

# MacKay Shields Fixed Income Quarterly Outlooks

June 2025



INVESTMENTS

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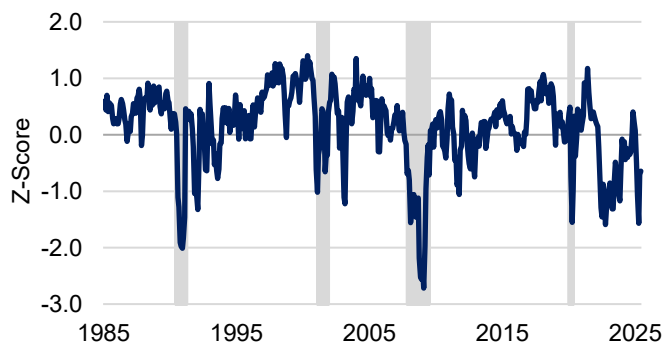
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# Macroeconomic 3Q2025

## Back from the Brink

Last quarter's economic outlook highlighted the significant shock to the U.S. economy that was likely to result from tariffs, a shock that would substantially lower growth and threaten a recession while risking a sharp rise in consumer goods prices. In the subsequent months, and in the face of significant market pressure, the administration has taken a more measured approach to trade policy, first, by deescalating trade tensions with China and more recently, by delaying the implementation of reciprocal tariffs once again, until the beginning of August. In light of these developments, and assuming that the further delay in tariff implementation provides a runway for new bilateral trade agreements, trade policy should not pose as serious a headwind to growth as initially anticipated. We believe the economy is likely to grow this year in the 1% to 1.5% range, still a subpar outcome but markedly higher than the 0.50% estimate in the prior Quarterly. Importantly, the reduction in trade tensions also lowers recession risks, in part because greater clarity about the likely endgame for tariff rates reduces uncertainty and allows businesses and households to plan future spending.

**Figure 1: Composite Business and Household Expectations Index: Off the Recent Lows**

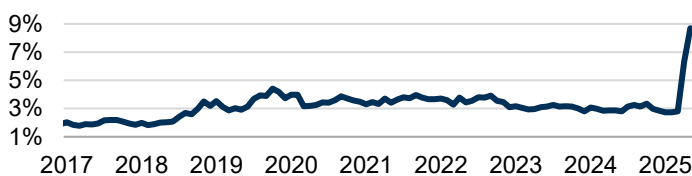


Data through June 2025  
Shading represents NBER recessions  
Source: Federal Reserve Banks of New York, Philadelphia and Dallas, Chief Executive Group, University of Michigan, Conference Board, S&P Global, National Federation of Independent Businesses, MacKay Shields.

Despite the improved outlook, the second half of the year is not without its challenges. First, the full effects of tariffs on prices and consumer spending still lie ahead, given front-running by households and businesses prior to tariff implementation.

As an indication of the delayed effects, the effective tariff rate has begun to rise but still remains below where it is likely to settle, in the 15% to 20% range. In addition, recent developments suggest non-negligible risks that trade tensions could flare up again. Most importantly, President Trump has stated that the new August 1 date for reciprocal tariff implementation will not be pushed out again, and he has also announced a new 50% tariff rate on copper imports and threatened a higher tariff rate on Canadian imports. A comprehensive trade agreement with China has also yet to be hammered out, and there has been no clear guidance on the state of negotiations with the European Union.

**Figure 2: The Effective Tariff Rate Has Only Just Begun to Move Higher**



Data through May 2025  
Source: Department of the Treasury, Census Bureau. The effective tariff rate is the monthly sum of daily customs and excise tax revenue deposits into Treasury's General Account, divided by the dollar value of monthly goods imports.

Outside of trade-related risks, the housing market also presents a headwind for the economy, given significant affordability issues for homebuyers. Home sales and residential investment are unlikely to pick up meaningfully, absent some combination of home price declines and lower mortgage rates that brings potential buyers back into the market. Recent months have seen some downward pressure on home prices as inventories have risen, and this is likely to continue in the second half of the year. Mortgage rates, however, are unlikely to move significantly lower until the FOMC has made more progress in returning the policy rate to a neutral setting. Meanwhile, the Treasury Department will remove one potential impediment to lower mortgage rates, signaling that longer-maturity Treasury auction sizes will remain stable for the foreseeable future, even as the deficit picture has worsened.

