Exploring Opportunities in High Income Solutions

The outlook for global bond markets has evolved significantly in recent months, with a greater divergence emerging between the path for US and eurozone interest rates. Hopes of swift and substantial rate cuts by the Federal Reserve (Fed) have faded. Investors now anticipate a much more gradual and modest easing of monetary policy by the US central bank in 2025. In Europe, the situation is different. Investors still expect multiple rate cuts by the European Central Bank (ECB) in the coming months, with the deposit rate projected to fall to 2.0% (Bloomberg, 31 January 2025) by the end of the year.

Against this backdrop, we believe European high yield bond solutions remain appealing. In our view, the asset class benefits from strong fundamentals and currently offers yields well above inflation. A sizeable yield cushion also provides some defence against future rate rises. Elsewhere, we continue to see potential opportunities in Nordic high yield, financial subordinated debt, and emerging markets debt.

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In summary:

- The yields offered by High Income strategies are currently above 5% and even surpass 8% in some instances, e.g. Nordic high yield.
- Expectations of default rates for European high yield bonds continue to fall and yields-to-maturity remain well above inflation.
- Nordic high yield bonds continue to stand out for their high yields-to-maturity and low volatility.
- Financial subordinated debt remains supported by robust earnings by European banks.
- Emerging markets debt (EMD) could be affected by a strong dollar and the introduction of tariffs, but the impacts of US policy will not be uniform across the asset class. Furthermore, economic fundamentals continue to improve in many emerging economies.

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I. 2025 Outlook

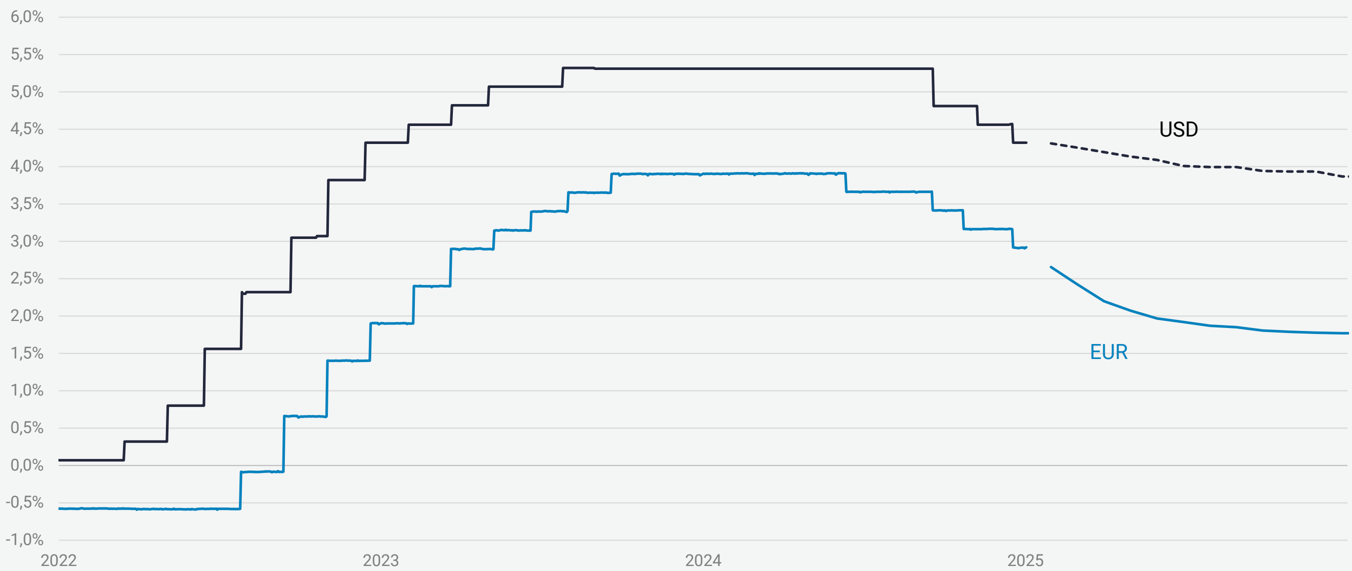
In this second High Income solutions report, we provide insights from key members of our macroeconomic and bond portfolio management teams. We asked them about the current economic environment and outlook, and their analysis of the bond markets.

