The Case for Bonds in 2025: Yields, Stability, and Strategic Allocation

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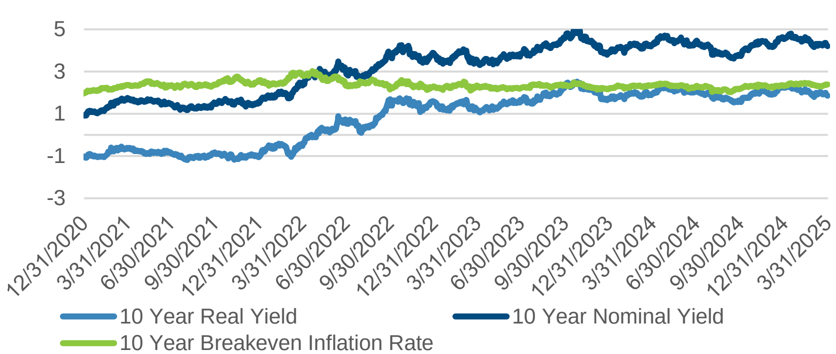
Market Recap

In the first quarter of 2025, the fixed income market generally delivered positive returns while the U.S. equity market experienced significant volatility. The Bloomberg U.S. Aggregate Index (AGG) returned 2.7% in Q1, providing portfolio diversification when the S&P 500 pulled back, returning -4.3% for the quarter. The long-term U.S. Treasury bonds accelerated 4.2% in Q1, outperforming the S&P 500 by 9%, the largest quarterly win since April 2020. 2025 began with Wall Street in consensus with an election equity rally and hope for deregulation and lower taxes. However, new tariffs and trade tensions, shifting Fed policy, softening economic data and deteriorating confidence have driven investors toward fixed income in a flight to safety assets. The 10-year U.S. Treasury yields decreased during the quarter, with the nominal 10-year yield ending the quarter at 4.21%, compared with 4.57% at the end of last year. The decrease in real yield contributed primarily to the shift, with real yield down by 39 basis points for the quarter, while inflation expectations, measured by the 10-year inflation breakeven rate, inched higher to 2.38% from 2.34% at the end of the fourth quarter of 2024 (see Exhibit 1).

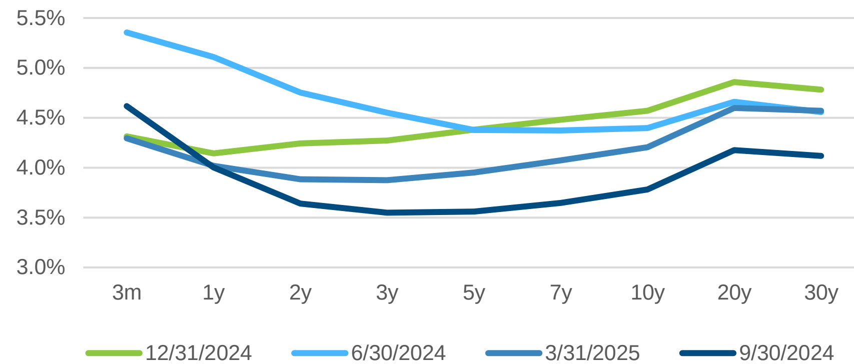
Exhibit 1: Treasury Yields Decreased in the First Quarter of 2025



Source: Bloomberg.

In the first quarter of 2025, Treasury yields across all maturities decreased as investors soured on the economy. The three-month yield fell the least with a marginal decline of 2 bps as the Fed held its policy rates unchanged during the quarter. At the same time, the steepening trend for the rest of the yield curve remained, with the spread of 10-year and 2-year yields staying at 32bps. (see Exhibit 2).

Exhibit 2: U.S. Treasury Yield Curve



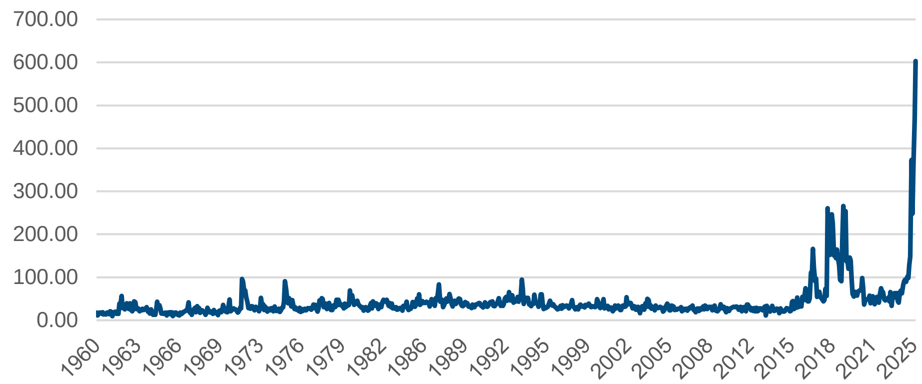
Source: Bloomberg.