Any increases in Treasury supply will be concentrated in shorter-maturity securities and Treasury bills in particular, limiting the potential impact of increased supply on long-term Treasury and mortgage rates.

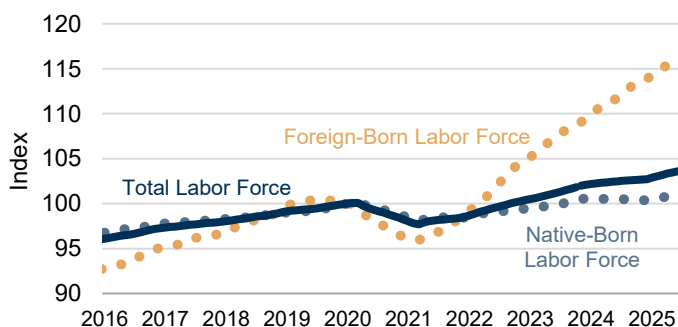
# Macroeconomic 3Q2025 (cont'd)

## Back from the Brink

The Trump administration's migration policies represent a final challenge to the outlook, and one with longer-term consequences for economic growth. Immigration remains a hotly contested political issue, but the surge in unauthorized immigration during the Biden presidency nonetheless had a positive impact on labor supply, contributing to a strong rate of economic growth without boosting inflation. With an aging native-born population, limitations on immigration, as well as increased deportations, will reduce labor force growth. This is a key reason why we expect only a modest improvement in growth next year. In addition to monetary policy easing, the investment incentives and household tax breaks in the new tax legislation will provide demand-side support for the economy, especially as the legislation's cuts to transfer payments are more backloaded. But the economy's ability to boost output in response to fiscal easing will likely be constrained by weak labor supply growth.

**Figure 3: Labor Force Growth by Nativity**

Rebased to 100 on January 2020

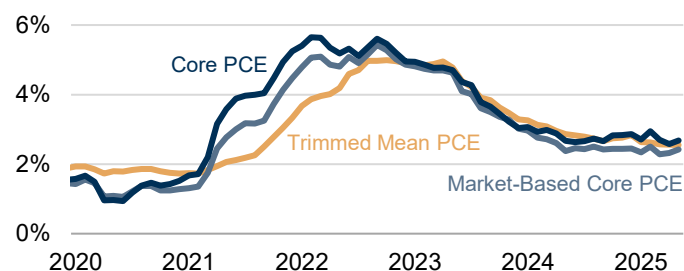


Data through June 2025

Source: Bureau of Labor Statistics, MacKay Shields

An environment of subpar growth but tariff-related price pressures creates a challenging environment for the Federal Reserve, especially given recent disappointing progress in returning inflation to the 2% objective. The minutes from the June FOMC meeting indicate that most Committee participants are focused on “the risk that tariffs could have more persistent effects on inflation.” So long as the economy looks likely to avoid a recession, the risk of persistent inflation effects will keep the Fed in wait-and-see mode, perhaps delaying a resumption of rate cuts until the fourth quarter.

**Figure 4: Disinflation Progress Has Stalled**



Data through May 2025

Source: Bureau of Economic Analysis, MacKay Shields, Federal Reserve Bank of Dallas. Trimmed mean PCE inflation calculates the average price change across the basket of PCE goods and services after first “trimming” the distribution of prices changes to remove outliers. Market-based core PCE includes goods and services components with observed market transactions for which there are price measures.

## International Developments

The substantial shift in U.S. trade policy is leading to a broad-based deceleration in global growth compared to 2024, with country-level outcomes a function of export exposure to the U.S. market and the scale of the domestic policy response. For many economies, the disinflationary impulse from tariffs creates space for central bank rate cuts. In the Euro area, the economic outlook for the remainder of 2025 is one of modest growth, supported by monetary easing over the past year. Growth should improve next year, as the fiscal impulse gathers steam. Germany, in particular, has loosened the fiscal reins, but the recent NATO agreement to increase defense spending implies a shift to looser fiscal policy in much of the euro area.

The outlook for China has improved given the de-escalation of trade tensions with the U.S. Nonetheless, even if more prohibitive tariff levels have been avoided, higher tariff rates will weigh on the export sector. The Trump administration has also increased its focus on using tariffs to thwart efforts by Chinese firms to offshore production to other East Asian manufacturing hubs, such as Vietnam. Overall, Chinese exports have demonstrated resilience, successfully navigating U.S. tariffs by expanding into alternative markets. But this risks a backlash from other countries, including many in Europe, against what is perceived as Chinese dumping. The strength in the external sector also highlights the persistent weakness in domestic demand, which has yet to show signs of a significant recovery.

