MacKay Shields Fixed Income Quarterly Outlooks

April 2025

New York Life Investments

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System Shock

The administration's move to high tariff barriers on U.S. goods imports will usher in a stagflationary environment in the near term.

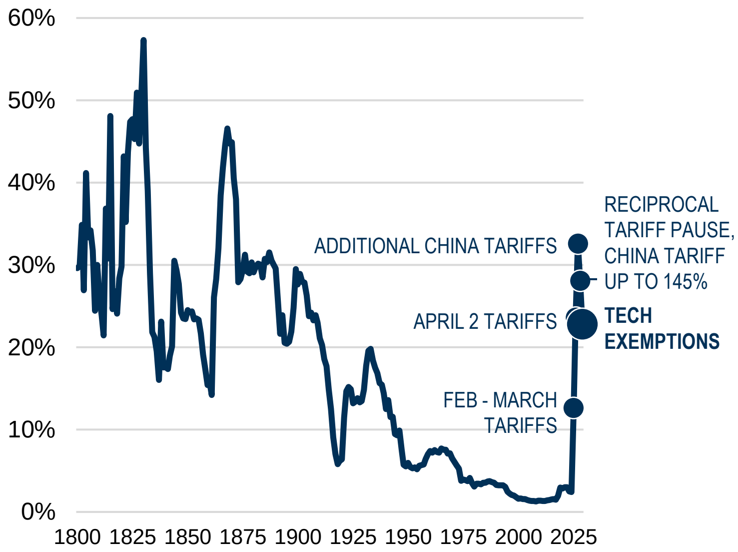
If sustained, tariffs will prompt a costly and laborious reordering of global supply chains.

Fiscal policy may be used to counter the negative growth effects of tariffs but would only add to inflationary pressure.

The Trump administration's implementation of sizable global tariffs represents a profound economic shock that moves the near-term outlook in a decidedly stagflationary direction, lowering inflation-adjusted household income and raising the level of unemployment. Longer term, the unfolding trade war with major trade partners, if sustained, will reorder decades of global supply chain integration and remake the global financial system. Quite simply, tariffs of this magnitude represent a regime shift that is likely to have consequences for the economy for years to come. Protectionism also fits within the broader pattern of the administration's efforts to roll back many of the norms and institutions of the post-war international order.

To date, tariffs announced by the Trump administration will quickly take the effective tariff rate to levels not seen since the early part of the 20th century. The effective tariff rate will then drift lower over time, not only due to the shifts in trade flows that tariffs induce, but also as a result of ongoing negotiations with many of our largest trade partners. In addition, judging by delays in implementation of some tariffs and exemptions granted to some imports, the administration now appears to appreciate the near-term harm that protectionism and retaliation can cause to households and businesses. The market reaction to tariffs, especially broad-based dollar depreciation and the rise in long-term Treasury yields, likely had a disciplining effect on economic policy as well.

Figure 1: Effective Tariff Rate



Static calculation based on composition and level of 2024 imports
Source: The Budget Lab, MacKay Shields.

All this suggests that we are likely already past "peak tariffs". Still, given President Trump's long-standing belief that protectionism can revitalize the U.S. manufacturing sector, there are meaningful constraints on how far tariff levels can fall from here. Looking forward a year or two, the economy is thus likely to face a steady-state level of trade protection that would still represent a major shift in trade policy. That steady-state tariff regime could include:

- A minimum 10% global tariff baseline.
- Higher tariffs on a range of imports from China, including both intermediate goods used in production and final consumer goods.
- A tariff rate as high as 25% on sectors deemed of national security or symbolic importance, including steel, aluminum, pharmaceuticals, microprocessors and motor vehicles.
- Some "reciprocal" tariffs set on a country-by-county basis aimed at reducing bilateral trade deficits and incentivizing a more level playing field for U.S. businesses operating abroad.

