LOMBARD ODIER
INVESTMENT MANAGERS

Alphorum

Alpha-seeking perspectives on global fixed income

For professional investor use only • Fixed Income

Q1 2025

Key points

- **Portfolio positioning.** After two years dominated by monetary policy, 2025 will see a more complex macro scenario in which trade tariffs and fiscal policy play key roles. Fixed income remains attractive, but in view of short-term uncertainty we are taking a more balanced stance that favours a mix of lower duration and higher-quality credit. **See p.02**
- **Potential US-EU divergence.** Expected inflationary US policy risks stifling the Federal Reserve's ability to normalise rates, whereas downside pressure on growth could force the European Central Bank to normalise more rapidly. We therefore favour a tactically neutral stance on government bonds, while standing ready to adjust our positions as the situation evolves. **See p.06**
- **All about the carry.** Credit investors should be ready to say farewell to spread tightening in 2025, but carry will compensate nicely. The mix of credit and duration risk at investment grade is attractive, and away from lower-rated high yield, creditworthiness is unlikely to be an issue. **See p.08**
- **A tale of two targets.** When it comes to emission reductions, targets only tell half the story. In our view, a company that backs up its decarbonisation goals with clear processes, accountability and a willingness to be engaged is much more likely to succeed than one whose lofty ambitions hide a lack of real strategy. **See p.09**
- **Capturing carry through CDS.** The rapid hiking cycle of 2022 has turned the 'search for yield' into the 'search for carry'. Accessing high yield markets via credit default swap indices offers both enhanced liquidity and higher realised risk-adjusted returns, providing a clear value incentive over corporate bonds. **See p.12**

Contents

- Lead commentary p.02
- Convictions dashboard p.05
- Global sovereigns and inflation-linked bonds p.06
- Corporate credit p.08
- Sustainable fixed income p.09
- Systematic research p.12

In our monthly Forum, LOIM's fixed-income specialists debate market dynamics to clarify their convictions. *Alphorum* reflects this pursuit of diverse alpha sources, which drives our global strategy.

LEAD COMMENTARY
A new year, a new outlook for fixed income

Sandro Croce
CIO, Fixed Income

Philipp Burkhardt, CFA
Fixed Income Strategist and Portfolio Manager

Key takeaways

- While the past two years have clearly been dominated by monetary policy, in 2025 factors from trade tariffs to fiscal policy are likely to play a significantly more important role in a more complex macro environment
- The dominant fixed income market narrative foresees diverging fortunes, with the US economy potentially reaccelerating while Europe's weaker position deteriorates further. However, there are risks to this scenario
- Fixed income remains attractive on balance, with carry compensating nicely. In view of short-term uncertainty, we are shifting to a more balanced stance, favouring a mix of lower duration and higher-quality credit

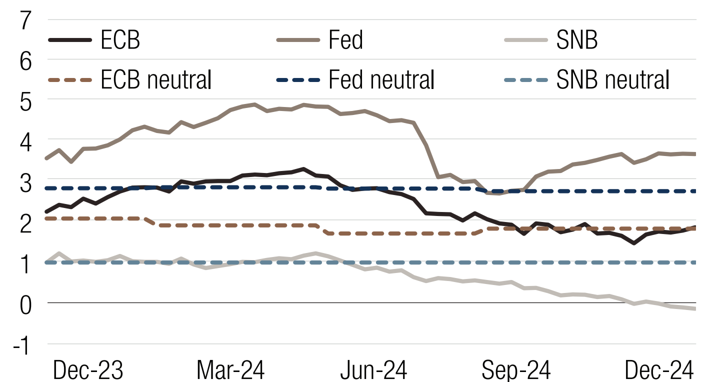
The start of a new year is a good opportunity to take a step back, put recent events in perspective, and think about what could be different over the next 12 months. In the wake of the post-pandemic inflation shock, the past two years have seen monetary policy dominate the macroeconomic environment, as central banks first fought to tame inflation and then sought to plot the way back towards normality through monetary easing. While monetary policy will remain an important tool in 2025, other economic policies are likely to start playing a much more important role, creating a more complex environment for investors.

The macro view: diverging fortunes?

In the US, the new administration seems determined to make a splash from day one with a growth-oriented agenda. Tariffs and tax cuts may spur domestic growth, but they are also likely to be inflationary – as is the potential impact on the labour market of stricter immigration controls. The stimulatory effect of the Trump administration's policies will arrive at a time when the Federal Reserve (Fed) is trying to fine-tune monetary policy to slow growth by just the right amount to engineer a soft landing. With the exact nature and size – and therefore the possible impact – of the new administration's policies still unclear, there is the potential for rates to be more volatile as monetary policy is adapted to smoothen their impact.

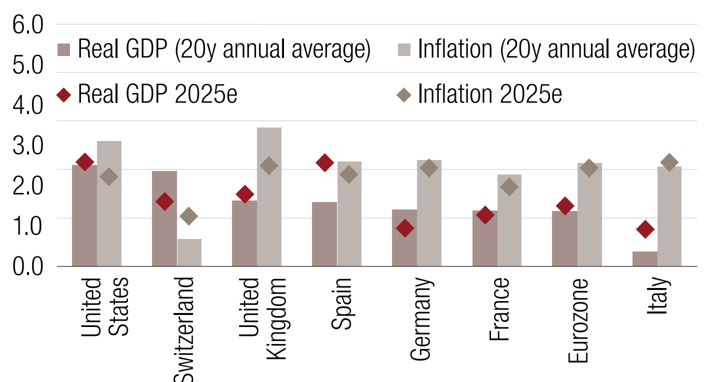
While the US economy could reaccelerate, in Europe tariffs are likely to have the opposite effect, creating a case for divergence. Figure 1 shows how markets have priced bottom-of-current-cycle rates versus neutral rate estimates for the Fed, ECB and Swiss National Bank (SNB) through 2024, while Figure 2 shows estimated growth and inflation for key countries and the Eurozone in 2025 relative to 20-year annual averages.

FIG 1. BOTTOM OF CURRENT CYCLE RATES VERSUS NEUTRAL ESTIMATES FOR FED, ECB AND SNB



Source: Federal Reserve Bank of New York, ECB, SNB, Bloomberg, Lombard Odier. As at January 2025. For illustrative purposes only.

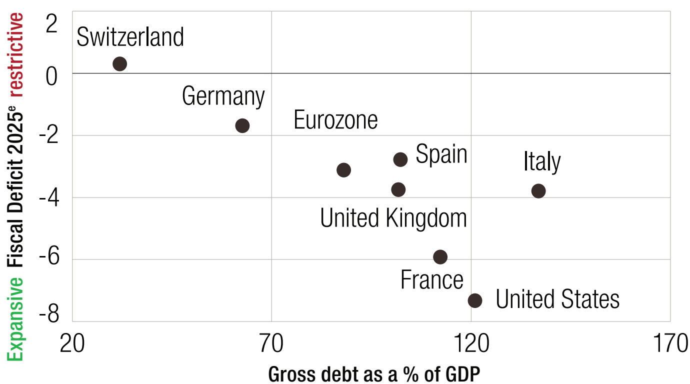
FIG 2. REAL GDP GROWTH AND INFLATION: 2025 ESTIMATES VERSUS 20-YEAR ANNUAL AVERAGE



Source: IMF WEO as at October 2024. For illustrative purposes only.

The situation within the European Union (EU) is further complicated by the fact that while individual countries' economies are performing differently – for example, Spain's economy grew at 3% in 2024 while Germany's essentially stagnated – all must operate under the same monetary policy. Other than economic performance, where countries also differ is in the potential to deliver fiscal stimulus (see Figure 3). With a fiscal deficit below 3% and debt-to-GDP levels at 63%, Germany has room to use policy to stimulate growth, but for France

FIG 3. ESTIMATED 2025 FISCAL DEFICIT VERSUS GROSS DEBT AS PERCENTAGE OF GDP FOR KEY COUNTRIES



Source: IMF WEO as at October 2024. For illustrative purposes only.

and Italy, the question is more about how to avoid further deterioration and bring debt closer to levels that leave more room to manoeuvre by tightening fiscal policies. At the same time, rising populism and political fragmentation mean the unpopularity among electorates of such measures makes desired objectives difficult to achieve.

