

# Midyear fixed-income outlook: Strategic scenarios for bond investors

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How will policy uncertainty and macro headwinds shape opportunities in fixed income?

As we approach the midpoint of 2025, the bond market presents a complex landscape influenced by policy changes and evolving global macroeconomic conditions. Gene Tannuzzo, head of fixed income, shares perspectives on the current state of the bond market and offers insights into key themes that will likely shape bond markets through the remainder of the year, with a focus on opportunities in selective high yield, and asset-backed and agency mortgage-backed securities.

## **Policy uncertainty drives markets**

Policy decisions – particularly those related to trade and tariffs – have been the primary market driver so far this year, and this is expected to continue through the second half of 2025. The current administration issued an unprecedented number of executive orders in its first 100 days, creating an environment of uncertainty for companies. As a result, there's a reluctance to provide forward guidance, with many companies opting to provide scenarios rather than concrete projections.

Corporate decision-makers are hesitant to make significant capital decisions until they have greater clarity on "the rules of the road," particularly regarding tariffs. The volatility in trade policy – where tariffs on specific countries or regions can change rapidly – has made it challenging for companies to make long-term investment decisions.

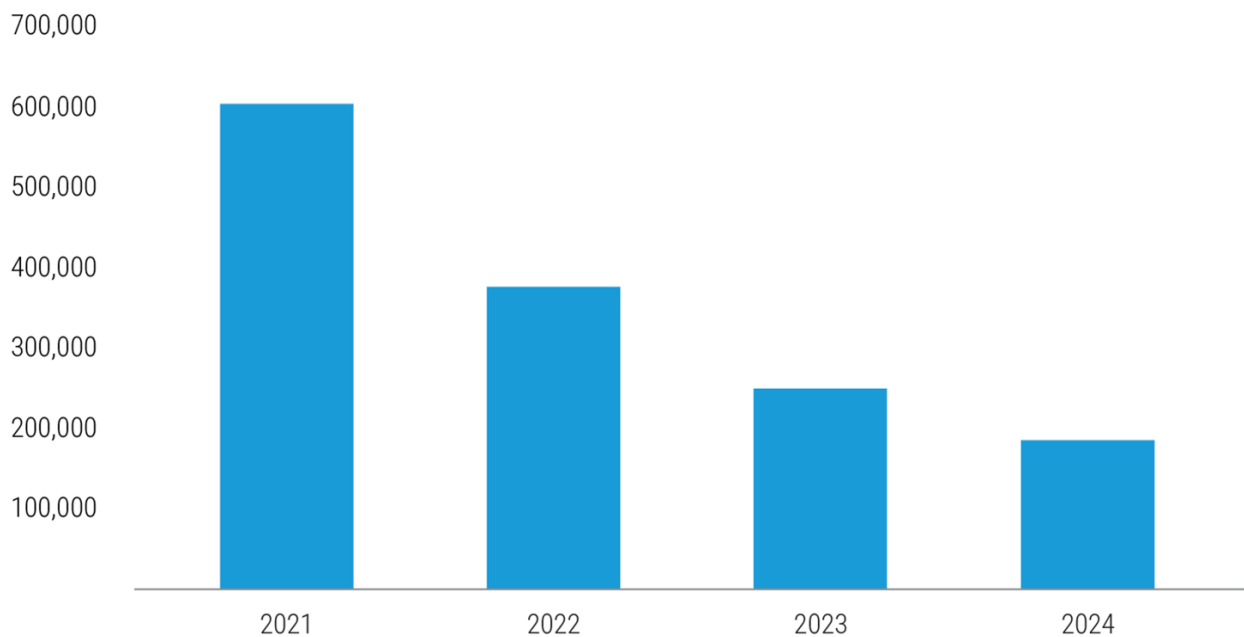


## All eyes on the labor market

The labor market is a crucial metric for fixed-income investors to monitor in the coming months. Current expectations are that the Fed will remain on hold until the labor market shows clear signs of deterioration. While the unemployment rate has been holding steady at 4.2%, a meaningful increase toward 4.5% could prompt Fed action. Similarly, the year-over-year growth rate of non-farm payrolls (currently at 1.2%) bears close watching – historically, drops below current levels have coincided with economic slowdowns.

