Vontobel

Fixed Income Quarterly

Hate to say we told you so …

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Content

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—
Andrew Jackson
Head of Fixed Income,
Vontobel

Staying ahead with alpha opportunities

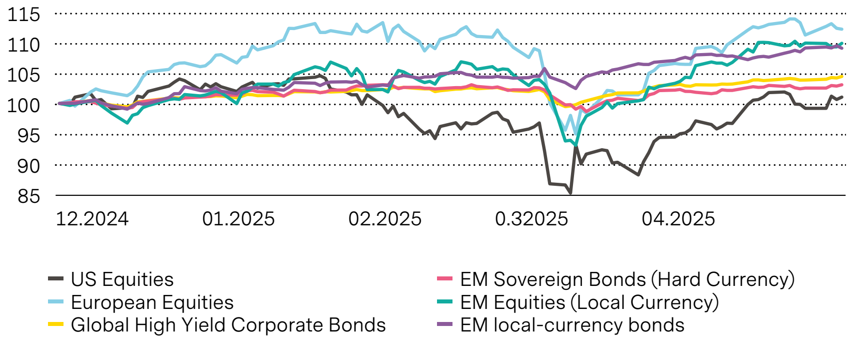
In our last quarterly publication, we highlighted the limited potential for short-term beta returns from Fixed Income, and we emphasized the significant alpha opportunities that we anticipated. The events of the past quarter could not have validated that prediction more accurately.

We now find ourselves reflecting on one of the most volatile and unpredictable periods in recent financial markets history. Clearly, the primary driver of this volatility was the sanctions regime implemented by the Trump administration following "Liberation Day." That was set against a backdrop of stretched valuations, shifting macroeconomics, a gradual rebalancing of global financial and military power, and the lingering aftershocks of the inflation surge that flowed through developed market economies in 2022. Together, these factors created fertile ground for heightened turbulence.

Given our focus last quarter on the value of alpha, I sincerely hope many of you incorporated that insight into your portfolio positioning. At the Fixed Income Boutique, we have benefitted significantly from maintaining this view. Year-to-date, our flagship, highly active portfolios have delivered incredibly strong risk-adjusted returns, even though markets have, in fact, returned to the same levels they were at during our previous quarterly publication.

Chart 1: Liberation Day showed how quickly investors can panic

Indexed performance



Source: FactSet and Vontobel, data as of 30.05.2025

Key takeaways

1. Having tested "fear territory," markets are now firmly back into "greedland." Exercise caution!
2. Our conviction that further volatility is on the horizon remains strong and our active approach continues to deliver.
3. The debate around the decline of US dollar exceptionalism has ramifications for markets worldwide, but we believe emerging markets may be one of the few beneficiaries.

Much has been written about the sagacity of the Liberation Day strategy, but the market reaction was a risk-off event that blew through any protections that one may expect from diversification. This is often the case during extreme risk-off episodes. Correlation across asset classes trends towards 1 (perfect positive correlation), liquid assets experience the sharpest sell-offs (in the initial phase), historically higher-beta asset classes are disproportionately impacted (even if their fundamentals have improved), and panic sets in.

In the few weeks since President Trump shifted course, markets have fully recovered their losses. Some may interpret this as evidence that the sell-off was a "dip buying opportunity." Others may believe that current market levels are justified, even though the global economy is demonstrably and undoubtedly on less stable footing. However, I would absolutely and categorically restate the fact that we believe, at these levels, alpha is worth far more than beta. We are confident that markets are irrationally complacent about downside risks. We are equally confident that the path forward for US foreign and trade policy will not be a straight one. This leaves us certain that further volatility lies ahead—an environment of "rich pickings" for skilled, genuinely active managers.

Our aggregate risk appetite is broadly unchanged from last quarter. Fixed Income continues to exhibit strong fundamentals and relatively robust technicals. Indeed, the latest test suggests that Fixed Income is in a more resilient position relative to other asset classes than it has been for quite some time.

Below the surface, however, several key relative value themes have emerged. These themes are central to our current thinking, and we explore them in greater detail throughout the rest of this publication. They are highly notable and are reflected in the positioning of our most active and flexible products.

Relative value themes and conviction drivers

- US Dollar exceptionalism is over (at least for a while). We are likely entering a dollar bear market—creating a highly attractive backdrop for local currency EM Fixed income.
- European Banks continue to show resilience despite recent volatility, particularly Additional Tier 1 (AT1) instruments.
- The European Yield curve has behaved significantly more predictably than the USD, GBP or Yen yield curves.
- The "belly" of risk distributions, on average, appear to offer less value than more barbell-shaped risk distributions.
- Emerging market sovereign risk premiums present far better relative value than developed market risk premiums, despite emerging markets representing a significantly larger share of global markets.