Macroeconomic 2Q2025 (cont'd)

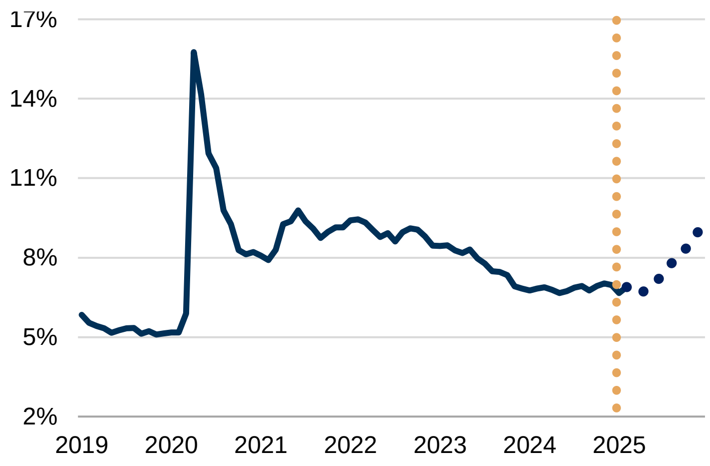
System Shock

While tariff rates may continue on a gradual downward trajectory, still-high levels of tariffs imply a much weaker growth outlook for this year, with elevated risks of a recession. While tariffs will lead to a near-term improvement in net exports, this modest boost to growth will be more than offset through the following channels:

- **Consumption tax:** Tariffs will increase prices faced by consumers, reducing real income and spending.
- **Margin compression:** To the extent some of the tariff duties are absorbed by businesses, the resulting margin compression will restrain hiring and investment.
- **Uncertainty:** The lack of clarity about the long-term steady-state for tariffs, including the on-again/off-again nature of their implementation, will keep uncertainty elevated, further weighing on business investment and hiring. The uncertainty may also lead households to build up precautionary savings at the expense of consumption.
- **Financial conditions tightening:** Declines in the stock market will weigh on consumer and business sentiment, further reducing aggregate demand, while the rise in consumer borrowing rates and wider credit spreads will have a similar impact.
- **Retaliation:** Retaliation from our major trading partners will hurt foreign sales for a range of U.S. firms, further impacting hiring and investment.

These effects of tariffs on economic activity will drive real GDP growth sharply lower this year, to below 0.5% on a Q4/Q4 basis. This growth estimate also incorporates the effects of weaker population growth resulting from the administration's migration policies, which will constrain labor availability while also reducing aggregate consumer spending. With economic growth slowing meaningfully from 2024's 2.5% pace, the unemployment rate is likely to rise to 5% by early-2026. Households will not only face weaker job prospects, but tariffs will put upward pressure on prices, taking the core rate of PCE inflation to above 4% by year-end from 2.8% currently, undoing a meaningful portion of the disinflation of recent years.

Figure 2: The Misery Index to Rise Through Year-End



The Misery Index is the sum of the unemployment rate and core PCE inflation.
Source: Bureau of Labor Statistics, MacKay Shields

Given the stagflationary consequences of such a profound shift in trade policy, along with the haphazard manner in which tariffs have been announced, measures of household and business expectations have deteriorated sharply in recent months. This deterioration, however, may also reflect broader concerns about the direction of economic policy, concerns that may also be reflected in asset price movements that include a sharp decline in equities accompanied by higher long-term Treasury yields and a weaker dollar. Specifically, not only is the economy set to experience a rare policy-induced slowdown, but there are a number of tensions, if not contradictions, at the core of the administration's economic policy goals and actions. These include, for example:

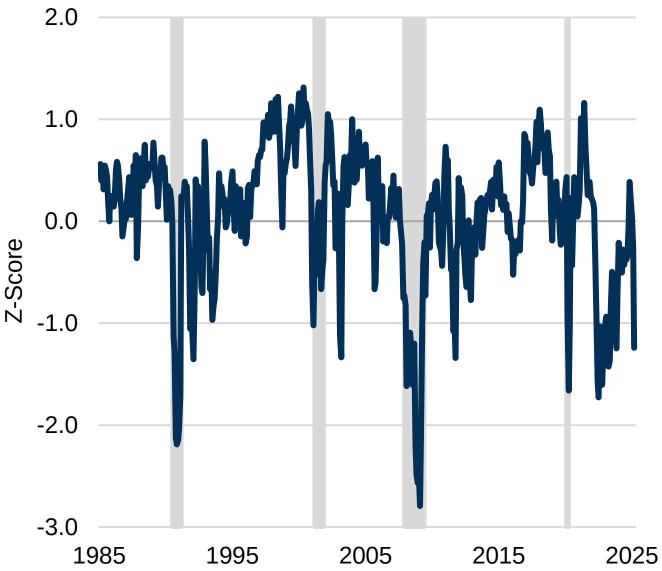
- A desire to eliminate trade deficits while preserving capital inflows (i.e., simultaneously running current and capital account surpluses).
- Restoring the manufacturing sector while pursuing policies that reduce the supply of workers available for the onshoring effort.
- Seeking lower long-term yields while engaging in fiscal expansion.
- Using tariffs for both protectionism and as a source of long-term revenue.