What is your current overall analysis of the interest rate markets?

Ron Temple: The backdrop is currently dominated by expectations of a probable rebound in US inflation. The dot plots of anticipated future rate movements released on 18 December indicated that Fed members now anticipate only two interest rate cuts in 2025, which is a major change from September's expectations. Interest rate markets have further adjusted rate cut expectations to now project only one reduction in 2025, as market-implied inflation expectations continue to rise. With inflation likely to persist at or above 2.5%, I believe upward pressure on long-term bond rates could push the US 10-Year Treasury yield over 5%.

Julien-Pierre Nouen: In Europe, the ECB seems likely to continue cutting its key rates at a relatively steady pace in 2025, which should widen the interest rate differential with the US (Exhibit 1). However, caution is advised. This rate differential could put pressure on the euro, leading to inflationary effects in Europe and potentially limiting the ECB's ability to continue lowering interest rates, especially by 2026.

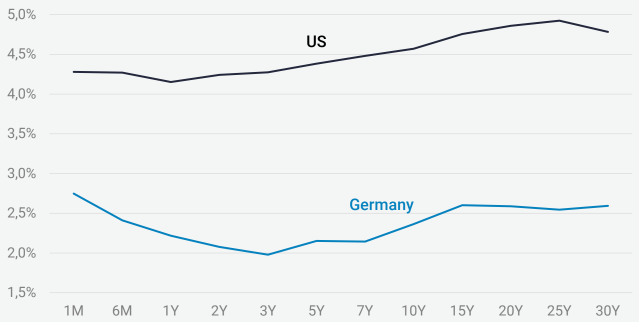
Exhibit 1
Diverging Rate Expectations: US vs. Eurozone Short-Term Rate Expectations



Source: Bloomberg. Swap OIS as of 31 December 2024.

Werner Krämer: We can also expect yield curves to steepen in 2025, returning to a classic configuration where short rates are significantly lower than long rates. This is still not the case today, especially in Europe (Exhibit 2).

Exhibit 2
Fixed Income Markets | Yield Curves



Data as of 31 December 2024.
Sources: Bloomberg.

How high could US inflation go in 2025?

Ron Temple: US core consumer price inflation (CPI) appears to have stabilised at 3.2% to 3.3% year-on-year (Exhibit 3), posing the risk that ongoing economic strength could prevent the Fed from reaching its 2% inflation target. The measures could be partially offset by a stronger dollar and lower energy prices due to increased US oil and gas production; however, low global demand and US peak production pose challenges to significant increases in oil and gas production.

The extent to which President Trump's announced programme can or will be implemented remains to be seen. Ultimately, I expect core CPI inflation to remain above 3% in 2025, with the Fed's preferred Personal Consumption Expenditure (PCE) inflation bound between 2.5% to 3.0%, with further increases in 2026 as the new administration's measures take effect.

US or Europe: which bond market is currently more attractive?

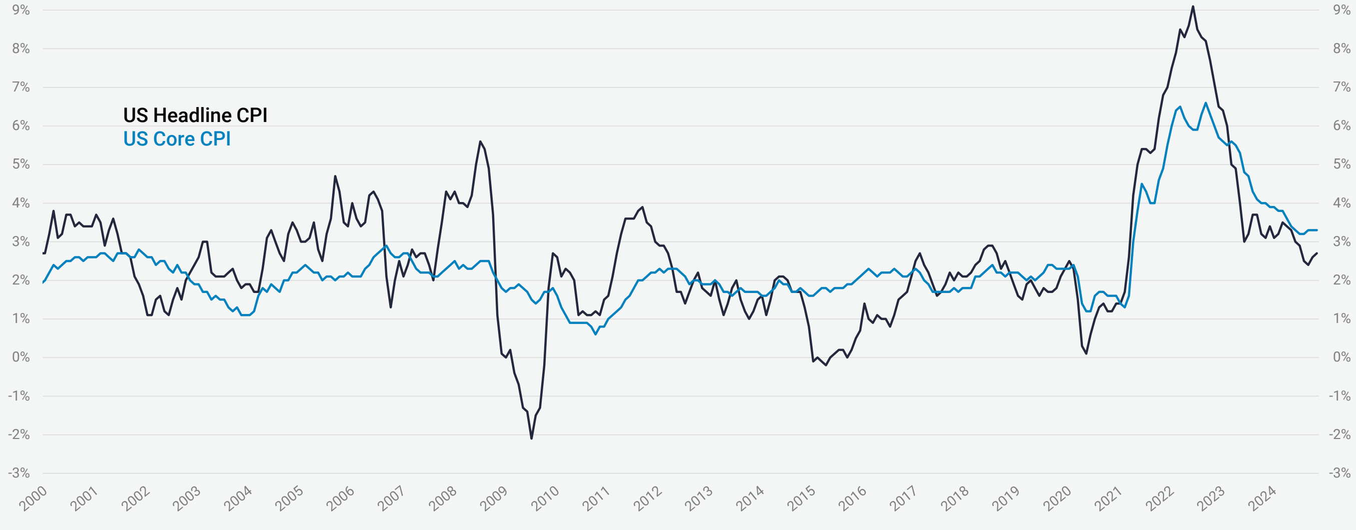
Julien-Pierre Nouen: As Ron mentioned, the risk in the US is of a gradual return to inflation in 2025 and 2026, which could push interest rates back up. These risks are weaker in Europe. And the growth differential between the two sides of the Atlantic, which could widen in 2025, currently favours European debt holders. For now, we believe it is preferable to take advantage of the downward pressure on interest rates in Europe.