Risks to the dominant narrative

There appears to be broad market consensus around the view that the US will outperform Europe in 2025, so that it is partly priced in by the market. However, that in itself creates the risk that such divergence will not materialise as expected in one of two ways. First, European economies could prove more resilient than expected, especially given that in most countries, indicators such as employment and wage levels remain strong, while lending surveys are supportive. Secondly, the US economy could face an unexpected slowdown, potentially due to the difficulty for the Fed of calibrating monetary policy in an uncertain environment.

Other scenarios are less likely but still within the realms of possibility. Political stasis or polarisation in key European countries, or both, could create policy gridlock within the eurozone, at a time when unity is required to face the threat of new tariffs and/or lower US support at a geopolitical level. Meanwhile, were the new US administration to replace Fed Chair Powell with a more malleable figure, the damage to the central bank's credibility and independence could have worrying repercussions. Finally, the worst possible scenario for fixed income would be stagflation – with inflation rising at the same time as the economy deteriorates. At that point, the Fed would have to decide which side of its dual mandate – maximum employment or stable prices – it chooses to pursue.

Strategy implications: a shift in positioning

We believe the environment remains broadly positive for fixed income globally. However, to best exploit the evolving situation, a shift in positioning out of government bonds is required. We see value in investment grade corporate bonds in particular, which offer an attractive mix of duration risk and credit risk and are likely to perform well in a strong economic environment.

Previously we saw a strong case for ongoing monetary policy easing and a long-term trend towards bringing policy rates down towards neutral levels. This led us to favour a long duration bias, particularly in the US, with occasional tactical moves towards neutral when short-term dynamics seemed overdone (as in September 2024, when 10-year US Treasury yields fell as low as 3.60%). However, with the Fed potentially needing to counterbalance the inflationary impact of stimulatory measures, the case for rates being cut to neutral levels, along with the likelihood of a steeper yield curve, has become weaker.

This changed macro environment is enough to cause us to shift our overall duration bias from long to neutral in the US Treasury bond market, with a need for agility to make tactical shifts towards either a shorter or longer bias depending on the evolving situation. We see value in US inflation-linked bonds to smoothen the potential noise around the policy measures discussed by the new administration and their impact once implemented.

At the same time, within a global fixed income portfolio we prefer a more balanced exposure between duration risk and credit risk. We therefore prefer being overweight investment grade corporate bonds in our allocation, as these offer such a combination.

Another way of looking at the situation is that in fixed income, securities offer return through a combination of carry linked to income and mark-to-market price changes linked to moves in interest rates. However, the case for lower interest rates and positive mark-to-market gains is now less clear than before. At the same time, the case for capturing value through carry remains valid, as long as the economic momentum remains supportive.

> *“Looking through current uncertainty, we believe fixed income is attractive, although we do prefer good quality credit and like to act tactically when we believe rates are too high or low. However, overall, carry compensates nicely and fixed income has no need to hide behind other asset classes.”*

Our market view: volatility is not the enemy

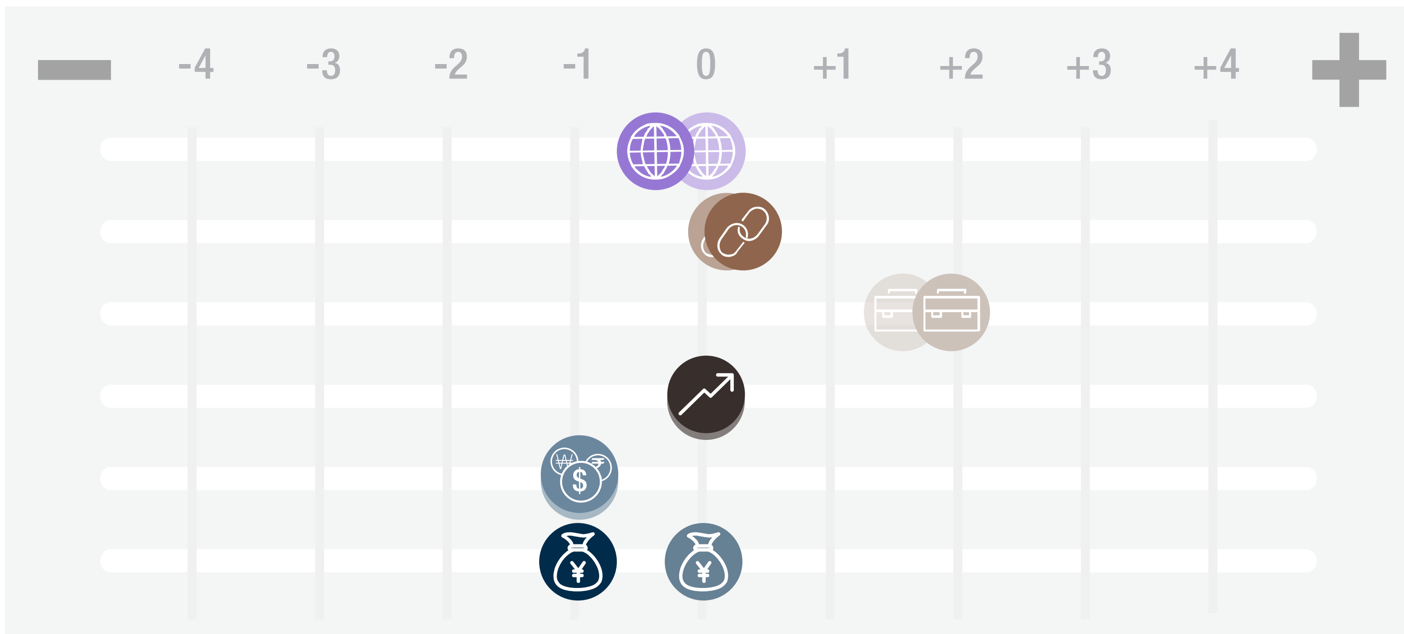
While we expect the level of uncertainty to create volatility – especially at the start of the year as the Trump administration looks to make its mark – we maintain the view that volatility means opportunity, so long as there is still confidence in the overall trajectory. Ultimately, rates tend to be mean reverting, so given that in most economies rates currently remain above what would generally be considered neutral, we can still expect the long-term trend to be a descent in rates. Opportunities to adopt a long duration bias and position for potential mark-to-market gains may therefor arise once short-term political uncertainty in the US decreases.

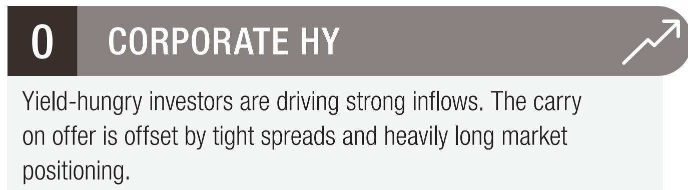
In the meantime, rates are generally attractive, while quality is not a major concern in credit. Corporate bonds offer limited but positive performance potential due to tight historical spread levels, provide diversification from sovereign exposure, and can help to deliver smoother returns.

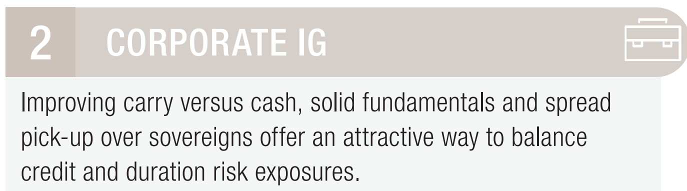
Should expectations of a strong economy prove mistaken, this would be negative for spreads, but duration should compensate. Meanwhile, if expectations prove incorrect on the rates side, there is still the potential to benefit from spread tightening while enjoying the reasonably attractive carry.