# Global Fixed Income 3Q2025

Fixed income markets in Q2 2025 navigated a complex environment shaped by economic uncertainty, evolving geopolitical dynamics and a divided Federal Reserve, which signaled a cautious, data-dependent approach to future interest rate cuts. Minutes from the Fed's June meeting revealed differing opinions among policymakers regarding the timing and necessity of rate reductions for the remainder of the year. Credit markets delivered attractive yields while maintaining rich valuations, with both high-grade and high-yield credit spreads trading at cycle lows with minimal margin for error.

## Credit Markets:

- **Investment-Grade (IG) Corporates:** IG corporate bonds provided attractive yields, though they only slightly outperformed Treasuries during the first half of 2025.<sup>1</sup> Fundamentals for IG issuers are generally stable, but their spreads are low, providing a limited buffer in case of economic slowing.
- **High-Yield Bonds and Leveraged Loans:** These assets demonstrated resilience despite trading at compressed spreads. Defaults remained low by historical standards, though modest increases are projected for 2026. Floating-rate assets, including bank loans and CLOs, offered relative value during the quarter.

## Securitized Markets:

- **Residential Mortgage-Backed Securities (RMBS)/Commercial Mortgage-Backed Securities (CMBS):** The securitized fixed income landscape exhibited sector-specific dynamics throughout Q2. RMBS demonstrated notable resilience, with seasoned and higher-quality deals leading performance. The CMBS market showed bifurcated results—office sector challenges persisted with elevated delinquencies and special servicing transfers, while multifamily and industrial properties maintained stability. Lodging sector cash flows began showing early signs of softening.

- **Asset Backed Securities (ABS):** The ABS sectors, including auto leases and credit cards, exhibited resilience, while subprime auto and private student loans experienced higher delinquencies within historical ranges. The ABS market absorbed significant new issuance with minimal spread widening, indicating robust investor demand.
- **Collateralized Loan Obligations (CLOs):** CLOs outperformed other securitized sectors, with AAA-rated tranches demonstrating particular resilience. However, lower-rated tranches, especially CCC-rated securities, faced pressure from increased loan defaults and distressed exchanges, with the loan default rate reaching 3.9% by quarter-end.<sup>1</sup>

## Strategic Positioning for H2 2025

Given the current market environment, our strategic positioning emphasizes four key pillars:

**Quality Focus:** Economic uncertainties warrant prioritizing high-quality segments, particularly investment-grade corporates and structured products with strong credit ratings. Robust fundamentals remain intact, but heightened trade uncertainty and sector-specific challenges support a more defensive approach.

**Duration and Curve Management:** With the Federal Reserve maintaining a cautious stance on rate cuts, active duration risk management is essential. Shorter-duration securities may provide protection against potential interest rate volatility, while curve steepening strategies likely offer superior risk-reward profiles compared to directional duration plays.

**Selective Diversification:** Balanced diversification across asset classes and geographies helps mitigate sector-specific and regional risks while capitalizing on targeted opportunities. In the current environment, this means diversifying within credit by balancing high-quality corporate bonds with floating-rate assets like ABS, leveraged loans and CLOs. Within securitized products, focus on resilient ABS such as auto leases and credit cards, and in CMBS, maintain exposure to stable property types such as multifamily and industrial, while avoiding the challenged office sector.

1. JP Morgan

# Global Fixed Income 3Q2025 (cont'd)

**Active Security Selection:** Given tight valuations, security selection is crucial for enhancing risk-adjusted returns. With credit spreads at cycle lows, the focus should be on issuers with robust fundamentals that offer a buffer against potential economic slowing. In CMBS, this means emphasizing high-quality, well-located assets, while avoiding exposure to transitional or lower-quality office properties facing elevated delinquencies. For CLOs, it is prudent to concentrate on higher-rated tranches to mitigate the credit risk from an increase in loan defaults and distressed exchanges. A potential slowdown in new ABS issuance could also support valuations, making careful selection within that sector critical.