Chart 2: Managing volatile environments is becoming more important: Transition to a multi-plural world order will sustain volatility

RANKING BY GDP* (NOMINAL, IN USD B)	1970		2000		2030 (PROJECTED)	
1	United States	1,076	United States	10,290	United States	37,153
2	Soviet Union*	433	Japan	4,968	China	25,828
3	Japan	209	Germany	1,969	India	5,576
4	West Germany*	209	United Kingdom	1,669	Germany	4,956
5	France	146	France	1,362	Japan	4,279
6	United Kingdom	125	China	1,199	United Kingdom	3,775
7	Italy	109	Italy	1,151	France	3,277
8	China	91	Canada	745	Brazil	2,948
9	Canada	88	Mexico	742	Italy	2,795
10	India	63	Brazil	655	Canada	2,680

* Note: The Soviet Union and West Germany no longer exist in their 1970 form; data reflects historical aggregates.

Source: IMF, World Bank, as of May 2025. 2030 Projections are from the IMF and, thus, to be considered without guarantee, the presented figures are subject to change.

2 of the top 3 global economic powers will be from BRICS.

The risk-free instrument
Beneath the heated conversations around trade, tariffs, and tactics lies a subplot which has been evolving over the last few decades: the issue of debt sustainability.

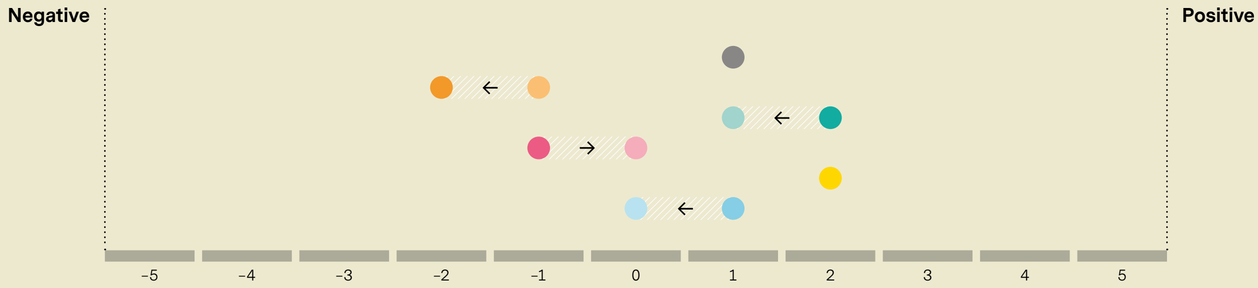
For historical context, during the third quarter of 2013, financial markets were shaken by the possibility of several “peripheral” European countries exiting the Eurozone and redenominating their currencies. This precipitated huge volatility and led to Mario Draghi’s now-famous “whatever it takes” statement. At the time, Italy’s debt-to-GDP ratios were approximately 130 %.

Fast forward to today, US debt-to-GDP ratios stand at around 123 % and are projected by the Congressional Budget Office to exceed 150 % by 2055. This raises a more consequential question than the fate of Italy or Greece. The US dollar is the world’s reserve currency, and US treasuries are considered the risk-free instrument in most financial models.

While this topic is far too vast and complex to be fully addressed here, it is absolutely the case that hushed conversations (as well as rather well reported heated ones on social media) are taking place globally. Seismic shifts are occurring, albeit slowly, with profound implications for the speed and magnitude of moves across all financial markets. In this environment, we remain steadfast in our belief that now is a time to heed caution, to focus on alpha generation, to maintain liquidity, and to take an active approach.

Above all, we encourage investors to “think the unthinkable” so they can be prepared for a wide range of potential outcomes.

Scorecard



Source: Vontobel. For illustrative purposes only. As of 19.06.2025

Economic outlook

Move to 0 from 1

It would be hard to argue that the events surrounding Liberation Day did not adversely impact the economic outlook for major economies, but the most severe potential consequences seem to have been averted. We continue to watch this closely and maintain the view that the European economy is on more stable footing than the US.

Credit fundamentals

Unchanged at 2

Corporates continue to deliver strong results and an ability to refinance their debt. Leverage levels and debt maturity walls look historically very positive at this point in the cycle. European and US global banks have delivered strong results in 2024 and appear resilient with improved capital ratios. Emerging market sovereign debt-to-GDP ratios continue to appear broadly positive.

Valuations

Move to 0 from –1

Credit spreads, having widened, are now back at tight and compressed levels. Aggregate credit market beta does not look attractive by historical standards. Relative value persists in some pockets and Fixed Income valuations look compelling versus other asset classes.