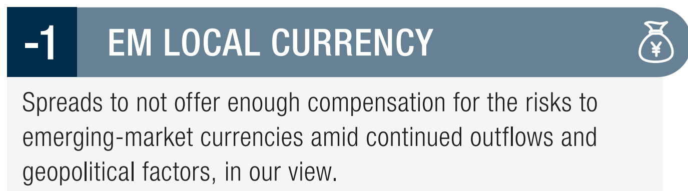
Looking through current uncertainty, we believe fixed income is attractive, although we do prefer good quality credit and like to act tactically when we believe rates are too high or low. However, overall, carry compensates nicely and fixed income has no need to hide behind other asset classes.

CONVICTICTIONS DASHBOARD









Source: LOIM as at 31 December 2024. For illustrative purposes only.

GLOBAL GOVERNMENT AND INFLATION-LINKED BONDS
A year of potential US-EU divergence as 'known unknowns' loom large

Nic Hoogewijs, CFA
Senior Portfolio Manager

Key takeaways

- The outlook for sovereign fixed income in 2025 is dominated by 'known unknowns'. US policy shifts are taking shape, while political turmoil in Europe creates uncertainty just as concerted action may be needed
- The potential for divergence is growing, with the Federal Reserve's ability to normalise US rates hampered by upside inflation risk as downside pressure on growth in the eurozone pushes the European Central Bank towards more rapid normalisation
- In this uncertain environment, we believe a more tactical approach makes sense. We have moved to a more neutral stance yet stand ready to adjust our positions as the evolving policy scenario becomes clearer

Fundamentals and macro

To use the phrase popularised by former US Secretary of Defense Donald Rumsfeld, as we enter 2025, the macroeconomic outlook is dominated by a series of 'known unknowns'. While control of both Congress and the White House gives the new US administration a clear mandate, the extent and timing of the rollout of Trump's flagship policies remain unclear. Meanwhile, an increasingly fractured political landscape in the eurozone risks inertia and inaction just as existing geopolitical crises are joined by a potential trade war caused by US tariffs. This creates the potential for diverging fortunes.

The unusual degree of uncertainty will have inevitable implications for sovereign bond markets. Of the Trump administration's four policy priorities – tariffs, immigration, tax cuts and deregulation – all but deregulation will tend to be inflationary. Tariffs are particularly likely to put upward pressure on prices, even if they are ultimately used as a negotiating tactic and not implemented as severely as threatened on the campaign trail. A boost to business confidence and animal spirits could initially be supportive for US growth. However, were tariffs to lead to a global trade shock and the need for a return to restrictive monetary policy from the Federal Reserve (Fed), consumer confidence and economic activity could falter.

In contrast, for the rest of the world, an 'America first' policy agenda is likely to weigh on economic activity by reducing exports. The severity of any resulting trade shock will be highly dependent on the level of tariffs ultimately implemented. However, with growth under pressure and the fiscal lever already stretched – particularly for European nations – incremental monetary policy accommodation may be the only way to offset the impact of tariffs. This scenario continues to support the argument for locking in yields within the eurozone.

For emerging market (EM) economies, a trade shock would at least come in a context of normalising economic cycles, with monetary tightening already having brought inflation under control and commodity prices supportive. However, EM central banks will need to tread a fine line to balance the impact of tariffs and the imported upside inflation risk created by higher US policy rates and a strong US dollar. For specifically targeted countries such as China, the growth shock from increased tariffs is likely to dwarf inflation concerns when deciding monetary policy.

> *"With growth under pressure and the fiscal lever already stretched – particularly for European nations – incremental monetary policy accommodation may be the only way to offset the impact of higher tariffs. This scenario continues to support the argument for locking in yields within the eurozone."*

Sentiment

While sovereign bond markets underperformed cash in 2024, carry from historically elevated yields cushioned the negative impact of rising yields and meant many government bonds still delivered positive performance. The Bloomberg Global Treasury index closed the year at a yield of 3.16%, 50 bps shy of the multi-year high of 3.66% achieved in October 2022.[1] As we move into 2025, the buffer created by relatively elevated yield continues to be a supportive factor.

With central banks having embarked on their respective easing cycles over the past few quarters, sovereign bond yields are increasingly attractive relative to cash yields. As an example, following the Fed's December rate cut, the yield spread between benchmark US Treasury yields and the Secured Overnight Financing Rate – the cost of borrowing cash overnight using Treasuries as collateral – turned positive.

The positive carry created by this new dynamic is supportive for fixed income. Whereas the past two years have been an uphill battle against negative carry and rolldown, fixed income investors can now benefit – at least to some extent – from the cushion offered by

[1] Source: Bloomberg Fixed Income Indices at 31 December 2024.

rolldown and carry. However, this improving carry and the restored diversification benefits of sovereign bonds should be seen in the context of the elevated uncertainty that may temper investors' enthusiasm for the segment as 2025 gets underway.

In emerging markets (EMs), investor sentiment remains weak, with significant outflows since 2022. An 'America first' agenda could further threaten investor confidence in EM debt.

Technicals

Overall net-net sovereign bond supply is likely to remain plentiful in 2025, but there are significant uncertainties. In the US, the deficit and US Treasury issuance projections are closely tied to the incoming administration's policy agenda. Trump's nomination of ex-hedge fund manager Scott Bessent as Treasury Secretary was welcomed by investors who see him as having the credentials to navigate rising debt sustainability concerns. However, even without further deficit increases, Bessent may lift US Treasury issuance, since he has been a vocal critic of predecessor Janet Yellen's policy to raise short-term bill issuance over longer-term Treasury issuance in order to stem the rise in long-term debt. At the same time, how much money can be saved by efficiency drives and raised through tariffs remains to be seen. In the UK, meanwhile, the Government's October budget implied an ongoing need for deficit financing, so net UK issuance is likely to remain close to 2024's record high.

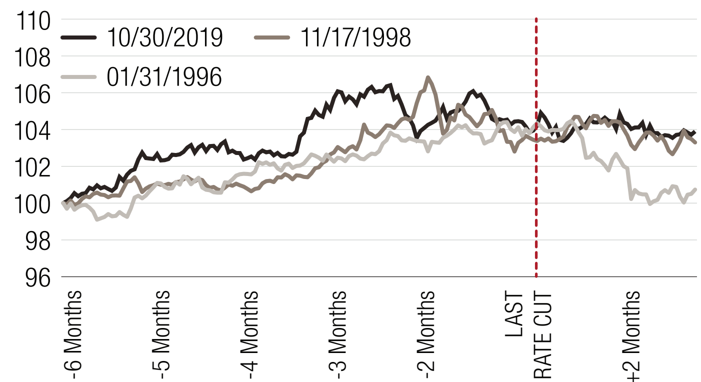
It is more difficult to make firm statements regarding supply net of quantitative tightening in the eurozone. If, as is widely expected, the ECB ceases reinvestments under the Pandemic Emergency Purchase Programme, somewhat reduced fiscal deficits will be insufficient to offset quantitative tightening. Meanwhile, the potential for reductions in issuance to address fiscal deficits is in question given German elections, a French budget stalemate and pressure to increase defence spending.

Valuations

Given the evolving environment, we have adjusted our valuation score to neutral. In the eurozone, we expect the ECB to move rapidly towards a neutral policy rate. Markets price the ECB policy rate to fall from 3% to 1.75%.[2] Given the (albeit unlikely) possibility that a severe geopolitical or trade shock could force the central bank to take rates even lower, arguably this is currently quite well priced.