The fixed income markets present a nuanced opportunity set for the remainder of 2025, balancing attractive yields against compressed valuations. Success will depend on maintaining vigilance around quality, managing duration risk effectively and staying informed about economic and geopolitical developments that could impact market dynamics. The current environment rewards disciplined security selection and strategic positioning over broad market exposure.

# High Yield 3Q2025

The ICE BofA US High Yield Index gained 1.86% in June, which represented its strongest monthly return since July 2024.<sup>1</sup> For the second quarter, the Index rose 3.57%, bringing first half 2025 returns to 4.55%.

Intra-year volatility in spreads has been remarkable. After bottoming at a 20-year low of 279 bps in mid-February, the high market's spread spiked to 476 bps in early April following the tariff announcements, only to then retrace its way back to 321bps (Source: JP Morgan).

Entering 2025, demand for high yield and all leveraged credit was already robust. After the volatility in March and April, the calmer market environment since May — driven by easing tariff concerns, growing expectations of Fed rate cuts and a surging stock market, with the S&P 500 up 25% from its low — has further boosted investor demand for high yield.

According to JP Morgan, retail investors pulled \$10.9 billion from high yield mutual funds and ETFs in April following the initial tariff announcements. They have already recouped nearly all of these outflows, posting \$6.6 billion and \$6.5 billion inflows in May and June, respectively. Year-to-date, high yield funds have seen inflows of \$9.5 billion.

The real demand, though, has come from institutional investors. After market volatility in March prompted multi-strategy hedge funds to reduce their high yield exposure, the sharp spike in spreads following the April tariff announcement was met almost immediately by many large investors increasing their high yield allocations.

The bulk electronic trading of pools of bonds, or “portfolio trading”, has facilitated the process of investing in high yield quickly and relatively efficiently, and has gained in popularity. According to Barclays, portfolio trades grew 90% in Q1 2025 compared to the same period in 2024. \$43 billion of portfolio trades happened in April, compared to just \$15 billion in April 2024.

There are not enough high yield bonds to meet this demand. Even though June represented the most active month of issuance so far in 2025, year-to-date new issuance of \$146 billion is 10% below 2024's pace. In addition, the net impact on the high yield market has been modest, as more than 72% of the proceeds so far in 2025 were used to simply refinance existing bonds.

The supply of new high yield bonds continues to be hampered by a sluggish corporate M&A environment and a lull in private equity sponsored LBO activity. Strong demand for leveraged loans, and to a lesser extent, the rapid growth in private credit have also played roles. Both markets vie to lend to companies that might otherwise issue high yield bonds.

Credit fundamentals remain strong. High yield issuers are mostly exposed to the U.S. economy, which has avoided a recession. The leverage ratio for high yield companies has declined below the historical average, and the interest coverage ratio remains higher than past levels of secured debt. In our view, high-yield credit trends remain, advantageous with more upgrades than downgrades, and low leverage ratios compared to historical averages.

Given favorable credit fundamentals, a spike in defaults in the foreseeable future would be surprising, absent a severe recession. Defaults remain low by historical standards—currently 1.5% compared to a 25-year average of 3.4%—and are expected to stay in the 2%-3% range over the next several years (Source: JP Morgan).

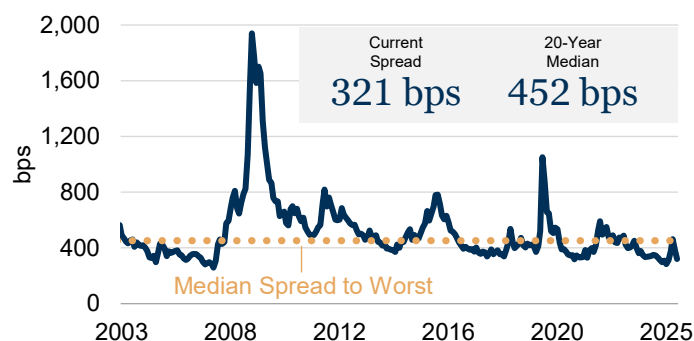
Optimism around credit has led to a sharp decline in the liquidity premium investors typically demand, in addition to compensation for default risk. Historically, investors required significantly higher yields to hold illiquid credits. Today, those same investors are rushing into private credit, readily sacrificing liquidity for the prospect of only modestly higher returns.