Technicals

Move to 2 from 1

Fixed Income technicals withstood the Liberation Day shock well, despite a few days of panic. They are now back into very positive territory with demand significantly outpacing supply. This has the capacity to keep spreads tight and force further compression.

Tail risks

Move to –2 from –1

Uncertainty remains very high. Geopolitical and US economic uncertainty are at recent highs. Complacency seems to be the order of the day in most risk markets.

Overall

Unchanged at 1

Caution and a laser focus on active management mean that we are excited about what the rest of 2025 will bring in terms of alpha, but our beta view is only mildly positive.

Sound fundamentals despite erratic trade policies

After the past few months, which were characterized by a high degree of uncertainty, the second half of the year may seem comparatively calm.

—
Daniel Karnaus
Portfolio Manager,
Fixed Income,
Vontobel

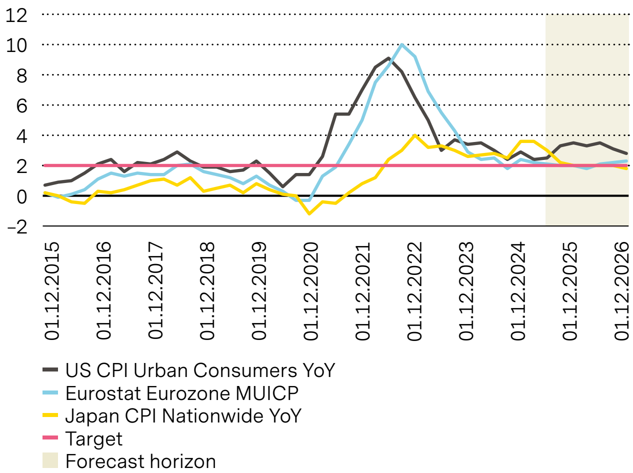
President Trump's tariff announcements on "Liberation Day" sent shockwaves through the global financial markets in early April. Not only did the amount of the tariffs seem arbitrary, but their purpose also remained uncertain. Speculation arose about whether the tariffs were intended as a bargaining chip or a revenue source. It was also unclear how long they would remain in place, and at what level, and whether trading partners could respond with countermeasures. As a result, both consumers and businesses felt greatly unsettled, causing survey values regarding the economic outlook to plummet and fears of a recession to surface. With the impending tariff hammer, consumers and businesses brought forward their purchases, aiming to avoid the potential tariff-related price increases as much as possible. This situation created a gap between soft data, such as consumer confidence, and hard data, such as retail sales, which did not bode well for the future.

In this tension between recession and inflation, not only did President Trump's approval ratings significantly drop, but stock prices did as well. Only a backpedaling on the tariff rate on Chinese imports from 145% to 30% for 90 days led to a significant easing in the markets. Nevertheless, the White House's erratic policy also impacted the bond markets, where interest rates were subject to large fluctuations. This stagflationary outlook posed a challenge for both the financial markets and the US Federal Reserve (Fed). Unlike market participants, the Fed kept a cool head and pursued a policy of steady hand, which led it to pause its interest rate cut cycle indefinitely.

What initially appeared to be an impending trade war and a major upheaval of common trade flows is now increasingly evolving into a reform of global trade. This reform no longer aims at the complete isolation of America but rather supports the Trump administration's reshoring efforts. Nevertheless, achieving balanced foreign trade with China is likely to be diametrically opposed to China's goals, which is why a failure of the negotiations within the ambitiously set 90-day deadline cannot be ruled out. In addition, a tariff rate of 10% seems to represent a lower limit for global tariffs.

The average tariff rate of 3%, which was in effect at the beginning of the year, is likely to rise to a total of approximately 16%. According to the Fed, 10% of the basket of goods used to calculate the relevant inflation (core PCE deflator) is based on expenditures for imported goods. In our scenario, we assume that 10% of the tariffs are borne by the exporter and 30% by the importer and retailer. This would result in 60%, or just under 8% in price increases, being passed on to the US end consumer. With this conservative and straightforward assumption, core inflation would rise by about 0.8%. Therefore, the value of 2.8% forecasted by the Fed in March, on average, for the year 2025 will likely exceed 3% at its peak. We expect this would push the target value for core inflation of 2% for the next 12 months far into the future (Chart 1).

Chart 1: Headline inflation
In %



Forecast based on external analysis; not guaranteed; and actual outcomes may differ materially.
Source: BBG, Vontobel forecasts, as of May 2025

Similar to the Fed, we also do not yet see the risk of rising inflation as averted, given the backdrop of significantly higher tariffs and ongoing deportation of undocumented immigrants. At the same time, we do not expect a recession, even though the rising price levels due to import tariffs represent an additional tax burden on US consumers. This particularly affects lower-income groups, and pre-emptive expenditures will have an additional dampening effect. Shrinking margins for importers and retailers, as outlined in our scenario above, strain the US economy comparably to declining tourism and the resumption of student loan payments.