Macroeconomic 2Q2025 (cont'd)

System Shock

These tensions in economic policy are likely to persist beyond this year, suggesting elevated levels of uncertainty and persistent market volatility. In addition, any attempt to use fiscal policy to counter the adverse growth effects of tariffs and foreign retaliation would only further complicate the inflation outlook. This would likely lead to higher long-term yields as investors demand extra compensation for inflation risks and anticipated increases in Treasury supply.

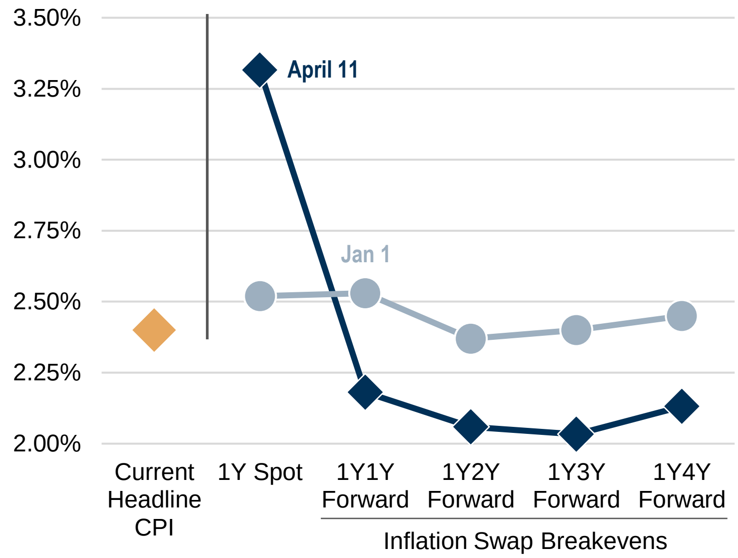
Figure 3: Composite Business and Household Expectations Index



Shading represents NBER recessions.
Source: Federal Reserve Banks of New York, Philadelphia and Dallas, Chief Executive Group, University of Michigan, Conference Board, S&P Global, National Federation of Independent Businesses, MacKay Shields.

The combination of weaker growth and higher inflation creates a challenging environment for the Federal Reserve, even setting aside pressure from the President to lower rates. Thus far, policymakers have generally stressed that with the economy still on a sound footing, they can afford to be patient in making any adjustments to policy.

Figure 4: Market-Based Measures of Inflation Compensation Remain Well-Anchored Beyond this Year



Source: Bureau of Labor Statistics, Barclays

More recently, however, a new strand of thinking appears to be creeping into Fed communications. In an April 14 speech, Governor Waller remarked that under his baseline of temporary inflation effects from tariffs, he would advocate for responding to elevated recession risks with rates cuts “sooner, and to a greater extent than I had previously thought.” This view hinges critically on inflation expectations remaining well anchored. There has been some upward drift in survey measures of household and business inflation expectations, but policymakers have recently put more weight on market-based measures that suggest well-anchored long-run inflation expectations. For example, inflation swap markets discount a much higher inflation outcome over the next year, but forward rates suggest sharply lower inflation thereafter. This may reflect the elevated probability that investors attach to a recession. And this is precisely the challenge facing the Federal Reserve. Steps to counter recession risks with more accommodative policy may undo the stability in inflation expectations that justified lowering rates.

Global Fixed Income 2Q2025

Post-Tariff Thoughts

Liberation Day brought with it an abrupt shift in sentiment and a wave of selling as investors digested a tariff announcement that was far more punitive than expected. The severity and magnitude of the levies will have far reaching implications on supply chain countries, particularly in Asia. The tariff landscape today is much more complex than it was years ago and for this reason, we believe the potential disruption to U.S. corporate issuers could be more significant.

While we recognize the degree of the impact will vary across industries, as some are more insulated to tariffs than others, profit margins will likely compress as companies are forced to absorb some of the near-term tariff headwinds. It's not realistic to expect them to completely pass on any price increases to consumers, nor extract meaningful concessions from suppliers to cover higher costs. Utimately, we believe these new tariffs could stunt consumer spending and slow growth. Credit fundamentals are healthy now, and most companies have termed out their debt[1], but in our view, a deterioration in credit quality should be expected, particularly if tariffs remain in effect for an extended period of time.