> *"The growth differential between the two sides of the Atlantic currently favours European debt holders."*

Do you prefer investment grade or high yield?

Werner Krämer: We believe investment grade bonds typically perform best in an environment of falling interest rates and concerns over economic growth. It is an attractive asset class for hedging against economic weakness, but, in my opinion, the likelihood of a recession in 2025 seems rather low. Europe is still enjoying moderate growth overall, while the US economy is maintaining its solid momentum. Therefore, we currently view the landscape as favourable for European high yield, which has outperformed European investment grade lately (Exhibit 4).

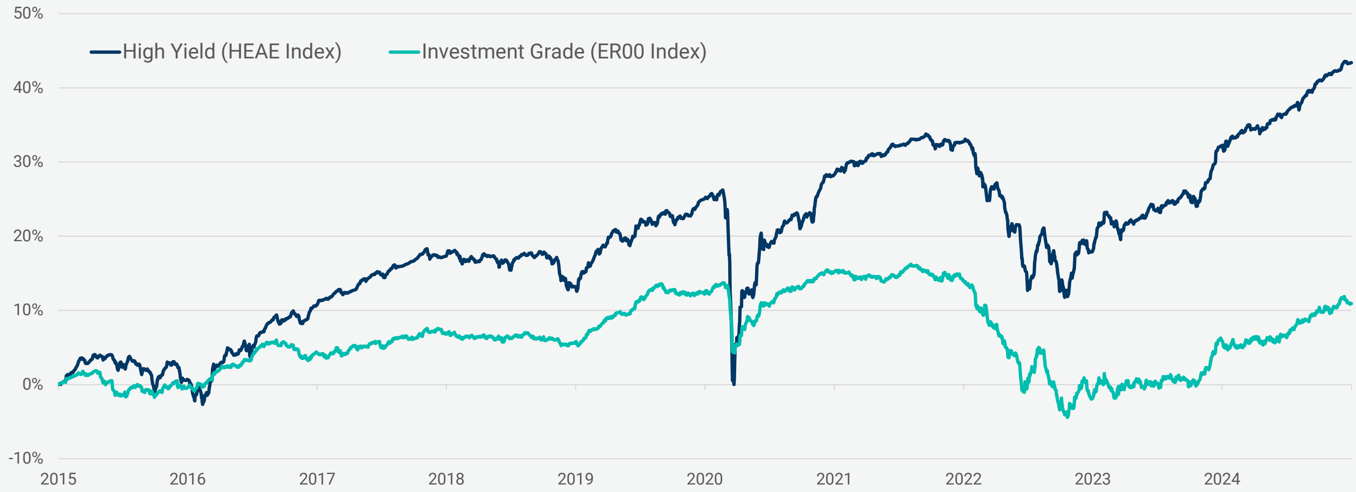
Exhibit 3
Has Core US Inflation Stabilised Above the Fed's Target?



Year-on-year change.
Source: Bloomberg. Data as of 31 December 2024.