This year, we anticipate only a minor fiscal impulse from the Republican budget package, which was passed by the House of Representatives' Budget Committee. With the current version of the bill, the budget deficit for 2025 and 2026 should remain unchanged. However, since it is expected that the Senate will make amendments, a higher budget deficit for 2026 cannot be ruled out. This, together with Moody's downgrade of the US country rating, could lead to higher borrowing costs, which would also inhibit growth.

Against this backdrop, we believe that weak economic growth in the third and fourth quarters could allow the Fed to resume its interest rate cutting cycle, provided there are no second-round effects on inflation. However, the Fed is likely to raise its long-term neutral interest rate from 3% to 3.5%, limiting the scope for further interest rate cuts. We expect the Fed Funds Target Rate to be at 4% and the 30-year US Treasury yield at 4.75% by the end of the year, with the Fed waiting until September for its next interest rate cut (Chart 2).

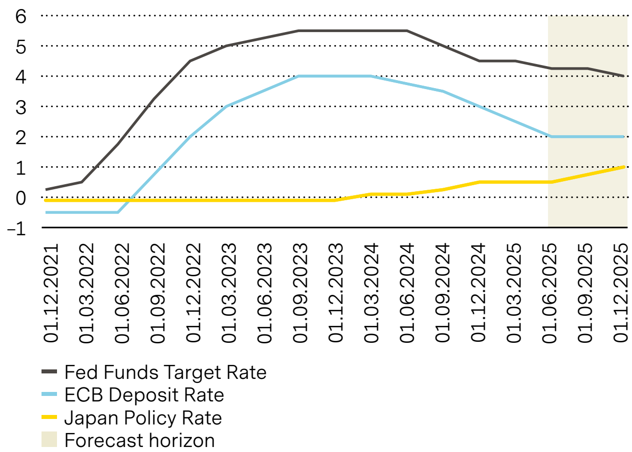
The Trump administration's erratic policy is also leaving its mark on the Eurozone, as its economy, similar to the US, is suffering from the high uncertainties surrounding trade policy. Another side effect of US import tariff policy is that it will likely lead China to try to sell its exports that can no longer be sold in the US to the Eurozone and the rest of the world. This could become a disinflationary force in the Eurozone and the rest of the world. Together with significantly lower energy prices and a strong euro, this caused inflation to dip below the target 2% rate set by the European Central Bank (ECB), which enabled the ECB to lower its key interest rate to the neutral level of 2% in June (Chart 2).

Lower interest rates and stronger government demand, triggered by the necessary investments in infrastructure and defense (as described in our March 2025 Fixed Income Quarterly publication), are likely to boost the Eurozone economy again in 2026. For this reason, we consider a deposit rate below 2% to be unlikely, but we cannot completely rule it out. In our view, yields on 30-year federal bonds could reach their lowest point around 3% and close slightly above this level at the end of 2025 (Chart 2).

Like the Fed, the Bank of Japan (BoJ) will also delay its next interest rate move due to the currently high trade policy uncertainties. Unlike the Fed, however, the BoJ will raise its key interest rate as soon as the economy recovers after a trade policy-induced slump. The BoJ explicitly states that "given that real interest rates are at significantly low levels, if the aforementioned outlook for economic activity and prices will be realized, the Bank, in accordance with improvement in economic activity and prices, will continue to raise the policy interest rate and adjust the degree of monetary accommodation."[1] We continue to expect a key interest rate of 1% by the end of 2025. Yields on 30-year Japanese government bonds are likely to trend towards 3.5% and close just below this mark at the end of the year.

Chart 2: Central bank rates

In %



Forecast based on external analysis; not guaranteed; and actual outcomes may differ materially.
Source: Fed / ECB / BoJ, Vontobel forecasts, as of May 2025

[1] Outlook for Economic Activity and Prices, April 2025, Bank of Japan

Banking on Banks?

In the context of higher macroeconomic uncertainty, we recently analyzed US bank results, searching for weak spots.