## New job creation continues to step down

Non-farm payrolls (Average monthly change)



Source: Bureau of Labor Statistics, as of May 31, 2025.

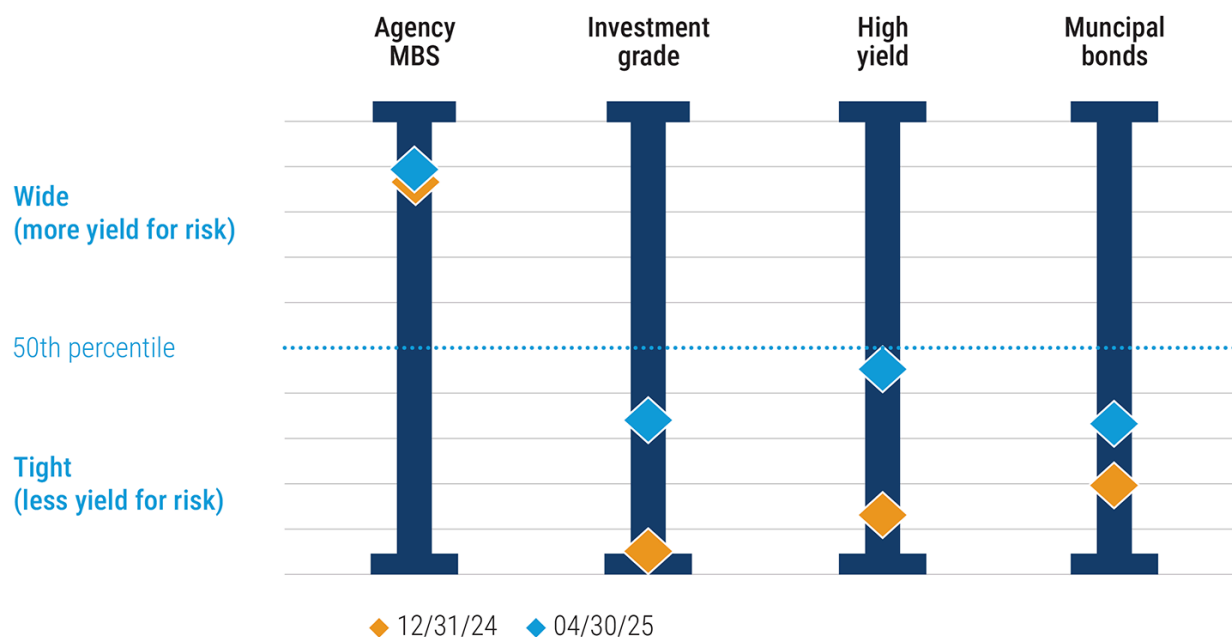
How is the Fed going to react to diverging signals on inflation and unemployment? We believe the Fed is likely to look through higher inflation resulting from tariffs and may feel comfortable cutting rates if the labor market deteriorates. Recent comments from Fed Governor Christopher Waller support this perspective, suggesting that the Fed views tariffs as a tax outside its influence, while maintaining its mandate to support employment if weakness emerges. What may be underpriced in current market expectations is the potential magnitude of rate cuts in 2026, suggesting a "do less now, do more later" approach from the Fed.

## Credit compelling as spreads widen

Heading into the second half of the year, we believe there are opportunities in credit as spreads have widened from historically tight levels. In short-term bonds, spreads have widened from record tightness to historical median levels. Investment-grade corporate bonds have widened as well, but not significantly above long-term averages. Meanwhile, longer dated investment-grade bonds remain expensive for technical reasons (sustained demand from institutional investors coupled with limited supply). The spread move was most pronounced in the high-yield corporate bond market, which is more sensitive to both economic growth and risk sentiment. Specifically, higher quality high-yield bonds (BB and B rated) appear to present attractive opportunities, while we are selective in the lower quality credit (CCC rated high-yield bonds), which remains the most vulnerable to an economic downturn.