In the US in contrast, less than 50bps of additional easing is priced in. Given the risk to the inflation outlook, this broadly aligns with our view. Further out on the yield curve, the term premia of US Treasuries may face upward pressure; at the time of writing, no details are available regarding how the new administration plans to fund planned tax cuts in the context of an already challenging fiscal outlook (the Congressional Budget Office projects annual deficits above 6% over the next decade).[3] Inflation-linked bonds offer a means to counter upside inflation risk in the US. Treasury Inflation-

FIG 4. RECENT SHALLOW FED EASING CYCLES SHOW THAT US TREASURIES' GAINS OVER CASH END BEFORE THE FINAL RATE CUT



Source: LOIM, Bloomberg at 31 December 2024. Past performance is not a guarantee of future returns. For illustrative purposes only.

Protected Securities (TIPS) look particularly cheap, with real yields trading just 25bps shy of their all-time high. One thing to note is that in recent shallow Fed easing cycles, there has been scarce outperformance of treasuries versus cash in the months before the end of easing (see Figure 4).

EM sovereign bonds offer attractive carry but expensive spread premiums compared to historically low US yields. EM currencies underperformed the G10 major currencies in 2024.

Outlook

Given the uncertainties, the risk of non-linear outcomes is higher than usual. In this context, we prefer to take a more cautious stance in readiness to incorporate any incoming information on the Trump administration's policy intentions and implementation into our economic projections, while exploiting tactical opportunities as they arise.

A key theme in 2025 will be regional divergence. With US money-market rates set to stay relatively high, US fixed-income investors are likely to face less pressure to lock in yields with longer maturities. For the rest of the world, we continue to see the normalising of policy rates as the key theme. Depending on the scale of US tariffs and the global trade shock they are likely to provoke, central banks such as the ECB may have to reduce rates into accommodative territory. In this context, European markets are our preference to express long positions.

We have reiterated our overweight stance in inflation-linked bonds – which offer attractive real yields and protection against higher inflation – while scaling down our nominal bonds score from overweight to neutral. At the same time, we have turned cautious on EM local debt, our view being that spreads fail to compensate sufficiently for poor EM currency performance.

[2] Source: Bloomberg as at 31 December 2024.
[3] Source: Congressional Budget Office, accessed December 2024.

CORPORATE CREDIT

Ashton Parker
Head of Credit Research and
Senior Portfolio Manager

Farewell to spread tightening, but there are plenty of reasons to carry on

Key takeaways

- For credit investors, 2025 seems likely to be dominated by carry rather than valuation opportunities. However, the mix of credit and duration risk offered by investment-grade bonds is attractive
- US tariffs should have only a minor impact on corporate creditworthiness. We expect few issues for investment-grade and crossover companies to refinance – although seeking extra carry in lower-rated high yield may be a fool's errand
- The slowdown in the automotive sector could potentially generate opportunities, particularly in terms of second-round effects in the supply chain. Elsewhere, rising M&A in the crossover segment is interesting but difficult to predict and exploit

As we move ahead into a new year, it's difficult not to look back in the rearview mirror at 2024 with a certain sense of nostalgia. Credit markets had a good year in general, with some sectors – like real estate – generating excellent opportunities for our strategy. Given such a hard act to follow, what are the prospects for 2025? Beyond robust investment-grade markets (IG), credit seems reassuringly boring. But that's not necessarily bad.

Trump: big news? Not for credit markets

The world in 2025 may seem a somewhat volatile and unpredictable place. A second Trump presidency promising radical change, an increasingly complex scenario in the Middle East, the war in Ukraine almost certain to enter its fourth year, China's sabre rattling over Taiwan, political uncertainty in France and Germany… Yet on recent evidence, credit markets seem happy to shrug off anything short of a major supply shock.

Of the factors mentioned above, probably the one most worth considering in more detail is the potential impact of greater protectionism under the new Trump administration. A lot of IG names are global players with a production footprint in the US. For these companies, US tariffs could be highly beneficial in making their products more competitive against cheaper imported goods. The higher cost of imported raw materials and components used in manufacturing may be an issue, but this will affect all US businesses equally, and tariffs should offset the potentially cheaper input costs enjoyed by foreign firms. IG businesses have the scale, capacity and flexibility to manage these challenges, or simply to bide their time until trade wars work themselves out.

By comparison, high-yield (HY) companies may seem smaller and more vulnerable, but are often also more regionally focused. For US HY names selling into the domestic market, tariffs may impact input costs, but firms should be able to compensate for this with higher prices. While this is inflationary, it's not directly an issue for the profitability of individual companies. Meanwhile, for HY firms in Europe and elsewhere selling into their own domestic markets, US tariffs will be irrelevant.

Overall, this would point to the logic of preferring domestic operators such as utilities, while being more cautious on basic materials, since these are USD-denominated and are more likely to be impacted by tariffs.

The maturity wall? More of a low hedge

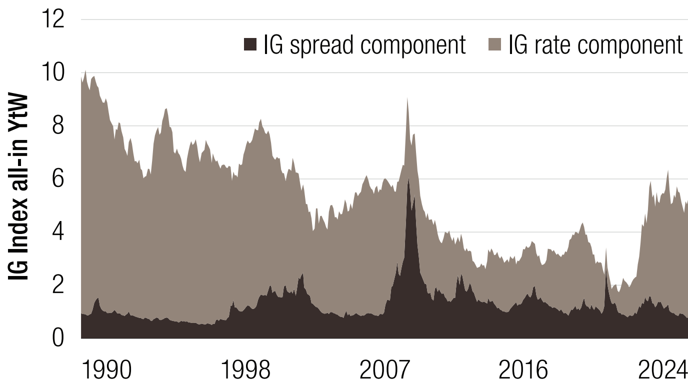
As we have discussed in the past, the so-called maturity wall for HY refinancing is rarely as significant an obstacle as the term implies. In a carry environment, capital markets are open to more companies and investors will tend to go down in credit quality to seek better returns, making it easier for marginal companies to refinance. That creates risk, and makes a thorough assessment of fundamentals critical to avoid investing in a materially weaker company for the sake of a few extra basis points. As rates normalise, IG bonds and the higher quality end of HY offer reasonable all-in returns even if spreads are very tight. In our view, this makes the search for extra carry lower down in the HY ratings spectrum potentially something of a fool's errand.

> *“It was a timely reminder of some basic bond-investing truths – namely that sectors tend to come back, bonds usually get repaid, and on average, investors get their money back with at least a little extra (coupon) for their trouble.”*

Carry on, regardless

If 2024 was a good year for credit overall, for specific sectors and instruments, it was little short of fantastic. Our continued insistence on the strong fundamentals of quality real estate and our preference for hybrid bonds benefited our strategy, with prices recovering 'miraculously' from a collapse that had left them in distressed territory (indeed, in some cases, we saw prices well below 50).

FIG 5. IG SPREADS ARE CONTRIBUTING LESS TO ALL-IN YIELDS THAN RATES



Source: Bloomberg, LOIM analysis at 31 December 2024.
For illustrative purposes only.

It was a timely reminder of some basic bond-investing truths – namely that sectors tend to come back, bonds usually get repaid, and on average, investors get their money back with at least a little extra (coupon) for their trouble. We're thankful for the good times, but realistic about the prospects for outsized returns in 2025. Across sectors, there is no longer the scope for significant further price recovery – and with spreads so tight, the foreseeable future is going to be all about the carry trade.

Autos: nearly an opportunity

One sector that is currently looking quite challenged is automotive; with production levels down thanks to slower-than-expected uptake of electric vehicles (EVs). Arguably, markets have already priced in the bad news, with spreads for automakers 20-30bps wider at IG than they would be normally.

We would characterise this as 'nearly' an opportunity. Component manufacturers, who are more directly dependent on ongoing production levels, will suffer more, while there is also the potential for second-round effects back along the supply chain among firms that supply the raw materials such as chemicals, plastics and metals used in car production. None are likely to be compelling trades, in our views, but we may become a little less well disposed to auto suppliers than to the big car brands themselves.