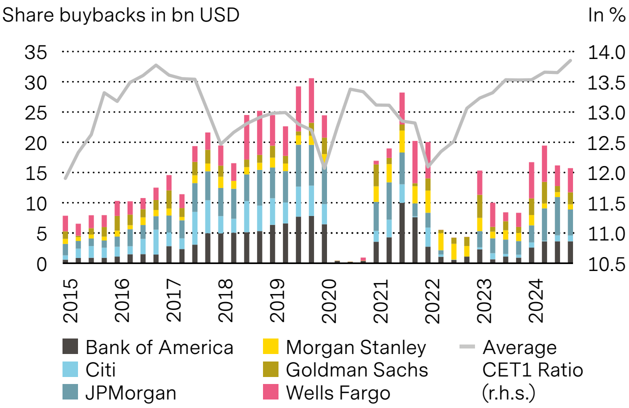
Investment grade

—
Christian Hantel
Portfolio Manager,
Global Corporate Bonds,
Vontobel

—
Claudia Fontanive-Wyss
Portfolio Manager,
European Corporate Bonds,
Vontobel

Overall, 1Q2025 results were reassuring for investors: earnings were lifted by strong capital market activities as banks were able to monetize market volatility in their trading businesses. Credit quality trends were largely stable with non-performing loans at about 0.6% of total loans for the largest banks and about 0.75% for US regional banks, on average. Capital levels remained elevated and have likely peaked, supported by lower share buy-back activities in past quarters. Despite the macroeconomic uncertainty, most banks have kept their FY2025 guidance unchanged.

Chart 1: Large US Banks: CET1 ratio and share buy-backs since 2015



Note: CET1 ratio = Core Equity Tier 1 Ratio as a measure of the strength of bank's capital base.

Source: Barclays, Vontobel, 05.2025.

Despite the solid results, we will continue to focus on bank loan delinquency trends, among others. Here, we recently observed an increase in small business loan losses from US regional banks. Commercial real estate loans could also come back on the agenda if US interest rates remain higher for longer.

What's next?
The Federal Reserve (Fed) Bank Stress Test results are expected in the coming weeks. Given the current state of US banks, we do not expect any major surprises. More interesting could be announcements on regulatory changes, such as the supplementary leverage ratio (SLR). A SLR relief would relax capital requirements, allowing banks to add to low-risk weighted assets, such as US Treasuries.

Overall, large US banks are in good shape, but further improvements seem unlikely. However, bank spreads still trade favorably versus non-financial spreads and therefore justify an allocation to the sector.

European investment grade credit rides a wave of technical strength
In our last Fixed Income Quarterly, we highlighted the surge in Reverse Yankee issuance. This quarter, we follow up by examining the robust technical backdrop that has absorbed record supply with surprising ease.

Despite heavy primary issuance in recent weeks, European investment grade (EUR IG) corporate credit spreads have shown resilience. Spreads have almost fully reversed the Liberation Day widening, although they are not as tight as in March—an unusual outcome that underscores strong technical support likely to persist through year-end.

Net supply

Gross supply is set to surpass EUR 300 billion by end-May (Citi Research), but net supply remains subdued at around EUR 60 billion—25% below the 10-year average. Even the surge in Reverse Yankee issuance hasn't disrupted this constructive technical backdrop.

Coupon reinvestments

A growing share of primary issuance is being absorbed by coupon reinvestments. Goldman Sachs Research estimates that roughly 65% of net EUR IG supply will be offset by reinvested coupons for the rest of the year.

Flows follow performance

European credit funds have seen strong inflows since the poor performance of 2022, with cumulative flows exceeding 20% of assets under management since 2023. With potential rate cuts ahead and moderately tighter spreads expected, this flow support should continue. The BofA MOVE Index for Europe at around 70 signals market calm—well below the 90+ levels that typically trigger outflows.

We expect strong demand, resilient spreads, and supportive technicals will keep EUR IG well-anchored. With solid fundamentals, steady inflows, and attractive carry, the outlook remains constructive.

> **"Current and expected default rates for US high yield are low."**

High yield

—
Stella Ma
Portfolio Manager,
Global High Yield,
Vontobel

—
James Stahl
Credit Analyst,
Vontobel

US high yield credit spreads tightened to pre-Liberation Day levels, reflecting strong fundamentals and robust technicals

The US high yield market continues to show strength amid market volatility, reflecting its robust overall health. Investors' concerns about unclear tariff policies persist, but tighter credit spreads suggest renewed faith in avoiding an imminent recession. While valuations overall have become less attractive at an index level, increased dispersion creates opportunities for active investors.

Fundamentals are supported by recent Q1 25 financial results for US high yield companies, which have largely exceeded expectations. However, due to tariff uncertainties, financial guidance, particularly for more cyclical sectors, was more cautious and included tariff rate scenarios.

Another feather in the fundamental cap is the low current and expected default rate for US high yield. The default rate is a key indication of a company's ability to repay its debt and is a key driver of the US high yield market. The current LTM (last 12 months) default rate for US HY companies remains low, at 1.25%, and is forecast to rise modestly to 1.50% by the end of 2025 and 2.75% by the end of 2026. As such, default rates are not expected to reach typical recessionary levels, which have previously peaked at 12% in the past four economic recessions (2020, 2009, 2002, and 1991). These figures are supported by the high-quality mix within the US HY market, with 35% of the US HY index secured and BB-rated credits representing 51%, as of year-end 2024.