Spreads across sectors, ratings, collateral types and structures have all widened since the announcement, but selling is relatively orderly.

The hit to sentiment has been noticeable, and it's keeping buyers on the sidelines. Recession odds are also moving higher with JPMorgan now forecasting a 60% probability of a recession this year.

Within the securitization market, commercial real estate is certainly vulnerable due to supply chain disruptions and reduced consumption. In the consumer ABS market, fundamentals are starting to soften, given a rise in delinquency rates[2]. Meanwhile, we believe agency mortgages should be more of a safe haven given their good liquidity and government support.

While we have not engaged in any material portfolio repositioning, we have reduced marginal risk in sectors that have performed very well over the last couple of years. Over the coming weeks, we believe spreads will continue to widen near term (absent a market-friendly resolution on tariffs), and this will eventually present compelling value for re-entry. Although we are not ready to add risk at these levels, we are evaluating securities that have been "thrown out with the bath water" while we continue to sell names most directly impacted by the new tariffs (e.g., consumer cyclicals). We maintain that relatively high absolute yields in fixed income combined with lower Treasury rates should assist with managing the risk against near-term spread widening.

1. MacKay Shields
2. Federal Reserve Economic Data (FRED) – St. Louis

High Yield 2Q2025

Outlook

Since last November's U.S. presidential election, financial markets have been divided on the issue of tariffs. Were they simply a tool the administration would use to negotiate more favorable trading terms? Or were they part of an audacious agenda to reset the landscape of global trade, even at the risk of damaging the economy?

Investors had initially been assigning a near zero probability of the latter scenario. The S&P 500 touched an all-time high on February 19, and the spread-to-worst on the ICE BofA U.S. High Yield Index (the "U.S. High Yield Index") tightened to near-record levels of 279 bps.

As the administration ratcheted up its rhetoric, markets began to waver. From February 19 through April 2, the S&P 500 declined 7.5%, mostly driven by weakness in large-cap technology stocks. The softness in high yield was modest by comparison; the U.S. High Yield Index declined 0.29%, with spreads widening from 286 bps to 364 bps.

Nervousness turned into fear following April 2nd "Liberation Day" when President Trump unveiled a 10% levy on all exports to the U.S. and additional "reciprocal" tariffs, to which China promptly retaliated. The April 2nd announcement has sowed enormous confusion and uncertainty. The tariffs themselves are difficult to quantify for most companies due to complex supply chains. Predicting additional levies and potential retaliation by the EU and others is nearly impossible.

According to Bloomberg, the S&P 500's 10.5% drawdown on April 3–4 marked the fourth-worst two-day performance since World War II — trailing only the 1987 crash, the 2008 financial crisis and the 2020 COVID panic.

Since February 19, all U.S. high yield sectors are negative, with most declining roughly in line with the 2.6% decline of the broader U.S. High Yield Index.

There have been outliers. Economically sensitive sectors, as well as those most exposed to potential tariffs — such as Energy, Transportation and Retail — have been the worst performers. Energy is especially notable for high yield, as it represents 11.3% of the U.S. High Yield Index and has been hit hardest in recent weeks. Since April 1, WTI crude has plunged from $71 to $59, driven by a combination of demand destruction and oil production increases from OPEC.

Source: ICE data

In contrast, higher-quality, domestically oriented sectors such as Utilities, Healthcare and Defense have fared better.

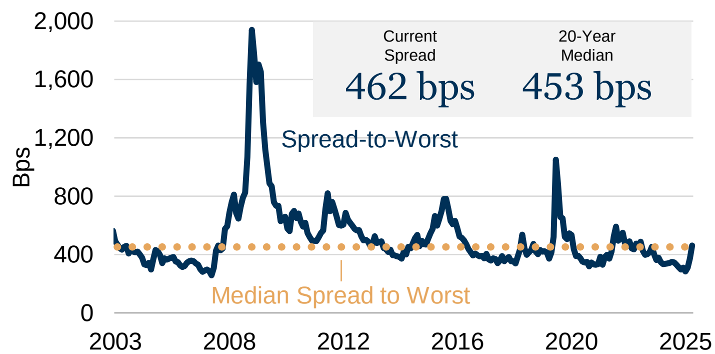
Despite the market volatility, trading in high yield has remained orderly, but elevated. According to JPMorgan and TRACE data, daily trading volumes for high yield increased about 60% on April 3 and April 4 compared to this year's average. In early March, there were market rumors of some hedge fund "pods" who were pulling back from high yield, but there has been little evidence of forced selling, even on April 3rd and 4th.