## Wider credit spreads present opportunities for bond investors

(Current percentile vs. 20-year average)



Source: Columbia Threadneedle Investments, as of April 30, 2025. Each bar represents the range for the last 20 years, with the current percentile position indicated. Agency MBS is represented by the Morgan Stanley 30-Year Conventional Current Coupon ZV Indicator, which represents the zero volatility spread for the hypothetical \$100-priced 30-year conventional mortgage over time. Investment grade is represented by the Bloomberg U.S. Corporate Investment Grade Index. High yield is represented by the Bloomberg U.S. High Yield Corporate Bond Index. Municipal bonds are represented by the Bloomberg Municipal Bond Index. **It is not possible to invest directly in an index. Past performance is not a guarantee of future results.**

This widening in spreads indicates that bond investors are getting compensated for taking on more risk (beyond U.S. Treasuries). And given where spreads are today relative to history, they also provide an indication of where we are likely to see positive excess returns in the next 12 months. For example, in higher quality high yield (BB rated), we selectively deployed capital to capitalize on the repricing opportunity. More broadly, this has allowed us to move from being very defensive in terms of our position – focusing on corporate investment-grade credit – to expand the opportunity investment set to include consumer credit like asset-backed securities and agency mortgage-backed securities.

Globally, we haven't observed significant relative value (U.S. versus non-U.S.) opportunities in credit markets. European credit, which appeared cheaper a few years ago, has largely converged with U.S. valuations. And emerging markets spreads have only marginally widened during recent market volatility. However, we are closely monitoring whether the pro-growth government policies in countries like Germany, China and Japan will help offset the negative impact of U.S. tariff policy on their economies.

### Assessing opportunities through investment scenarios

Looking forward, we see three primary scenarios that could shape fixed-income markets through year end:

Macroeconomic scenarios	Description
<b>Scenario 1:</b> Resolution	A return to pre-January global trade conditions could benefit credit but potentially pressure government bonds as interest rates might rise to reflect a Fed that maintains or even tightens monetary policy.
<b>Scenario 2:</b> Prolonged uncertainty	A protracted process of negotiating trade deals with multiple countries could create a more favorable environment for fixed income broadly. Credit selection will matter in identifying winners and losers.
<b>Scenario 3:</b> Recession	Economic contraction would likely prompt significant Fed rate cuts, benefiting certain segments while challenging credit markets.

The prolonged uncertainty scenario appears most likely and could be the most conducive to overall fixed-income performance. In this environment, a combination of intermediate-maturity, high-quality U.S. bonds complemented by high-quality overseas sovereign debt (e.g., German bonds) could help diversify portfolios. Specifically, our largest weighting (and overweight) remains agency mortgage-backed securities, which are guaranteed by U.S. government agencies. This is a valuation play, as Agency MBS currently offers a higher spread than investment-grade corporate bonds, but also serves to de-risk portfolios. We believe the catalyst to outperformance from this sector will be lower Treasury yields and interest rate volatility.

### **The bottom line**

For fixed-income investors, the primary driver of returns in the first half of the year was policy uncertainty – trying to guess what the policy would be. As we navigate the second half of 2025, the focus will shift to evaluating the tangible impact of these policies. With an evolving economic environment, an active approach is best positioned to identify potential winners and losers amid escalating trade tensions. Some industries, and even companies, are likely to be more directly impacted by levies on imported goods. For others, there may be opportunity created to take share from competitors who face a more direct impact. A research-based approach is needed to position portfolios to identify opportunities and manage potential risks.

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## GLOBAL HEAD OF FIXED INCOME

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As global head of fixed income, Gene provides leadership across the global fixed-income investment team. He also serves as senior portfolio manager, responsible for the firm's suite of multi-sector fixed-income strategies.



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