On the technical side, many positive factors support current spread levels. First, year-to-date net supply is down roughly 25% year-over-year, while non-US demand remains robust despite a weaker USD. Second, investors are still gravitating to the attractive all-in yields of 7–8%, which are hard to ignore given low default expectations. Many investors appreciate the carry component associated with a more benign default environment. Third, fund flows into US HY mutual funds provide further evidence that investors are becoming more comfortable. Following

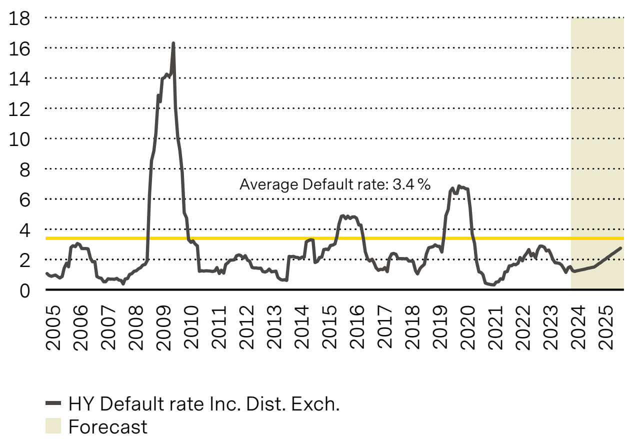
USD 12.8 billion of outflows over the three weeks after Liberation Day, HY mutual funds received USD 7.9 billion of inflows, recouping 62% of the prior outflows. Finally, the maturity schedules for HY companies remain supportive given the large refinancing wave in prior years. For context, only USD 13 billion of HY bonds mature by year-end 2025, which rises to USD 84 billion in 2026 and USD 170 billion in 2027. This should minimize the volatility associated with refinancing risk for the next two years.

From a sector perspective, the services sector has shown the strongest guidance, which is understandable given its insulation from direct tariff impacts. We also see strength in telecom and healthcare, driven partly by their more defensive qualities. Conversely, retail and energy have been the weakest, with the energy sector further pressured by lower oil prices but holding up fairly well given its starting point of lower leverage, manageable debt maturities, and robust liquidity. Despite some challenging sectors, the dispersion within capital structures, sectors, and ratings presents interesting investment opportunities for active investors.

Overall, we expect the sound fundamentals and robust technicals underpinning the US high yield market will buoy current tight credit spreads and offer reasonable total returns to prudent investors.

Chart 1: Default outlook should be benign in the US HY market

In %



Sources: J.P. Morgan; PitchBook Data, Inc., as of 30 April 2025

CHF bonds

—

Gregor Kapferer
Portfolio Manager,
CHF Bonds,
Vontobel

Revisiting Negative Interest Rates: Swiss Bond Market Reacts to Global Volatility and Trade Uncertainty

Jitters in global markets, driven by disruptive trade tactics from the US, also left their mark on Swiss bond markets, with interest rates rallying and credit spreads widening. These dynamics are reintroducing an old acquaintance we didn't exactly miss: negative interest rates. Uncertainty in the markets has once again put appreciation pressures on the Swiss franc, and markets anticipate that the Swiss National Bank (SNB) will address these dynamics with additional rate cuts.

Looking back to the period after 2015, when interest rates first went negative, almost everything carrying some spread performed well as investors reached for yield. We expect similar dynamics for the time being and particularly prefer issuers whose businesses are based in Switzerland and are thus not directly impacted by trade politics. Swiss government bond yields are negative out to four years, yet longer-dated tenors currently trade relatively high. Thus, we like the current roll yield the Swiss curve is offering and have positioned our portfolios with an overweight in the intermediate buckets.

EM debt is well-placed to benefit from the end of US exceptionalism

US trade policies have created market dislocations and value opportunities for EM hard-currency bonds. The end of US exceptionalism and the likely avoidance of a US recession present a good environment for EM bonds.

