



FIXED INCOME DEEP DIVE • SEPTEMBER 2025

Anticipating volatility in long-term rates

KEY TAKEAWAYS

- Political pressure on the Fed and persistent fiscal deficits risk reigniting inflation expectations and driving long-term bond yields higher.
- We favour 3–5-year USD and EUR bonds, where the balance between yield and interest-rate risk is more attractive.
- Longer-dated CHF bonds offer potential portfolio protection, supported by franc strength, low inflation and scope for further monetary easing.
- Historically tight credit spreads warrant defensive positioning, with a preference for single-A issuers and selective opportunities in EM bonds, bank AT1s and CLOs.

MONETARY POLICY & FISCAL DOMINANCE

The Federal Reserve's independence is increasingly under pressure. President Trump has been publicly demanding that the Fed lower interest rates to offset the cost of record government borrowing. To this end, the administration is seeking to expand its influence over the Federal Open Market Committee (FOMC) by all available means – including the recent attempt to remove Fed Governor Lisa Cook. If monetary policy were ultimately swayed, it would mark a **textbook case of fiscal dominance** – where budgetary needs start to shape, and eventually dictate, central bank decisions.

With inflation in the US still about one percentage point above target and the unemployment rate more than a percentage point below its 30-year average, significantly looser monetary policy does not appear to be a prudent course of action. Nevertheless, both the FOMC and the market are currently anticipating roughly three to four additional rate cuts over the next twelve months, reflecting, to some extent, the Fed's growing political tilt. While the September cut may have been justified by softer labour market data, pursuing a fiscally driven expansionary monetary policy – when a restrictive stance would in fact be appropriate – risks eroding confidence in US institutions and unanchoring inflation expectations. This could **trigger a disorderly rise in medium- to long-term bond yields and disrupt the orderly functioning of the Treasury market**, potentially sparking a global sell-off in long-term bonds similar to the

episode earlier this year following the US credit rating downgrade amid mounting fiscal concerns.

DURATION & SAFE HAVENS

In fact, market conditions could deteriorate to the point where the US Treasury might be unable to issue longer-dated bonds at reasonable rates. In such a scenario, the Fed would likely intervene with large-scale bond purchases financed by newly created reserves – effectively moving towards directly bankrolling the government. Investors increasingly view this as a realistic risk: in a recent Bank of America survey, 54% of fund managers said they expect the Fed's next chair to resort to quantitative easing (QE) or yield curve control (YCC). While industrialised countries already have experience with QE and YCC, it has so far been deployed only when both growth and inflation were weak. Implementing it in an environment of above-target inflation and above-trend growth would be an entirely different proposition, heightening the risk of inflation spiralling back out of control. Against this backdrop, we expect high volatility and underperformance of longer-dated USD and EUR bonds and **are positioning our fixed-income exposure in the short- to mid-term part of the curve (3–5 years). Swiss franc bonds appear to be among the few remaining genuine safe havens**, with the capacity to decouple in the event of a global bond market rout. In our view, maintaining duration in the Swiss franc market therefore provides valuable portfolio protection.

CREDIT MARKETS

Meanwhile, technical factors continue to dominate global credit markets. Spreads have tightened to multi-decade lows, driven by robust demand for corporate bonds alongside limited issuance in the biggest, USD denominated market. Investors are eager to lock in higher yields ahead of anticipated rate cuts, while issuers remain reluctant to borrow at still elevated levels – resulting in negative net supply overall (the EUR and CHF denominated Investment Grade markets being the exception). This demand-supply mismatch has pushed valuations to a point where the risk/reward profile has become asymmetric: little to no room left for further spread tightening, but meaningful downside if conditions deteriorate. According to research by BNP, based purely on historical ranges, a **spread widening in US Investment Grade credit over the next twelve months is the base case, with a probability of 58%**. However, strong technicals and a sound fundamental backdrop could support current spread levels for the time being. Overall, we remain defensively positioned with regards to credit risk, with a focus on single-A rated issuers.

PORTFOLIO IMPLICATIONS

- **Curve Positioning:** Given the ongoing uncertainty surrounding inflation and fiscal policy, we believe the risk of rising yields at the long end of the curve outweighs the likelihood of a sustained downward move. Considering the current steepness of the credit yield curve and the anticipated timing of rate cuts, **we favour the 3- to 5-year segment in USD and EUR**, which in our view offers the most attractive risk-reward profile.
- **Credit Exposure:** Given rich valuations and the possibility of shifting demand-supply dynamics, a cautious approach to credit risk is warranted. Triple-B rated bonds are trading tight relative to single-A rated bonds. As event risk stays high, we believe **single-A rated bonds offer more value**, especially from a risk-reward perspective.

- **Swiss Franc Bonds:** The Swiss franc is expected to continue its appreciation trend, supported by a significant inflation differential and its status as a safe-haven currency. With the SNB focusing on deflation risks, we anticipate further monetary easing **(with negative interest rates returning in 2026)**, which should support CHF-denominated bond prices. Overall, CHF bonds – particularly those with longer duration – offer a potential refuge from market volatility in the coming quarters.
- **Emerging Market (EM) Bonds:** **EM corporate hard-currency bonds continue to trade at a spread premium over developed market (DM) peers of comparable quality.** By focusing on BBB+ and single-A issuers, we see selective opportunities to enhance yield while diversifying our defensive positioning into EM. With most EM hard-currency debt denominated in USD, a weaker dollar – as we forecast – effectively lowers issuers' debt burdens. This can improve credit metrics, reduce default risk, and support the asset class.
- **Bank AT1 and Corporate Hybrids:** Bank **Additional Tier 1 (AT1) bonds and select corporate hybrids remain attractive, offering good value in our view despite** substantial spread tightening. We favour hybrids issued since 2022 due to their higher reset spreads, providing stronger incentives for issuers to call, thus mitigating extension risk. Additionally, the lower interest rate sensitivity of these instruments makes them less vulnerable to potential inflationary pressures.
- **Inflation-Indexed Government Bonds:** Inflation-indexed government bonds, such as US Treasury Inflation-Protected Securities **(TIPS), provide an attractively priced way to hedge against upside inflation surprises** and potential shifts in long-term inflation expectations.
- **Private Credit:** The asset class has attracted significant inflows. In our view, it offers attractive risk-adjusted returns, often with higher yields, stronger covenants and diversification benefits compared to traditional fixed income. **We favour CLO mezzanine tranches, which provide an attractive illiquidity premium without adding duration risk.**

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