The technical backdrop for high yield remains supportive. Retail flows have been modest, with mutual funds and ETFs experiencing only approximately $2.0 billion of outflows (or less than 1% of the market) from April 3 to 4. On the supply side, new issue activity has ground to a halt, with no new high yield deals priced during that two-day period.

The recent sell-off has improved high yield valuations. Spreads have widened from historically tight levels and are closer to their long-term historical average of 450 bps — the U.S. High Yield Index spread-to-worst currently stands at 462 bps.

The probability of a U.S. recession has increased since the beginning of the year. However, we believe high yield defaults are likely to remain historically low — absent a severe recession — due to the market's strong credit fundamentals. BB bonds comprise 53% of the market, and over 25% of the market is secured debt. In our view, high-yield credit trends remain advantageous with more upgrades than downgrades and low leverage ratios compared to historical averages.

Figure 1: Spread-to-Worst



Index: ICE BofA US High Yield Index
As of April 4, 2025
Source: ICE Data.

Convertibles 2Q2025

Edward Silverstein, CFA, Senior Managing Director,
Head of Convertibles

Performance

The first quarter of 2025 saw stocks and equity-linked convertible bonds drop in response to the Trump administration’s threats to impose steep tariffs on most U.S. trading partners. A bright spot for convertibles is that they have held up relatively well compared to the decline in equities. Through the recent nadir on April 8, 2025, the S&P 500, NASDAQ Composite and Russell 2000 were down 14.99%, 20.78% and 20.77%, respectively, or an average of 18.85%*. For the same period, the ICE BofA U.S. Convertible Index was down 7.61% for a downside capture of 41%, which is somewhat better than the typical downside capture rate of 50%.

Coming into the year, the average convertible bond was trading within five points of its par value providing for decent downside support in the event that underlying equities moved lower. This compares favorably to 2022 when the average bond price began the year well above par, making them sensitive to moves in the underlying equities, which afforded little bond protection when stock prices dropped sharply. Given the current balanced nature of most of the market, i.e., bonds trading close to par value, convertibles should continue to offer downside support in a falling equity market but still participate in much of the upside should stocks rally off their recent lows.

Issuance

Through the end of the first quarter of 2025, new issuance totaled $15.3 billion, *(from Bank of America data)* or an annualized rate of $60 billion, which, while below last year’s $87 billion total, is still a healthy rate of primary issuance. With the onset of volatility in the stock market and the sharp drop in price of many shares, companies may be more reluctant to issue a new equity-linked security, but those companies that need the infusion of cash are still likely to come to the market as it may be their best or perhaps only realistic opportunity to raise funds. The only new issue thus far in April came from electric vehicle manufacturer, Lucid Motors, which sold $1.1 bil of new convertible debt despite a stock price below $2.50.

Should volatility in the equity markets subside, we would expect new issuance to resume a more normal rate as many companies that issued debt during the pandemic need to refinance upcoming maturities. Companies that cannot refinance that debt from operating cash flow are likely to sell new debt through initial public offerings.

Positioning and Outlook

While the economy was reasonably healthy coming into the year, there remains a significant risk that consumer and business spending declines due to the imposition of new tariffs. Stocks were trading at historically high valuations prior to the recent sell-off and arguably are not cheap even after the recent decline. We are not incorporating any macroeconomic view into our investment decisions, as our investment process is focused on company-specific fundamentals. In the wake of the recent sell-off, however, we have lightened our holdings of several bonds in the Healthcare sector where either company fundamentals have deteriorated or the bonds had fallen to a level where they no longer had much equity sensitivity. We added to several holdings, particularly in the Information Technology sector, where fundamentals remain strong and the issuing company’s bonds have a balanced profile so that they should participate meaningfully in any eventual share price recovery. We remain overweight the Healthcare sector and underweight Utilities, and our portfolio has held up relatively well in the recent downturn. We continue to believe that our process, which emphasizes strong company fundamentals and reasonable valuation, will outperform over a complete market or economic cycle.

*Source: Bloomberg

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ICE BOFA US HIGH YIELD INDEX

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