Hard currency

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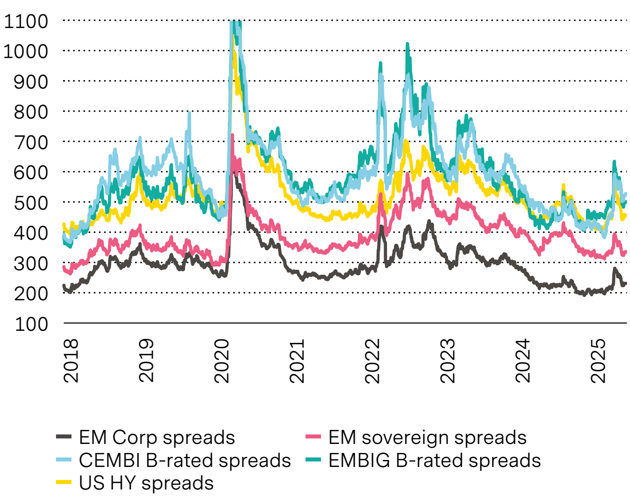
Carlos de Sousa
Emerging Market Debt Strategist,
Portfolio Manager,
Vontobel

Emerging market (EM) hard-currency sovereign and corporate spreads widened significantly after Liberation Day, mirroring trends in developed market (DM) credit. Following a 90-day tariff pause and partial rollback of U.S.-China tariffs, EM sovereign spreads returned to mid-March levels by mid-May. However, EM corporate spreads have not fully recovered from their April sell-off and are more aligned with US HY spreads (see Chart 1). EM spreads remain significantly wider than their February lows, which were below historical averages. We believe that disruptive US trade policies have created interesting value opportunities in this asset class.

Chart 1: EM spreads almost recovered to their pre-Liberation Day level

BB-rated credit US vs EM



Source: Bloomberg, data as of 02.06.2025

The retracement of spreads has been quite heterogeneous. EM IG spreads are nearly back to their end-February lows, while single-B rated sovereigns and corporates remain wider, and are now close to their 10-year averages. This reflects increased uncertainty in the US and global economies, resulting in reduced risk appetite. Spreads of oil-exporting countries like Angola, Cameroon, and Gabon are 125–200 basis points wider, with Nigeria about 50 basis points wider compared to end-February levels. This is due to lower oil prices amid the decision by OPEC+ to gradually increase output, limiting recovery potential. However, these countries do not face significant short-term default risk. Angola, for example, has ample foreign exchange reserves and could obtain an IMF program if needed, allowing it to stay out of the markets for an extended period. Thus, we believe their spreads generously compensate for the associated risks.

Several oil-importing high yield (HY) countries show wider spreads despite favorable conditions. In Sri Lanka and Pakistan, this may be due to potentially high tariffs if they fail to reach a compromise with the US, though this seems unlikely. For BB-rated Côte d'Ivoire and Benin, justifying the wider spreads is more difficult. Côte d'Ivoire's upcoming elections pose relatively low risks, while Benin's situation appears unjustified, as it could benefit from higher garment tariffs on larger producers like Pakistan, Bangladesh, or Sri Lanka.

Non-oil commodity exporters are better positioned, and metal exporters like IG-rated Peru and Chile, and CCC-rated Zambia, have fully recovered. However, gold exporters such as Uzbekistan and Tajikistan have not fully recovered despite higher gold prices. Another gold exporter in the region, B-rated Kyrgyzstan, took advantage of the situation by issuing its first Eurobond at a relatively low yield of 8% for a 5-year USD bond.

EM corporate trends indicate that the oil and mining sectors are lagging the recovery. Metals and mining are also underperforming, despite a better outlook. The outlook for oil-related issuers has worsened, but this deterioration is not uniform. Breakeven levels and buffer levels vary significantly among corporate and quasi-sovereign producers, which provides interesting opportunities for active investors.

The US imposition of tariffs on the entire world, not just China like in 2018, implies that the US economy is likely to weaken vis-à-vis the rest of the world. However, we do not expect this slowdown or tariff-related price increases to lead to a US recession. This shift away from US exceptionalism creates a favorable environment for EM debt. After three consecutive years of outflows from the asset class, the end of US exceptionalism should attract capital to non-US assets, including EM debt. Preliminary May data indicates modest retail inflows of about $1 billion into EM bonds, mainly into local currency, which we expect should be the main winner of a likely dollar bear market.

"EM spreads remain significantly wider than their February lows, which were below historical averages."

Local currency

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Carlos de Sousa
Emerging Market Debt Strategist,
Portfolio Manager,
Vontobel

EM local-currency bonds (GBI-EM) have significantly outperformed this year, achieving a total return (in USD) of more than 10% in just over five months. We believe there are compelling reasons to expect a continued decline in the US dollar, which would create favorable conditions for the sustained outperformance of this asset class.

Our multi-asset boutique now considers a US dollar bear market as its baseline scenario. This outlook is primarily based on the expectation of the end of US exceptionalism, which is mainly driven by cyclical economic factors. While we share this perspective, we lack sufficient information to forecast a multi-year bear market for the US dollar. Nevertheless, we believe that a pause in US exceptionalism for at least one to two years appears highly probable, considering the current policies and initial conditions.