As the switch to EVs gathers pace, young Chinese automotive firms will present a very real threat to carmakers in Europe and the US, with their legacy manufacturing infrastructure and overly complex product lines. However, for bond investors looking to be repaid within two to three years, the time horizon involved is too long for that to be a major issue.

Crossover market dynamics: M&A on the rise

Within the BBB-BB crossover market, interest cover remains a slow-burn story, with some companies lowering levels of cover, creating the potential for them to be tipped over from IG into HY. Meanwhile, with interest rates normalising, M&A seems to be gathering momentum; companies are in a better position to look ahead and plan M&A with greater confidence in terms of being able to borrow the money to finance it.

For bond investors, there is no single easy way to play M&A by predicting it, since so many variables are involved and permutations possible. Instead, transactions must be considered on a case-by-case basis. One thing we would never risk doing is to own a weak company in the hope that it might be taken over by a stronger one – instead, our tendency would be to underweight it for fundamental credit reasons. In fact, our approach might be best summarised as 'sell the rumour, buy the fact'. We may sell bonds to crystallise profits if they rally on stories about potential M&A activity, on the basis that either it won't happen or, if it does, the outcome won't be as positive as markets hope. In the best-case scenario, we will be able to buy back the bonds at a lower price once the rumours have gone away. At worst, the rumours prove true, and we perhaps lose out on a little extra profit.

IG credit: reassuringly boring in 2025

As we set out in our lead article, in a less favourable environment for sovereign fixed income, IG bonds offer an attractive mix of duration risk and credit risk, and are likely to perform well in the economic environment Trump's policies aim to create. This would favour seeking additional carry in crossover and the higher quality end of HY, following thorough fundamental analysis on individual names.

SUSTAINABLE FIXED INCOME

Cutting emissions: a tale of two targets

Elise Beaufils
Chief of Staff for Sustainability Research

Mona Shah
Senior Sustainability Strategist

Key takeaways

- Ambitious emissions-reduction targets can't always be taken at face value. While they reflect a firm's level of ambition, only effective strategy and strong discipline will ensure the desired results are likely to be achieved
- Ultimately, a company that backs up decarbonisation goals with clear processes and accountability will be far more likely to succeed than one that makes ambitious proclamations without a clear strategy to achieve them
- In our view, openness to engagement is an important factor, providing us with opportunities to add value to a business through actionable conversations that drive successful long-term decarbonisation outcomes

Can an ambitious, verified emissions-reduction target be taken at face value? Not always. Targets express a company's ambition, but strategy and discipline is required to turn good intentions into action and measurable results. In this issue of *Alphorum*, we present a tale of two targets. Both appear credible, but in reality, we believe one is more likely to be achieved than the other.

The companies involved are real but have been anonymised. Our intention is to demonstrate how seemingly comparable targets can mask factors that point to very different outcomes rather than highlight individual names. We have chosen firms in higher emitting sectors – steelmaking and shipping – that have significant parallels in terms of the challenges they face to decarbonise.

Such analysis is integral to our TargetNetZero investment-grade (TNZ IG) credit strategies, which focus on companies making real emissions reductions in such hard-to-abate sectors.

SteelCo: bold intentions, but do they mask a lack of true mettle?

According to the World Steel Association, steel is responsible for around 7-9% of total global greenhouse gas emissions. Steelmaking is a low-margin industry that is highly dependent on fossil fuels, particularly as a heat source for blast furnaces. Steel plants are massive, complex and typically have a lifespan of 30-50 years, making cost-efficient replacement or retrofitting of assets for lower carbon technologies extremely challenging. Currently, new chemistries and processes are still at the development stage and are not yet available for large-scale commercial deployment.

Despite the challenges, on the face of it 'SteelCo' looks to be setting out well on its decarbonisation journey. The Science Based Targets initiative (SBTi) has independently validated its decarbonisation targets, which are aligned with keeping global warming below 1.5 °C. The company is committed to a 50% reduction in its absolute scope 1 and 2 greenhouse gas emissions by 2030, and to reducing its scope 3 emissions from business travel and waste generated in operations by 14%. Meanwhile, it has pledged to ensure that 80% of its suppliers of purchased goods and services and upstream transportation and distribution by emissions will have science-based targets by 2025.

SteelCo is indeed a transition leader in terms of aligning itself to the 1.5 °C temperature trajectory set by the Paris Agreement. However, before investing we would want to understand why the firm has set its targets at these levels and what the implications for its balance sheet are of the capex required to achieve these goals. We would also question why it has yet to set a downstream scope 3 target for emissions. We believe strongly in direct engagement with companies on sustainability matters as a means to unlock long-term value for shareholders. To date, SteelCo has been unwilling to engage with us.

> *"Experience and expertise are needed to spot the difference between wishful thinking and achievable targets."*

ShippingCo: a clear route map and open to help with navigating their way forward

Shipping is vital to the global economy, being involved in the transportation of 90% of goods traded worldwide. It is also responsible for 3% of overall global emissions, making it imperative the sector decarbonises as quickly as possible. However, tight profit margins make transitioning to lower-carbon fuels challenging, while the cost of adapting infrastructure and rolling out new energy-

Please read important information at the end of this document

efficient fleets (or retrofitting existing ones) is often prohibitively expensive – particularly given that ships would usually have a lifespan of 20-30 years. To add to the issues, low-carbon fuels like hydrogen and ammonia occupy high volumes, reducing precious cargo space, while battery-powered and wind-assisted ships are not yet commercially viable for deployment at scale.

Yet, although the sector faces major challenges to decarbonise, 'ShippingCo' is taking clear action to maximise its chances of success. The company has just appointed an expert on biofuels and other alternatives to its board, who will head a committee of experts to comprehensively oversee its decarbonisation strategy. Having already committed to a target of reducing emissions by 30% by 2030, it has announced a capital-expenditure programme aligned with achieving this goal. Finally, it has commissioned additional consulting studies to assess the potential to further improve on its goals and aims to declare a science-based target by the second quarter of 2025.

In contrast to SteelCo, ShippingCo has signalled to us that engagement around decarbonisation could be very fruitful. Its actions to date show strong intentions, but at the same time they are honest about not yet knowing exactly what they can achieve and by when. The company's openness presents a strong opportunity for holistic conversations in which we can contribute our understanding of what its peer group are doing to address the issue, as well as how they can benefit from developments beyond the sector and across the value chain.

Ultimately, the right course of action for ShippingCo will depend on its specific situation. In an industry with very high fixed costs and significant capex outlays, the company will need to pay careful attention to protecting its balance sheet. It may be in a position to elongate the lifespan of its existing fleet by retrofitting ships with lower-carbon technologies within a reasonable timeframe. On the other hand, the age of its fleet may make the best option to plan investment in new vessels as soon as the right technology is available and affordable. The right decision should also consider a range of other factors, from changes to port infrastructure and cost curves for alternative fuels, to decarbonisation progress in the fossil-fuel sector.

Assessing achievability requires sustainability experience and expertise

These two examples demonstrate the importance of looking beyond bold proclamations and enthusiastic press releases to understand the reality behind companies' aspirations to decarbonise. Only by understanding a firm's fundamentals and thoroughly assessing the strategy designed to achieve decarbonisation goals can investors make an accurate judgement regarding whether they can be achieved. Experience and expertise are needed to spot the difference between wishful thinking and achievable targets.

We have been applying our understanding of decarbonisation to our TNZ IG credit strategies for almost four years. LOIM was among the first asset managers to create proprietary Implied Temperature Rise metrics – and indeed our methodology was commended by the Task Force on Climate-Related Financial Disclosures. We have also developed strong qualitative expertise in terms of an understanding of nuances by sector, region and across value chains relating to the issue. This arms our engagement team with market-leading, non-consensual insights to enable actionable conversations with companies that support successful long-term decarbonisation outcomes in hard-to-abate sectors.