Exhibit 4
A Decade of Outperformance: European Corporate High Yield vs. European Investment Grade

Past performance is not a reliable indicator of future performance.



Source: Bloomberg. Data as of 31 December 2024.

Is the fall in eurozone purchasing manager surveys (PMIs) at the end of 2024 a warning signal for European economic growth and therefore for European high yield?

Julien-Pierre Nouen: November's HCOB Eurozone Composite (manufacturing and services combined) PMI reading was disappointing, but this important measure rebounded in December to 49.6 (source: Bloomberg), close to the 50 threshold that implies economic expansion. The IMF continues to forecast a slight improvement in eurozone growth for 2025, projecting an increase to 1.2% from 0.8% in 2024. Although this forecast is down on its April prediction of 1.5% growth in 2025, the overall outlook remains positive, despite notable differences in growth rates across the eurozone.

Are the political risks in France and Germany something to monitor for European fixed-income markets?

Werner Krämer: While France's high budget deficit hinders the scope for any fiscal stimulus, Germany's economic sluggishness has opened a serious debate over whether to increase debt to invest in infrastructure, an issue at the core of the upcoming general election. In this context, the ECB is under pressure to act more convincingly. It will likely continue to cut its key rates at a steady pace, even below the neutral rate in 2025. For bond investors, this should make for an interesting prospect.

Julien-Pierre Nouen: We are often asked whether the risks associated with the French political crisis and France's high level of public indebtedness could not only lead to an increase in eurozone sovereign bond yields but have an even greater negative impact on European high yield bonds. The trauma of the 2008-2012 eurozone debt crisis is still relatively fresh in people's minds. What we saw in 2024 is that the effects of France's domestic turbulence are currently tending to balance each other out. On the one hand, political turmoil accentuates the prospect of a more dovish ECB, driving down the risk-free rate. On the other hand, France has seen its risk premium increase, offsetting the effect of lower rates.

In the high yield segment, it is more difficult to quantify this phenomenon due to the specific fundamentals of each bond issuer. In general, however, we believe the same pattern can be observed. The overall balance is neutral, and investors have therefore continued to take advantage of the relatively high level of carry. Of course, if France continues to increase its budget deficit in 2025, it risks exacerbating current tensions. This is a risk to keep an eye on, but one that I believe could turn into an opportunity.

Exhibit 5
French Sovereign Risks Rising: France vs. Germany 10-Year Government Bond Spread

Basis points for Y axis.
Source: Bloomberg. Data as of 31 December 2024.

II. High Income Strategies: Updates and Outlook

To learn more about the outlook for different High Income market segments, we interviewed our portfolio management teams.

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How did the high yield segments of the European bond market perform in 2024?

Éléonore Bunel: European high yield corporate (+8.5%) and financial subordinated debt (+14.3%) recorded strong returns in 2024 in euro terms (Exhibit 6, source: Bloomberg). EMD generated 13.9% in euro terms, partly due to exchange rate fluctuations. These market segments clearly outperformed European investment grade and sovereign debt.

Can you provide an overview of the market for subordinated and hybrid financial debt, which was the top performer in 2024?