Macro Landscape

Economy and Policy Uncertainty: The US economy's performance ended last year undeniably strong, with real GDP growth at 2.4% for the fourth quarter. Coming into the new year, areas of strength remain, including a low unemployment rate (only slightly above 4%), record high housing prices, and solid industrial production. Signs of weakness, however, have emerged with high credit card delinquency rates, rising job cut announcements, and contracting manufacturing activity after two months of expansion. Although the first quarter's hard data (quantitative metrics) suggests the US economy remains somewhat resilient, the soft data (survey-based sentiment) are rapidly deteriorating with mounting risks from monetary policy uncertainty, new tariff policy and higher inflation expectations. Consumer confidence plummeted, according to both the University of Michigan's survey (from 74.0 last December to 57.0 in March) and the Conference Board's consumer confidence index (from 109.5 last December to 92.9 in March). Housebuilder confidence and small business optimism also continued their downward trend in Q1.

The policy uncertainty and mounting global trade war have weighed on consumer and business sentiments. The typically uneventful US Trade Policy Uncertainty Index has surged to a record high, far past the previous peaks during the 2018 trade conflict between the US and China (Exhibit 3). The new administration's policies present both upside potential and downside risks for the US economy – higher tariffs and aggressive government spending cuts pose challenges to the economy, while increased tax cuts and deregulation may boost growth. In the short term, however, we believe a variety of new tariff measures will increase near-term inflationary risks and impose disruptions to the economy by reducing consumer purchasing power, increasing domestic production costs, and negatively impacting exporters as other countries respond with retaliatory measures.

Exhibit 3: U.S. Trade Policy Uncertainty Index



Source: U.S. Federal Reserve

While the precise impact of tariffs on US GDP is still difficult to forecast, we expect growth to slow and have recently downgraded our real GDP growth forecasts for 2025. The heightened trade barriers will likely increase inflation and reduce consumption, investment and export. With new immigration policy and increased layoff announcements, we also expect a tighter labor market to weigh on consumer spending. Several leading organizations have sharply taken down their GDP forecasts recently, underscoring growing concerns about economic headwinds. The Atlanta Fed's GDPNow model published on April 1 predicts a contraction of US GDP by an annualized rate of -2.8% in Q1 2025, down from an earlier estimate of -1.5%.

Inflation concerns: The recent inflation data has been mixed. The January CPI (Consumer Price Index) accelerated, with the headline CPI climbing 0.5% monthly, followed by a moderating February CPI of 0.2%, lowering the annual rate from 3.0% to 2.8%. The core CPI (excluding food and energy) also came in lower than expected in February, increasing 0.2% month over month after a sticker of 0.4% in January. Shelter inflation remained in line with our prediction, with the owners' equivalent rent moderating to 0.28% from 0.31% in February. However, the Fed's preferred inflation measure, core PCE (personal consumption expenditure), rose 0.4% in February, lifting the annual rate from a revised 2.7% to 2.8%.

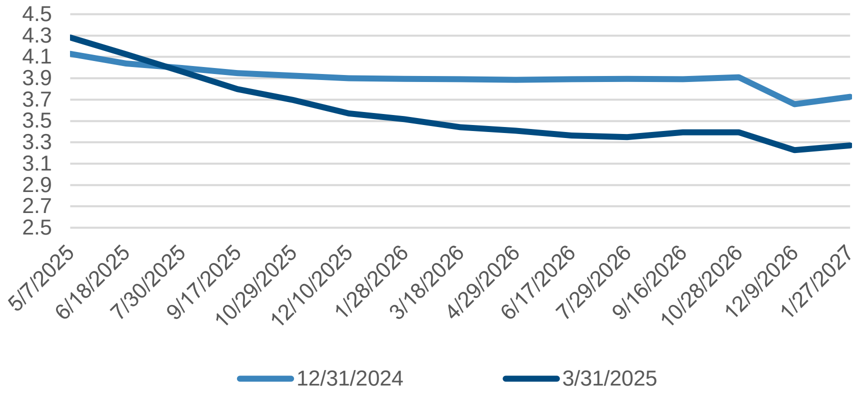
The outlook for U.S. inflation gets more complicated due to trade policy uncertainty, and inflation expectations soared in the first quarter. According to the final estimate from the University of Michigan consumer sentiment survey in March, the one-year inflation expectations accelerated to 5.0% from 4.3%, and the five-year expectations rose to 4.1% from 3.5% in February. Although Chairman Powell stated in March's meeting that the committee's base case is that tariff-related price pressure will be "transitory." We see risks associated with this "transitory" assumption: an intensifying trade war could lead to retaliatory policies that increase the prices of a wider range of products, potentially causing inflation expectations to become unanchored.