SYSTEMATIC RESEARCH

Capturing carry: a CDS-based approach

Anando Maitra, PhD
Head of Systematic Research and Portfolio Manager

Jamie Salt, CFA
Systematic Fixed Income Analyst and Portfolio Manager

Key takeaways

- The rapid hiking cycle of 2022 has changed the dominant investment thesis for fixed income, with the 'search for yield' in the zero-interest rate world of the 2010s and early 2020s giving way to the 'search for carry'[4]
- While corporate bond indices are usually seen as the go-to option to capture carry, accessing high-yield (HY) markets through Credit Default Swap (CDS) indices offers both enhanced liquidity and higher realised risk-adjusted returns
- With CDS spreads also currently offering a value incentive over corporate bonds, a CDS-based HY allocation should be a strong consideration for fixed income allocators in 2025, in our view

The dominant investment thesis in fixed-income markets in the zero-interest-rate world of the 2010s and early 2020s was often characterised as 'the search for yield'. The rapid hiking cycle of 2022 has created a new regime of higher yields across all fixed-income securities, rendering the search for yield largely redundant. Yet as touched on in the lead article of this issue of *Alphorum*, we now find ourselves in an environment of elevated yields and credit spreads near record tights, leaving a substantial portion of yields attributable to risk-free cash rates. The search for yield has become the search for carry.

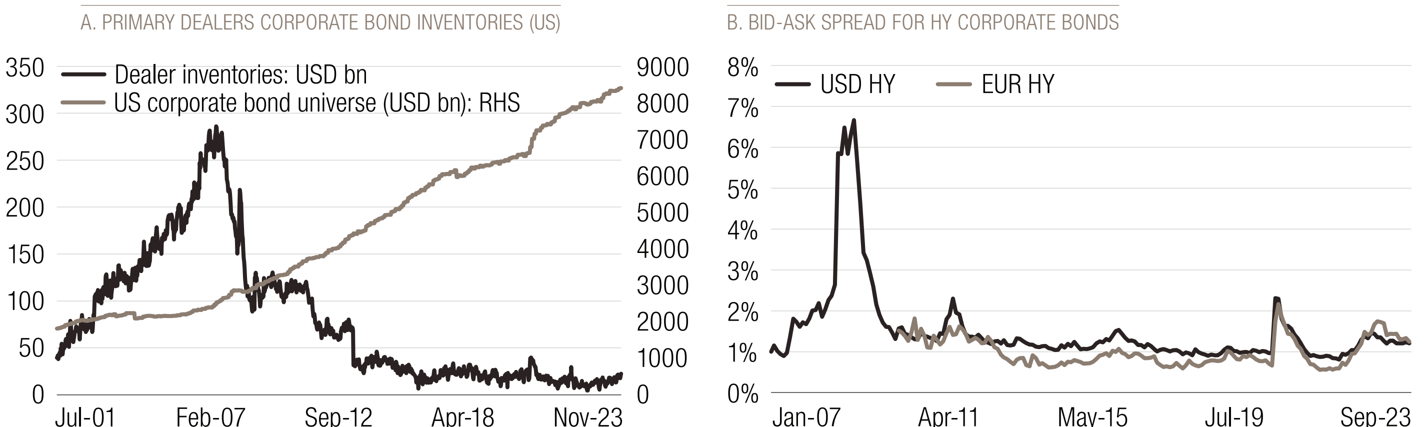
The investment implications of both worlds are extremely similar, with investors moving down the credit spectrum looking for the best opportunities to access yields in excess of cash rates. As a result, high-yield (HY) markets are an important allocation, with HY corporate-bond funds being the obvious choice in this space. However, HY bonds come with a complex set of considerations, from default risk to illiquidity. So, are there more efficient ways to access their attractive carry?

Here, we explore the use of credit default swap (CDS) indices as a vehicle for accessing HY credit carry, namely via iTraxx Crossover in Europe and CDX HY in the US. We set out the liquidity benefits these products can bring and analyse how they perform versus traditional HY corporate bond indices, as well as assessing in what environment they may be the best suited mechanism for accessing HY carry.

Illiquidity is costly

Corporate bond markets have grown massively in the last 20 years, with the US market alone increasing almost fivefold. Yet over that same period, banking regulation to strengthen balance sheets has seen dealing desks become more like brokerages. The result has been a 90-95% collapse in the level of corporate bond inventories held by primary dealers (see Figure 6A). This impact is particularly acute in HY, where balance sheet usage for bank desks is most elevated. These contrasting dynamics have made liquidity conditions within corporate bond markets extremely challenging, keeping trading costs in the form of bid-ask spread elevated despite innovations in broader market trading capabilities (see Figure 6B).

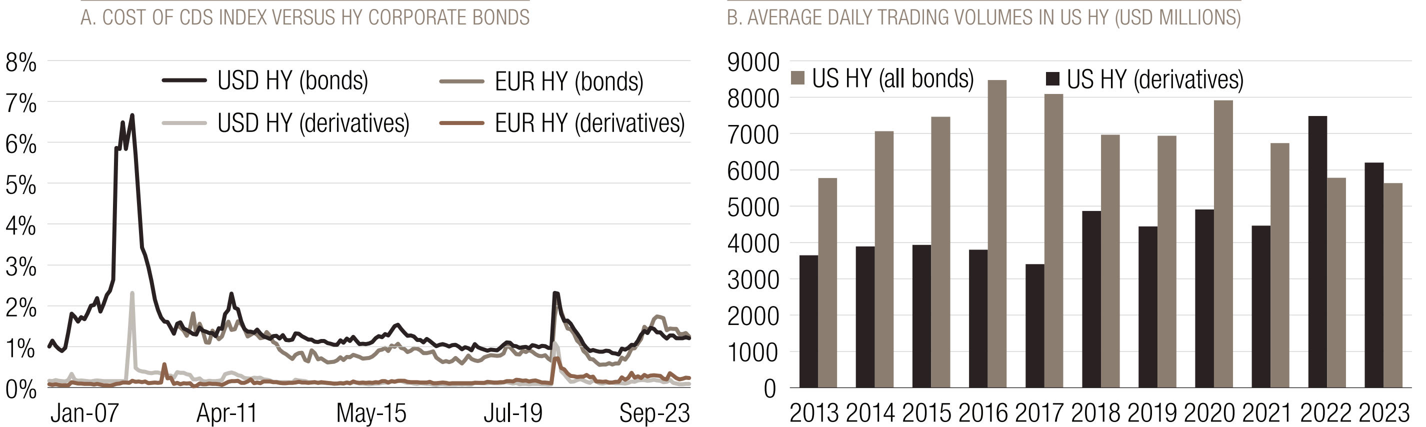
FIG 6. CORPORATE BOND MARKET LIQUIDITY CONDITIONS AND COSTS



Source: US Federal Reserve; Bloomberg at 31 December 2024. Past performance is not a guarantee of future results. For illustrative purposes only. Bid-ask costs do not show the full picture, with Bessembinder (2018) showing that block trade frequency and average trade size declined in the wake of the Global Financial Crisis (GFC and Dick-Nielsen (2018) showing a doubling in the cost of immediacy post-GFC.

[4] We define carry as the excess yield over risk-free cash rates.