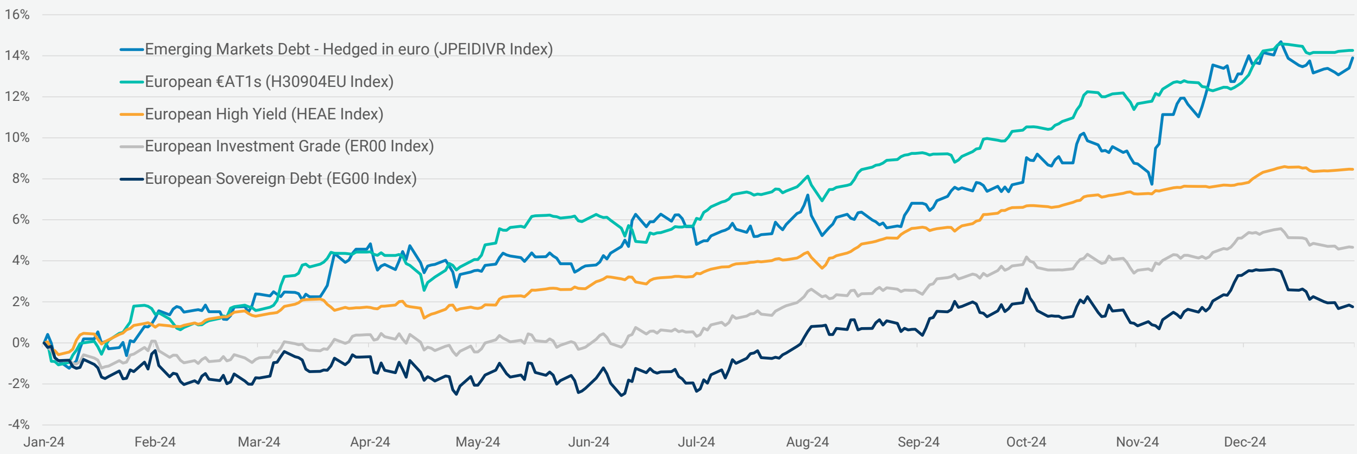
François Lavier: All segments are relatively short dated, with durations ranging from 3.4 to 3.8 years, making this asset class a genuine carry product without being overly exposed to the sometimes strong fluctuations in long-term interest rates. In terms of yields, Tier 2 instruments currently offer yields of 3.6% in euros for an investment grade BBB+ rating, while AT1s yield 5.7% for liquid instruments rated BB+ (source: Bloomberg).

It is also worth noting that almost all issuers are of good quality and investment grade-rated, with only the subordinated instruments, which are therefore lower rated, sitting in the high yield category for AT1s.

Could the financial subordinated debt segment be negatively impacted by rate cuts undermining bank results?

François Lavier: European banks have already prepared for these rate cuts, and models suggest the magnitude of the hit to their earnings will be much smaller than the positive impact of the rate hikes in 2022. Last year's earnings are expected to slightly surpass the record-breaking bank earnings of 2023, and this

Exhibit 6
Performance of the Featured Bond Market Segments in 2024

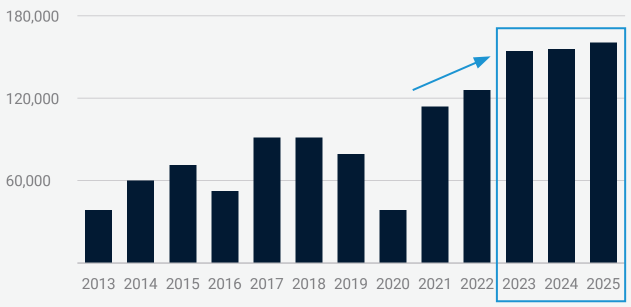


Performance in euro terms.

Source: Bloomberg. Data as of 31 December 2024.

trend is anticipated to continue into 2025 (Exhibit 7). This dynamic is very positive for holders of subordinated debt, as the risk of default by European banks is further reduced.

Exhibit 7
European Bank Earnings Have Been Climbing



2013-2025 (estimations, €mn).
Source: BofA Global Research estimates, company report. Data as of 31 December 2024.

Has the European high yield segment exhausted its potential for gains after two years of strong performance?

Alexia Latorre: European high yield spreads tightened in 2024 but yields-to-maturity remain attractive at around 6% (Exhibit 8). Investors entering this market segment continue to benefit from a solid level of carry, with yields close to their historical median and currently standing at well above inflation. It should also be noted that the average maturity of high yield bonds has fallen, giving the segment a low-volatility profile. Additionally, according to ratings agency Moody's, 12-month default rates are still expected to decline.[1]

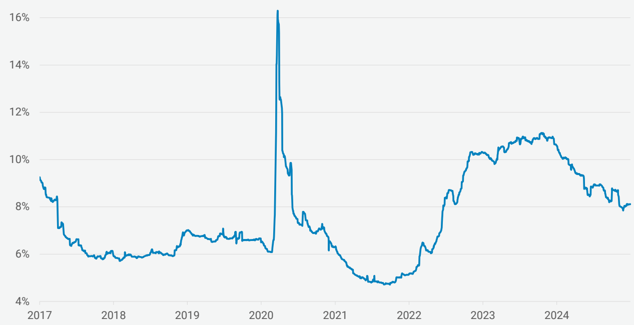
Exhibit 8
Yield-to-Maturity - European Corporate High Yield

HEAE Index.
Source: Bloomberg. Data as of 31 December 2024.