Shifting Fed policy: As widely expected, the Federal Reserve held its policy rate unchanged at 4.25% - 4.5% in its March meeting. The latest Summary of Economic Projections shows a boost in inflation forecast, with the median PCE estimate rising to 2.8% from 2.5% in its March meeting. However, the Fed officials still indicated two 25bps cuts this year, no change from the projections in the December meeting, owing to lower expectations for economic growth. The median expectation for real GDP was downgraded to 1.7% in March from 2.1% in December.

The Fed is currently grappling with a tougher situation to balance its dual mandate to pursue two key goals: maximum sustainable employment and price stability. The Fed faces difficult choices between the two mandates: prioritize inflation control by keeping rates high but risk triggering a recession, or support growth by lowering rates but risk entrenching inflation above target levels. In our view, the risk of an economic downturn is looming with a slew of new tariff policies as the intensifying trade tension will increase production costs, reduce consumer spending and hurt exports. As a result, the risks are shifting from high inflation to slow growth, leading to the Fed's potential interest rate cut to boost the economy. If the labor market deteriorates rapidly, the Fed will be biased to cut rates quickly, even if inflation remains above target.

Market expectations have adapted but despite that the Fed's March meeting still projected two rate cuts in 2025. During the first quarter, market expectations about the Fed's policy change schedule have become slightly dovish. As of 03/31/2025, the Fed funds futures market forecasted a fed fund rate of 3.6% by December 2025, compared with 3.9% forecasted at the end of the fourth quarter (see Exhibit 4).

Exhibit 4: Fed Fund Rate Implied by the Futures Market



Source: Bloomberg.

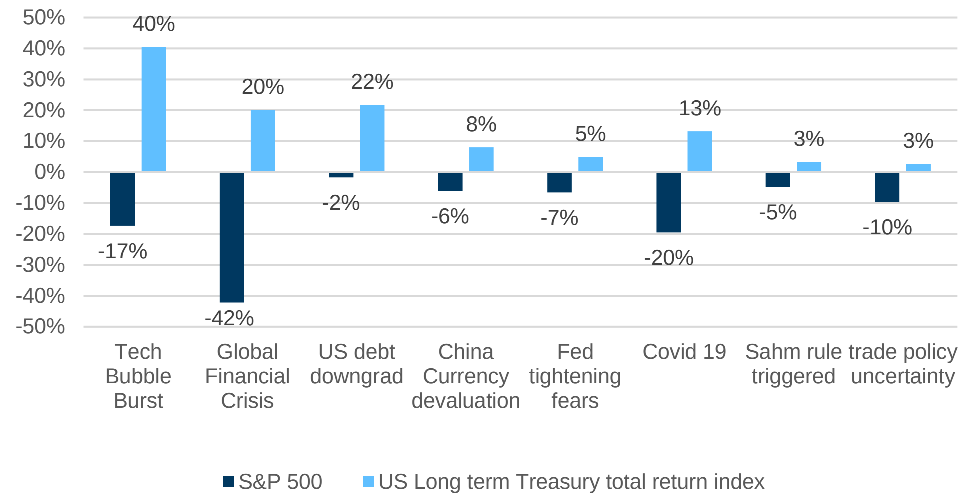
Fixed Income Outlook

We believe that fixed income is better positioned nowadays with high yields, shifting Fed policy and downside growth risks. The emerging signs of economic strain have led investors to favor safer assets, especially amid recent equity market selloffs. We believe the investors will continue to benefit from fixed income allocation with attractive income, capital gain potential, and downside protection. In this commentary, we would like to discuss the following three themes in investing in fixed income in today's environment: attractive yields, hedge against downside growth risks, and international opportunities.

Attractive yields: Bond yields are still attractive compared with historical levels and equity valuation. The yields of the Bloomberg U.S. Aggregate Bond Index (AGG) stood at 4.6% as of March 31, 2025, compared to the medium level of 2.6% over the last ten years. Yields of high-quality fixed assets have significantly enhanced income potential and are strongly correlated with 5-year forward returns. Also, current bond valuations are attractive relative to equity, with the yield on the Bloomberg U.S. Aggregate Index surpassing the earnings yield of the S&P 500 Index even after the recent equity market corrections.

Hedge against growth fears: Investors have recently questioned the diversification benefit of fixed income due to its increased correlation with equities over the past two years. This positive correlation stems from the inflationary shocks and tightening monetary policy that have dominated both equity and bond markets during this period, as fixed income instruments are not inherently designed to shield portfolios from inflationary pressures. However, fixed income continues to play a crucial role in portfolio diversification by providing protection against growth shocks. Historical data also demonstrated bonds as effective risk hedge instruments, especially in adverse market conditions (see Exhibit 5). With the risks now shifting from high inflation to growth shocks in the marketplace, we believe it is essential to allocate to fixed income for both income generation and portfolio diversification in 2025.