FIG 7. CORPORATE BOND MARKET LIQUIDITY CONDITIONS AND COSTS



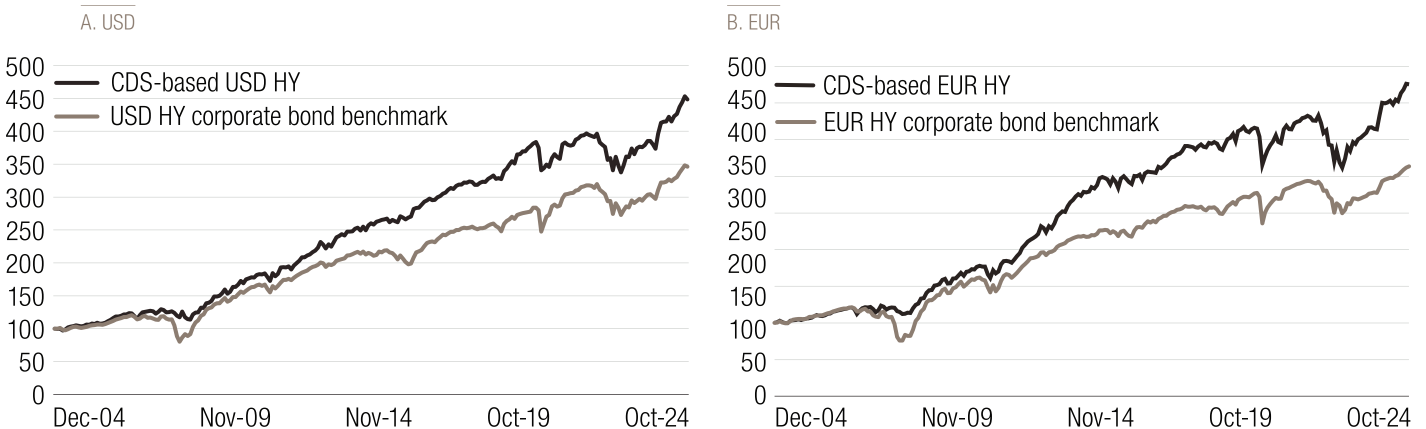
Source: LOIM; Bloomberg; FINRA TRACE at 31 December 2024. We use trading volumes from FINRA TRACE for bonds and Depository Trust and Clearing Corporation for derivatives. Past performance is not a guarantee of future results. For illustrative purposes only.

This dynamic does not translate across into the CDS index space, however. In fact, the disparity in liquidity between HY corporate bonds and HY CDS indices is enormous. On average, CDS indices offer bid-ask spreads 10 times lower than corporate bond indices in the HY space, across both euro and USD-denominated markets (see Figure 7A). This is supported further by an increasing volume in CDS indices – so much so that CDS index trading volume is now comparable to that of the entire corporate bond index combined (see Figure 7B). The increased adoption of CDS indices is further testament to the ease of access to HY markets – at high volumes and reasonable costs – they provide.

Outperformance as well as liquidity

While the increase in liquidity is welcome, the laws of finance posit that investors should receive a premium to compensate for holding illiquid assets in the long run. A long-term position in HY corporate bonds would therefore be expected to outperform a strategy which continually rolls a sell protection position in CDS indices.[5] However, this is not the case; Figure 8 shows the performance of US dollar and euro HY indices versus a strategy of selling CDS HY (iTraxx Crossover) combined with a duration exposure to match the HY index. With the duration exposures matched, potential outperformance comes from the HY credit exposure via CDS indices

FIG 8. CDS-BASED HY RETURNS VERSUS HIGH YIELD CORPORATE BOND BENCHMARK RETURNS

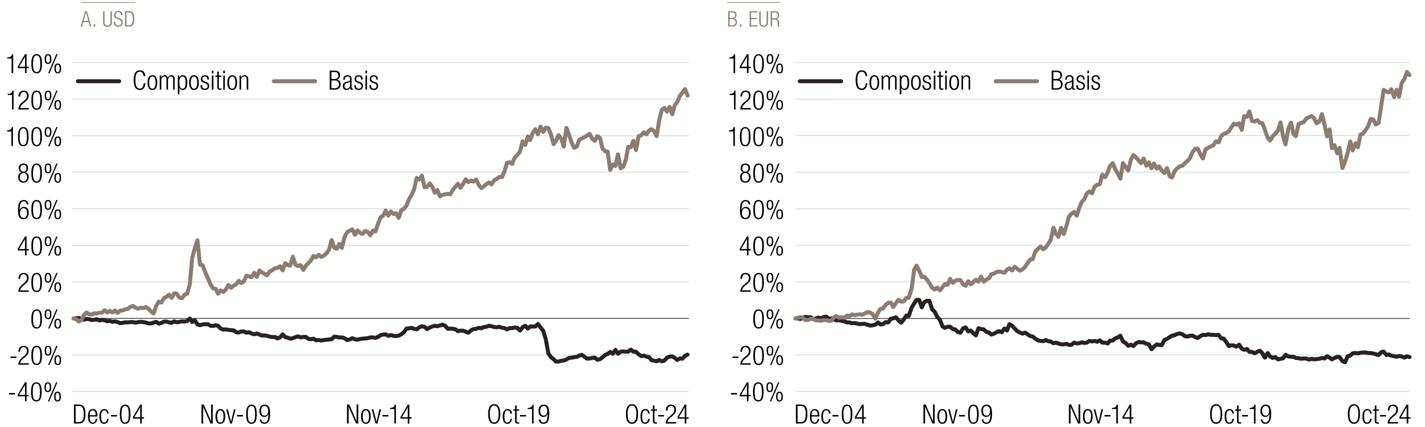


	LIQUID US HY	US HY: BENCHMARK	LIQUID EUR HY	EUR HY: BENCHMARK
Return (%/y)	7.86%	6.46%	7.58%	5.93%
Volatility (%/y)	7.83%	9.16%	7.95%	10.05%
Sharpe	**0.79**	**0.52**	**0.83**	**0.49**

Source: LOIM, Bloomberg indices at 31 December 2024. We combine the unfunded returns of CDS indices with funded mirror swap indices that replicate the rate exposure of the relevant benchmark. These are based on external published benchmarks. We use the Bloomberg US Corporate High Yield (LF98TRUU) and Bloomberg Pan-European High Yield index (LP02TREU). Past performance is not a guarantee of future results. For illustrative purposes only.

[5] Selling protection in CDS indices is the CDS index equivalent of being long a corporate bond index.

FIG 9. BASIS VERSUS COMPOSITION IN CDS-BASED STRATEGIES – CUMULATIVE PERFORMANCE (DEC 2004 – OCT 2024)



Source: LOIM, Bloomberg as at 31 December 2024. Past performance is not a guarantee of future results. For illustrative purposes only.

over corporate bonds. Selling protection on HY CDS indices actually significantly outperforms the excess returns of a long HY corporate bond index in the long run across both currencies, in absolute terms and on a risk-adjusted basis, with a Sharpe ratio that is more than 50% higher.

All about the basis

So, what drives this outperformance? First, there are large constituent differences between the two investment vehicles. CDX High Yield and iTraxx Crossover contain 125 and 75 underlying single-name constituents respectively, while the Bloomberg US Corporate High Yield and Pan-European High Yield indices have almost 900 and 400 underlying tickers respectively. As a result, the two universes clearly have very different sector and ticker compositions, which will result in performance discrepancies. We call this the composition effect. We calculate this as the difference in return between the relevant bond benchmark and a CDS index-matched bond portfolio. However, there is also a basis effect, which is the difference between the performance of the CDS index and the aforementioned CDS index-matched bond portfolio.

Figure 9 shows the outperformance of the CDS strategies decomposed into these two subcomponents.[6] As you can see, it is in fact the basis, and not composition, which is the overwhelming source of outperformance for the CDS strategy – as well as the main source of volatility in tracking error between the two.[7] This implies an advantage over corporate bonds embedded within the CDS instrument itself that generates outperformance, rather than just a sectoral or security selection play.

A question of timing

One component of basis, which drives short-term performance patterns, is the spread difference between CDS and bond indices. The average spread differential through time has been roughly zero, so is not attributable to the long-run, persistent outperformance of CDS indices. However, the spread difference does deviate throughout the cycle – quite significantly at times – and ultimately acts as a source of volatility in the tracking error between the two strategies.

