Global Short Duration Bond Update

June transcript

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What's been happening this market?

So far in 2025, we've seen increased volatility, wider spreads and steeper curves. Volatility has sharply increased on the back of US policy uncertainty making it much more difficult to forecast GDP growth, inflation and central bank policies. As a result of this uncertainty, we've seen credit spreads widen and yield curves steepen year-to-date.

The Fed (Federal Reserve) is close to its dual mandate targets but with inflation still a little too high and unemployment a little too low, the Fed remained on hold. Meanwhile, the European Central Bank cut interest rates four times to 2% due to sluggish growth and falling inflation while the Bank of England also cut rates but at a slower pace, cutting only two times to 4.25% due to sticky inflation. This supported the global steepening of the yield curves we've seen this year as front-end yields have been falling on the back of lower interest rates, while the long-end moved higher reflecting globalised concerns around government deficits and levels of borrowing, which in practice mean higher supply of government bonds.

Our positioning

We started the year very defensively positioned being overweight cash and sovereign debt, neutral on investment grade credit and underweight high yield and emerging markets due to expensive valuations and an uncertain outlook. We also had a large exposure to US inflation-linked bonds in order to benefit from a potential increase in inflation expectations in the US.

In the aftermath of Liberation day, we took the opportunity of the large market sell-off to add to high yield and emerging markets at better levels while reducing our exposure to US linkers (inflation-linked bonds) to take some profit on a position that performed well. Therefore, we still remain defensively positioned but less underweight high yield and emerging markets.

From a sector perspective, we continue to like financials as they remain strong fundamentally while still offering attractive valuations. With the tariffs situation remaining very fluid and credit valuations back at fair-to-expensive across most asset classes, we stand ready to adjust our exposure to risk assets.

Global Short Duration Bond market outlook

We expect to see a continuation of the trends experienced in the first half of this year. We believe the global steepening of yield curves has further to go making short-duration the potential sweet spot within fixed income. Markets should continue to be very volatile as the outlook for the Fed and the US economy remains unclear due to still high interest rates, sticky inflation, mixed data, and ongoing uncertainties around US trade and fiscal policies.

This volatility also creates opportunities for active fund managers to add risk at better levels, as we did in the aftermath of Liberation day. We believe the European Central Bank and Bank of England will keep on cutting interest rates down to 1.5% for the Eurozone and 3.75% for the UK, supporting the performance of short-dated bonds through lower front-end yields. The situation for the US is much more challenging as while we expect the Fed to start cutting rates again in the autumn, this could be easily derailed by higher-than-expected US inflation on the back of higher tariffs.

Meanwhile, we expect yields at the longer-end to remain stable or even rise further on the back of higher government deficits to fund tax cuts in the US, more defense spending in Europe and support an ageing population.

Finally, we expect short-dated bonds to outperform cash over the medium-term as there is an opportunity cost to stay invested in cash or money market funds As, not only the yield you’re getting on cash keeps on going lower as central banks cut interest rates, but you also miss out on the expected positive performance of short-dated bonds on the back of lower yields.

Source: AXA IM as of June 2025