1. ICE data

# High Yield 3Q2025 (cont'd)

Valuations fully reflect the combination of favorable supply/demand, strong credit fundamentals and bullish investor sentiment. As of June 30, 2025, The ICE BofA US High Yield Index spread-to-worst of 321 bps is lower than its historical median and the post-GFC "non-panic" range of 325-525 bps, as illustrated below:

**Figure 1: Spread-to-Worst**



Index: ICE BofA US High Yield Index

As of June 30, 2025

Source: ICE Data.

While tighter-than-average high yield spreads are consistent with the current “everything rally” environment, overall yields in U.S. High Yield remain attractive. Current yields of 7.2% compare favorably to the post-2009 average yield of approximately 6.5% on the ICE BofA U.S. High Yield Index, especially when factoring in the improved credit quality of the market over that period.



# Convertibles 3Q2025

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

## Performance

Despite a few ups and downs, the first six months of 2025 have been a very good period for the U.S. Convertible market. Year-to-date, the ICE BofA U.S. Convertible Index is up 6.55%, slightly ahead of the S&P 500's 6.20% advance and the NASDAQ's 5.86% gain. Despite the presence of many small and mid-cap companies in the U.S. convertible market, the asset class has not been dragged down by the performance of the small-cap Russell 2000 Index, which is actually down 1.80% year-to-date. The solid performance of convertible securities relative to stocks has been helped a bit by the mixed performance of the so-called Magnificent Seven. While Meta, Nvidia and Microsoft are up by 26.26%, 17.66% and 18.46%, respectively, year-to-date, Tesla and Apple are down 21.34% and 17.88% respectively. None of these mega-cap tech companies are in the U.S. convertible Index. In addition, several large constituents in the U.S. convertible universe within the Information Technology sector have recorded large year-to-date gains.

While the convertible market's recent gain has been impressive, convertibles were also able to hold up well versus equities during the equity market swoon in early April. The S&P 500 was down 13.63% at the close of April 7, 2025, the market's low point for the year. On that same day, the U.S. Convertible Index was down just 6.60%, for a downside capture of just under 50%. Much of the convertible market's strong showing can be attributed to the fact that entering the year, the average bond price in the Index was just above par or \$100. When equities headed lower, convertibles held up relatively well, given their relatively short maturities, whereby, barring bankruptcy, in a few years' time, investors would have their bonds redeemed for \$100 at maturity, a price not very different from where most bonds were trading in the market. That convertibles have been able to outperform equities in both up-and-down markets this year is testimony to the unique nature of the asset class - its asymmetric return profile - the ability to participate in the upside of stocks, but also provide some measure of managing downside risk when equities decline.

\*(performance data from Bloomberg)

## Issuance

Through the end of the second quarter of 2025, new issuance totaled \$48.3 billion, (from Bank of America data) ahead of last year's \$40 billion of new issuance for the same period. While issuance declined to a trickle during the market sell-off, in April and early May, June alone saw \$17.6 billion of new issuance come to market once equity prices stabilized. New issuance has come from a variety of sectors and market caps. Many companies are eager to raise low-cost capital in the convertible market to refinance higher-cost debt or use the proceeds to expand operations. We purchased several new issue offerings, as we believed that these companies have solid underlying businesses, strong prospects for growth and reasonable valuations based on prospective free-cash-flow estimates. We expect new issuance to continue at a healthy clip, as many companies that issued debt during the pandemic need to refinance the upcoming maturities. In addition, many companies that were used to borrowing at very low rates in past years will find the convertible market an attractive source of low-coupon debt financing.

## Positioning and Outlook

With the equity and equity-linked convertible market at all-time highs, the sharp decline tied to the imposition of steep trade tariffs just three months ago seems like a distant memory. Since then, the markets have shrugged off geopolitical tensions, and seemingly, every market drop is seen as an opportunity to buy the dip. With equity valuations higher than they were at the end of last quarter, we are more concerned about investor complacency than a fear of missing out. We maintain a measured and agnostic stance on broad market direction, focusing instead on valuation discipline and quality fundamentals. We are not incorporating any macroeconomic view into our investment decisions, as our investment process is focused on company-specific fundamentals. Our largest exposure is the Information Technology sector which also has the largest representation in the U.S. convertible universe. We are relatively in line with the benchmark's 29% weighting to that sector. We continue to believe that our process, which emphasizes strong company fundamentals and reasonable valuation, will outperform over a complete market or economic cycle.

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