Exhibit 5: Fixed Income as Hedge Against Growth Shock



Source: Bloomberg. Data as of 3/31/2025.

Additional benefits of investing in international bond markets: Global fixed income markets provide more opportunities for active management as monetary policies and business cycles are less synchronized these days across regions, leading to lower correlation across different regions/countries. For example, given the still sluggish growth and easing inflation in Europe, more aggressive interest rate cuts are expected in Europe compared to the US. Intensifying trade tension can further support global diversification, as many disruptions are expected outside the U.S. to a different extent. At the same time, however, investors should be cautious of additional risks, such as currency volatility and geopolitical factors, when investing internationally.

Investment Implications

Slower global growth, escalating trade tension and uncertainty around monetary policy have created significant market volatility recently. We believe that risks are still tilted to the downside, and fixed income is better positioned with attractive income and downside protection. Historically, bonds have demonstrated strong performance during growth shocks and challenging market scenarios. While we still favor high-quality bonds, we emphasize the importance of active management as each sub-sector of fixed income has unique characteristics and risks, especially in the current changing environment. We moved from neutral in duration to slightly overweight duration during the quarter. For YTD as of March 31, 2025, our Dynamic Income strategy returned 2.4% net of fees, slightly underperforming the Global Aggregated Bond Index and U.S. Aggregate Bond Index by 0.2% and 0.4%, respectively (Exhibit 6). In the first quarter, we focused on several key themes in our strategies such as increasing duration exposure, decreasing beta exposure by improving credit quality and divesting out of high yield bonds, expanding to actively managed funds, and further diversifying through international fixed income markets. The details are highlighted below:

Exhibit 6: Net performance of Dynamic Income Strategy

	(% Net)	Annualized Returns (% Net)				
	YTD 2025	1-yr	3-yr	5-yr	10-yr	Since Inception 11/1/2012
Dynamic Income	**2.4**	**5.2**	**1.8**	**4.0**	**2.1**	**2.5**
Global Bond Agg	2.6	3.0	-1.6	-1.4	0.6	0.1
U.S. Bond Agg	2.8	4.9	0.5	-0.4	1.5	1.6

Source: NorthCoast Asset Management. Returns are presented net-of-fees. Net-of-fee returns are reduced by trading costs and the portfolio's actual management fee. Benchmarks - The Barclays Aggregate Bond Index and JP Morgan Global Aggregate Bond Index are used for comparison purposes. Past performance does not guarantee future returns. One may not invest directly in an index. Data as of 3/31/2025.

- **Mortgage-backed securities:** We kept a significant allocation to U.S. agency mortgage-backed securities through investing in MBB (iShares MBS ETF), as the MBS sector appears attractively valued and is supported by solid fundamentals.

- **Inflation-linked bonds:** With recent higher expected inflation and inflation proving to be more persistent than anticipated, we believe that inflation-linked bonds remain reasonably priced. Also, the proposed policy changes from the Trump administration, such as tariffs and tax cuts, could be more inflationary than currently priced in by the market, making TIPS a more appealing investment. We have recently added 2% more exposure to iShares TIPS Bond ETF (TIP).

- **International bonds:** Slower global economic activity and tariff uncertainties have led investors to seek safer assets like government bonds. The iShares International Treasury Bond ETF (IGOV) delivered a positive performance in Q1 2025, gaining 2.6%, marking a recovery for the fund. IGOV's exposure to high-quality government bonds from Japan, France, Germany, and other developed markets provided resilience amid broader market volatility. We added a modest IGOV position to our portfolio, and IGOV returned 2.6% in the first quarter.

- **Active fixed income ETFs:** We expanded our investment universe to include actively managed fixed income ETFs such as iShares Flexible Income Active ETF (BINC). We believe that active bond ETFs, including BINC, can effectively manage duration and credit risks amid global uncertainty. BINC attracted $2.2 billion in inflows this year, with nimble multisector positioning to help it to navigate inflation concerns and market volatility. Additionally, its yield of 6.2% further bolstered income, and BINC returned 1.6% during the quarter.

- **Interest rate hedged bonds:** During the quarter, we divested our position in IGBH (iShares Interest Rate Hedged Long-Term Corporate Bond ETF). Although the recent inflation data was mixed, and the new tariff policies are expected to be inflationary, we believe the looming economic downturn could shift the risks from high inflation to slow growth, leading to the Fed's interest rate cut to boost the economy. In this environment, the interest rate hedging strategy becomes less effective and potentially detrimental to performance as rates finally fall. IGBH returned -1% since we sold the position.

- **High-yield corporate bonds:** We divested our position in HYG (iShares iBoxx $ High Yield Corporate Bond ETF). We prefer high-quality bonds and believe that high-yield corporate bonds face headwinds with historically tight spreads, increased credit risks and economic uncertainty

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