 4.58% to 4.23% and 30-year yields fell from 4.78% to 4.59%.

Investment-grade credit spreads widened during the back half of the quarter. The option-adjusted spread (OAS) for the Bloomberg U.S. Credit Index touched +91 bps intra-quarter before settling at +89 bps (12 bps wider), generating 76 bps of negative excess returns for the period. The quarter ended as a risk-off period with lower-quality and longer-maturity securities underperforming their higher-quality and shorter-maturity cohorts. The vast majority of investment-grade industries also generated negative excess returns with transportation services (e.g., UPS and FedEx), industrial other (i.e., universities), utilities (due to LA fires) and autos (due to tariffs) leading on the downside. Subsectors that are less affected by tariffs (e.g., non-corporate credit and banking) fared better.

Investment Outlook

Proposed tariffs and other policy changes from the new US administration have created uncertainty and volatility in financial markets. Global growth is expected to slow given the heightened uncertainty but we believe should remain solidly in positive territory. US growth is downshifting due to a myriad of factors: uncertainty over tariffs, waning benefits from immigration and reduced government spending, among others. A significant fiscal boost from European defense and Germany infrastructure spending should support eurozone confidence and growth, providing some relief from tariff-related uncertainty. In China, deflationary pressures remain and confidence is weak amid property market concerns, but sentiment is improving with fiscal stimulus and policy easing.

The disinflationary trend may be interrupted as tariffs and retaliatory actions are implemented, but we expect inflation to move lower again over the longer term. Monetary policy remains restrictive. We expect central banks will continue to cut rates further in 2025. The Fed remains well positioned to provide support if the US economy falters. Public debt levels continue to rise and yield curves may steepen given concerns over fiscal policies globally.

Investment-grade credit valuations, which were outright rich at the start of the year, have repriced with spreads widening back toward levels seen last fall. Back then, the markets were digesting a growth scare primarily caused by disappointing payroll releases leading the Fed to begin this current rate-cutting cycle with a larger-than-normal 50-bp cut. Corporate fundamentals remain healthy overall with investment-grade balance sheets well positioned for a slower economic backdrop. The technical environment also remains balanced as demand is expected to remain robust from yield-based buyers while the rise in net supply is expected to decelerate in the near term as a wall of 5-year debt issued during the pandemic is set to mature. Given the increasingly uncertain policy backdrop, our current strategy is to stay closer to home. We continue to see opportunities in the banking sector, select parts of the energy sector, and in rising-star candidates, where allowed.

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The **Bloomberg U.S. Mortgage-Backed Securities (MBS) Index** tracks the performance of fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC).

Core Personal Consumption Expenditures (PCE) refers to the PCE Price Index excluding food and energy. The core PCE price index is closely watched by the Federal Reserve as it conducts monetary policy.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. These ratings are updated monthly and may change over time. Investment-grade bonds are bonds that are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Summary of Economic Projections (SEP) is released by the Federal Reserve four times a year. SEP features the Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation and the appropriate policy interest rate.

U.S. Treasuries are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

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