What differentiates Nordic high yield bonds from the broader global high yield asset class?

Daniel Herdt: Nordic high yield is a niche corner of the high yield market where many issuers are not rated by credit rating agencies. The issues are small, bringing a slightly higher liquidity risk than in other market segments. For this reason, Nordic high yield spreads are high, with yields-to-maturity of above 8% (Exhibit 9 - hedged in euros, as of 31 December 2024).

Exhibit 9
Yield-to-Maturity - Nordic High Yield

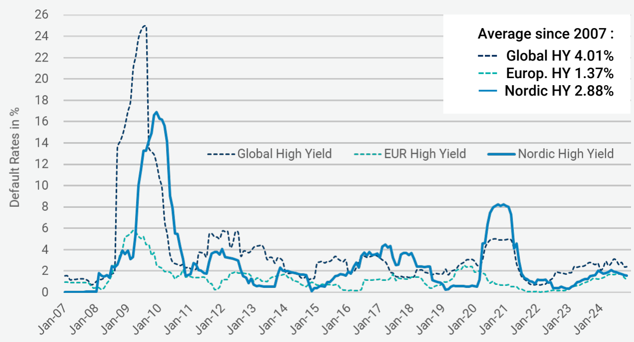


Data as of 31 December 2024.
Source: Lazard.

Importantly, the default rate in this area of the market remains broadly equivalent to the global high yield universe's average (Exhibit 10). In essence, the additional yield on offer is not a trade-off for a higher default risk.

Finally, this is a universe dominated by floating-rate notes and short-maturity securities. This allows this market segment to maintain low volatility, except during periods of market stress (e.g., the pandemic), when the low liquidity of Nordic high yield securities can briefly result in larger price fluctuations than in other market segments.

Exhibit 10
Default Rate of the Nordic HY Segment vs. Global HY and Euro HY



Data as of 31 December 2024.
Source: Lazard.

Given Nordic high yield bonds mainly comprise floating-rate notes, is there a risk of a gradual decline in yields?

Daniel Herdt: In our view, there is limited cause for concern here, given the yield-to-maturity associated with our Nordic High Yield strategy is still close to 9% (hedged in euros). The extra yield offered by this market segment is structural, due to its specific characteristics. Even though interest rates could fall, we believe the expected yield from Nordic high yield should remain higher than for the broader global high yield asset class.

How has the outlook for emerging markets evolved since the US election?

Denise Simon: The outcome of the US elections, resilient US economic growth and cautious guidance by the Fed on the prospects of interest rate cuts have contributed to a sharp increase in US Treasury yields and further dollar strength since the election of Donald Trump. This has weighed on EMD. However, measured in euro terms, Trump's re-election has had little immediate effect on the asset class's performance, which has benefited from the euro's depreciation (Exhibit 11).

Overall, EMD's performance was mixed during 2024. Sovereign and corporate credit generated solid returns, driven by carry and credit spread compression, while local debt declined due to the strong dollar.

It is important to bear in mind that the EMD universe is highly diverse. The economic fundamentals of emerging economies vary significantly from one country to another. The impact of US policy on emerging markets countries will not be the same everywhere. Indeed, it will likely create opportunities, based on factors including economic openness, monetary policy, and fundamentals.

Could a more modest trajectory for US interest rate cuts lead to a new 'taper tantrum' in emerging markets?