Figure 9 plots a scatter chart of the spread difference (CDS spread less index spread) against the 12-month forward outperformance of CDS versus bonds. There is a strong positive correlation between the spread difference and the future performance, suggesting that in times of higher CDS spreads versus bond spreads, CDS will outperform. Currently we find ourselves in such an environment, with CDS spreads moderately higher than corporate bond spreads.

> “We believe that accessing HY markets through CDS indices is an extremely compelling option for allocators, offering both enhanced liquidity and potentially higher realised risk-adjusted returns.”

[6] Basis calculated as CDS index return less matched bond portfolio return; composition calculated as matched bond portfolio return less benchmark return. The matched bond portfolio is similar to a portfolio of reference obligations underlying the individual single-name CDS.

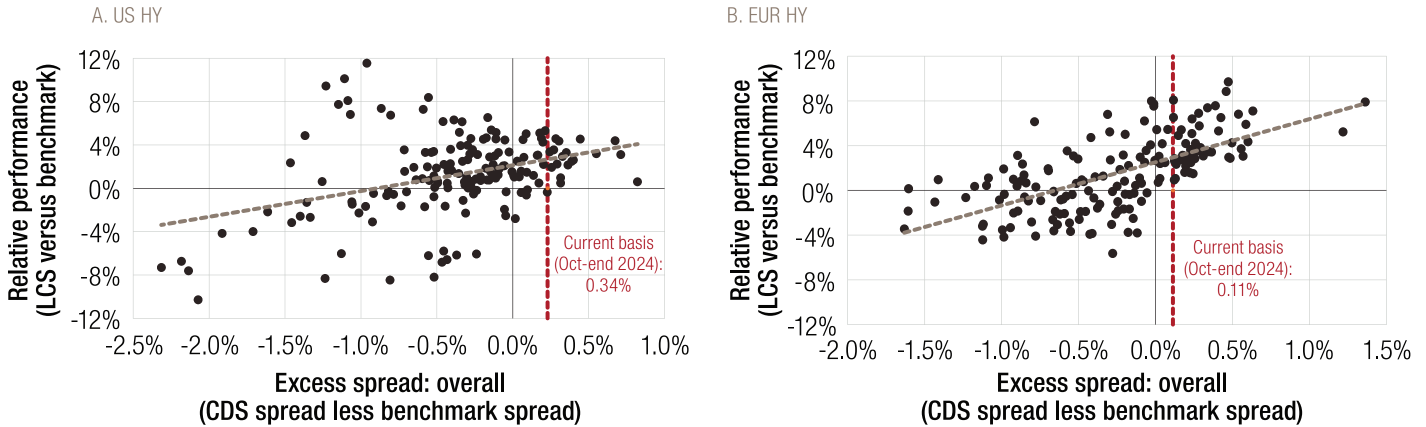
[7] We have extensively studied the drivers of the basis outperformance of CDS indices versus bond indices, however, that research is not covered in this piece. Please contact your sales representative or reach out directly if you would like to discuss the topic in more depth.

Conclusion

In a search for carry, an allocation to HY credit is vital. However, the way in which investors access it is often overlooked, with corporate bond indices being the go-to option. We believe that accessing HY markets through CDS indices is an extremely compelling option for allocators, offering both enhanced liquidity and potentially higher realised risk-adjusted returns.

With CDS spreads also currently offering a value incentive over corporate bonds, a CDS-based HY allocation should be a strong consideration for fixed income allocators in 2025, in our view.

FIG 10. CDS VERSUS BOND SPREAD DIFFERENCE PLOTTED AGAINST FUTURE PERFORMANCE



Source: Lombard Odier IM; Bloomberg. Past performance is not a guarantee of future results. For illustrative purposes only.

IMPORTANT INFORMATION

This document is a **Corporate Communication** and is intended for **Professional Investors only**.

This document is a **Corporate Communication** for **Professional Investors only and is not a marketing communication** related to a fund, an investment product or investment services in your country. This document is not intended to provide investment, tax, accounting, professional or legal advice.

This document is issued by:

Lombard Odier Asset Management (Europe) Limited (hereinafter the "**Company**"). The Company is authorised and regulated by the Financial Conduct Authority (the "**FCA**"), entered on the FCA register with registration number 515393.

This document is approved at the date of the publishing. The Company is clustered within the Lombard Odier Investment Management Division ("LOIM") of Lombard Odier Group which support in the preparation of this document and LOIM is a trade name.

Any opinions or forecasts provided are as of the date specified, may change without notice, do not predict future results and do not constitute a recommendation or offer of any investment product or investment services.

This document is the property of LOIM, is provided for information purposes only and is addressed for the recipient exclusively for its personal use. It may not be reproduced (in whole or in part), transmitted, modified, or used for any other purpose without the prior written permission of LOIM. It is not intended for distribution, publication, or used for any other purpose without the prior written permission of LOIM.

The contents of this document are intended for persons who are **professionals** and who have been vetted by LOIM and assessed as suitable to the investment matters set out in this document and in respect of whom LOIM has received an assurance that they are capable of making their own investment decisions and understanding the risks involved in making investments of the type included in this document or other persons that LOIM has expressly confirmed as being appropriate recipients of this document. If **you are not a person** falling within the above categories, you are kindly asked to either return this document to LOIM or to destroy it and are expressly warned that you must not rely upon its contents or have regard to any of the matters set out in this document in relation to investment matters and must not transmit this document to any other person. This document contains the opinions of LOIM, as at the date of issue or completeness of the information contained in this document, nor does it accept any liability for any loss or damage resulting from its use. All information and opinions as well as the prices indicated may change without notice.

The contents of this document has not been reviewed by any regulatory authority in any jurisdictions and does not constitute an offer or a recommendation to subscribe for any securities or other financial instruments or products.

It contains opinions of LOIM, as at the date of issue. These opinions and information contained herein in this document does not take into account all the specific circumstances of the addressee. Therefore, no representation is made that the information presented in this document are suitable or appropriate to the individual circumstances of any investors. Tax treatment depends on the individual circumstance of the investor and may be subject to change in the future. LOIM does not provide tax advice.

The information and analysis contained herein are based on sources believed to be reliable. While LOIM uses its best efforts to ensure that the content is created in good faith and with greatest care, it does not guarantee the timeliness, accuracy, validity, reliability or completeness of the information contained in this document, neither does it warrant that the information is free from errors and omission not does it accept any liability for any loss or damage resulting from its use. All information and opinions as well as the prices indicated may change without notice. Particular contents of third parties are marked as such. LOIM assumes no liability for any indirect, incidental or consequential damages that are caused by or in connection with the use of such content.

The Source of the data has been mentioned wherever it was available. Unless otherwise stated, the data is prepared by LOIM.

Not for US Person: This corporate communication is not intended for any "U.S. Person" as defined in Regulation S of the Act, as amended or pursuant to the 1940 United States Investment Company Act as amended and will not be registered pursuant to the 1940 United States Investment Company Act as amended, or pursuant to other US federal laws. Neither this document nor any copy thereof may be sent, taken into, or distributed in the United States of America, any of its territories or possessions or areas subject to its jurisdiction, or to or for the benefit of a United States Person. For this purpose, the term "United States Person" shall mean any citizen, national or resident of the United States of America, partnership organized or existing in any state, territory or possession of the United States of America, a corporation organized under the laws of the United States or of any state, territory or possession thereof, or any estate or trust that is subject to United States Federal income tax regardless of the source of its income.

Data Protection: You may be receiving this Communication because you have provided us your contact details. If this is the case, note that we may process your personal data for direct marketing purposes. For more information on Lombard Odier's data protection policy, please refer to www.lombardodier.com/privacy-policy

©2025 Lombard Odier IM. All rights reserved.

LOMBARD ODIER
INVESTMENT MANAGERS