Last quarter, our outlook for local-currency debt was binary: it could outperform EM hard-currency debt if the dollar declined or underperform if the US trade war led to dollar appreciation, as seen in 2018. However, the dynamics of Trump's Trade War 2.0 differ significantly from the 2018 trade war. The dollar has depreciated by 8.5% against major currencies (as measured by the DXY index). Unlike in 2018, the US administration has imposed tariffs on all countries, rather than targeting specific rivals like China. This broader approach implies that trade cannot be easily redirected. US consumers cannot simply shift from Chinese goods to imports from other countries, as all imports have become more expensive.

Consequently, we expect a more pronounced economic slowdown in the US compared to the rest of the world. The dollar's strength over the past decade has been underpinned by the relative strength of the US economy, which now appears to be waning, alongside reduced confidence in US institutions that play a structural role. The sustainability of the US large and persistent fiscal deficits has also come to the fore. In the medium-term, the US government would either undergo a significant fiscal adjustment, which would weigh on GDP growth and the dollar, or come closer to fiscal dominance. A situation in which the US has permanently higher inflation than the rest of the developed world, which would also weigh on the dollar.

"A prolonged dollar decline would, in our view, significantly boost sentiment toward EM assets, particularly local-currency bonds."

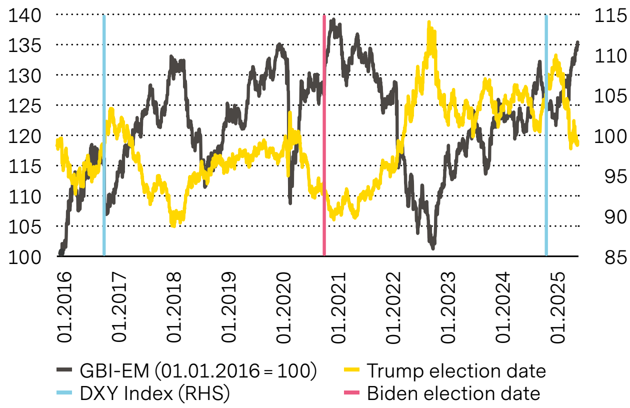
The US dollar appears overvalued based on measures of purchasing power parity and the real effective exchange rate, even after this year's observed depreciation. This overvaluation is attributed to the US experiencing significantly higher inflation than its trading partners since the pandemic. While elevated nominal interest rate differentials have bolstered the dollar in recent years, the accumulated inflation differentials must eventually be addressed; otherwise, they would lead to a further widening of external imbalances. Given the expectation of relatively higher inflation in the US and a diminished growth advantage compared to other DMs, an exchange rate adjustment seems to be the most likely outcome.

A continued decline in the dollar would, in our view, significantly boost sentiment toward EM assets, particularly local-currency bonds, which would appreciate as the valuation of bonds denominated in EM currencies rises in conjunction with the weakening US dollar. Furthermore, while the tariff shock is inflationary for the US, it is expected to have a disinflationary effect on the rest of the world (assuming most countries refrain from retaliatory measures). Reduced US consumption of imported goods—driven by higher prices—will likely lead to an oversupply of durable goods in the rest of the world.

These disinflationary effects are likely to provide EM central banks with the flexibility to adopt less restrictive monetary policies, which would subsequently lower domestic refinancing costs for both EM sovereigns and corporates. The resulting looser domestic financing conditions, coupled with reduced costs for imported capital goods, which are typically priced in dollars, should stimulate real investment in EMs. This dynamic would ultimately foster accelerated economic growth, establishing a positive feedback loop. Additionally, lower interest rates in EM economies would boost local-currency bond prices. Consequently, the outlook for EM local-currency bonds appears increasingly favorable, shifting from a binary perspective to a decisively positive one. While a more resilient-than-anticipated US economy could pose a risk to this outlook, it would not be an unpleasant one; rather a surprise that would favor EM hard-currency and DM credit (via tighter spreads).

Chart 2: The dollar and EM local-currency bonds

Indexed performance



Past performance is not a guarantee of future results.
Source: Bloomberg and Vontobel, data as of 05.06.2025

Investment implications

1. US Dollar exceptionalism is over (at least for a while). We are likely entering a dollar bear market—creating a highly attractive backdrop for local currency EM Fixed income.
2. European Banks continue to show resilience despite recent volatility, particularly Additional Tier 1 (AT1) instruments.
3. The European Yield curve has behaved significantly more predictably than the USD, GBP or Yen yield curves.
4. The "belly" of risk distributions, on average, appear to offer less value than more barbell-shaped risk distributions.
5. Emerging market sovereign risk premiums present far better relative value than developed market risk premiums, despite emerging markets representing a significantly larger share of global markets.

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