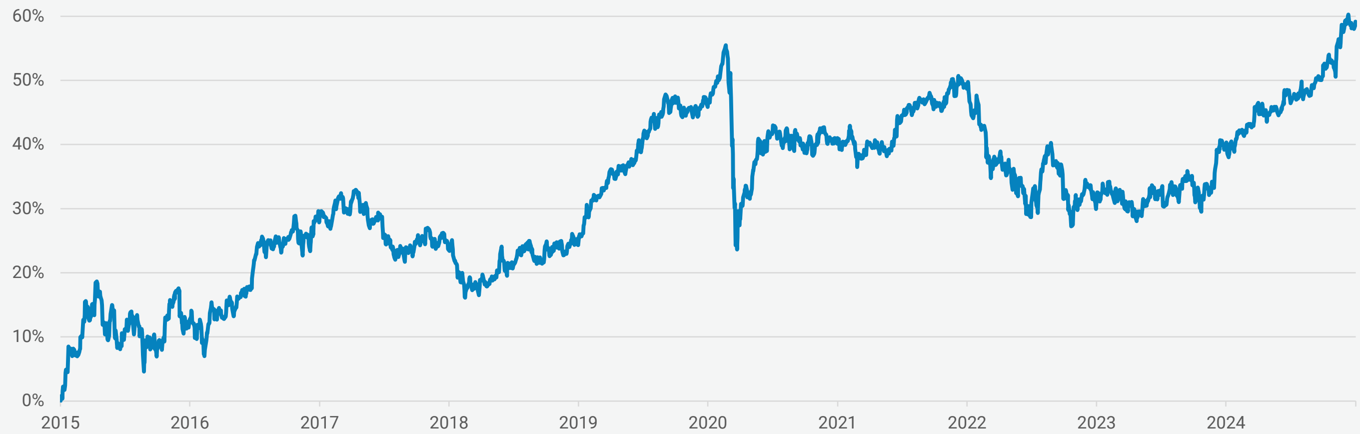
Arif Joshi: We are mindful that emerging economies might face the headwind of a stronger dollar and find themselves on the wrong end of President Trump's policies over the coming years, including trade tariffs. And in a world of renewed bond market vigilantes focusing on fiscal and current account deficits, countries with those vulnerabilities will certainly be at risk. That said, a large majority of emerging markets countries appear to be on a trajectory of improving fundamentals, due to a combination of orthodox governance and multilateral support, despite the complex global backdrop. As such, bottom-up credit and balance sheet work remains critical in constructing a portfolio that is insulated from 'taper tantrum' risk.

Where do you see the opportunities in emerging markets corporate credit in the context of US policy under the new US administration?

Adam Borneleit: We see several opportunity buckets: large countries with domestic drivers of growth, such as India; countries pivoting from unorthodox to orthodox policies, such as Turkey and Argentina; issuers with wide spreads because of headline reactions but where the underlying businesses are actually not exposed, such as Latin American utilities; and issuers in countries with trade deficits with the US but whose businesses are not exposed to that trade.

While we continue to closely monitor risks from changes to US policies, as well as emerging markets-specific changes, we note that only two of the approximately 60 countries in the emerging markets corporate debt investment universe have material trade goods deficits with the US. Furthermore, corporate balance sheets in emerging markets remain strong, yields are still high relative to history, and credit spreads are wider than for comparable developed market issuers. While volatility is likely to increase, we believe this could provide further trading opportunities during the year, given the attractive carry, low leverage, and typical investor overreactions in emerging markets.

Exhibit 11
Emerging Markets Debt Performance (€)



JP Morgan Emerging Markets Bond Index (JPEIDIVR Index).
Source: Bloomberg. Data as of 31 December 2024.

Exhibit 12
Summary: Lazard High Income Strategies and their Key Characteristics

Strategy	Region Bias	Sector	Average Issue Rating	Modified Duration (Years)	Yield to Maturity	High Income Profile
Corporate High Yield Debt	Europe	Corporate	BB-	2.2	5.4%	Core
Short Duration High Yield	Europe	Blend Corporate-Financials	BB+	2.0	5.1%	Defensive
Nordic High Yield	Europe (Nordics)	Blend Corporate-Financials	BB-	0.5	8.7% hedged in €	Dynamic
Subordinated Financial Debt Blend	Europe	Financials	BB+	3.0	5.7%	Core
Subordinated Financial Debt Hybrid Contingent	Europe	Financials	BB	3.1	7.1%	Dynamic
Emerging Markets Debt Corporate	Emerging Markets	Blend Corporate-Financials	BBB-	3.8	7.2% in $ 5.6% hedged in €	Core
Emerging Markets Debt Local	Emerging Markets	Sovereign	BBB	5.1	7.1% in $ 5.4% hedged in €	Core
Target Date High Yield Expertise 2029	Europe	Corporate	BB-	2.9	5.3%	Dynamic

Source: Lazard. Data as of 31 December 2024.

Past performance is not a reliable indicator of future returns.

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Important Information

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1. Moody's, "Trailing 12-Month Issuer-Weighted Speculative-Grade Default Rates" (PDF - December 2024).

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