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The Investment Conversation: What Will Influence Fixed Income in 2025?

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In this podcast, Lord Abbett Portfolio Managers Rob Lee and Steve Rocco explore the factors that could influence the performance of taxable fixed income investments in the coming year.

ANDY D'SOUZA: Welcome back to The Investment Conversation. I'm Andy D'Souza, partner and chief marketing officer here at Lord Abbett. As part of our 2025 Investment Outlook, we're going to talk with our investment leaders about key themes for the markets in the year ahead. And we definitely have a lot to talk about.

And today I'm here with Steve Rocco--

STEVE ROCCO: Excited to be here. Thank you, Andy.

D'SOUZA: Great to have you. And Rob Lee.

ROBERT LEE: Great to be here. Happy New Year.

D'SOUZA: Happy New Year to you too as well, Rob. Rob and Steve are our co-heads of taxable fixed income. And today we're going to dig a little bit deeper into the outlook for 2025 in the taxable fixed income markets.

In the year ahead outlook you both talked about a couple themes around things like above-trend growth in the economy, low unemployment, low inflation, or lower inflation I should say. And since then, we've had some clarity with the election, at least in some ways. So with that, let's talk about the backdrop heading into 2025.

LEE: Sure. So, the recent election in the U.S. I think in many ways surprised on the upside. What I mean by that specifically is there was at least some fear and some probability that we'd get a contested election, we'd get people debating, discussing.

[There were concerns that] we might get violence. We might get a constitutional crisis. None of that happened. We got a pretty decisive, clean election. It happened to be a Republican sweep, but just the fact that we cleared that potential risk event and had a decisive outcome was a positive thing.

There is in addition to that, I think, at least a reasonable rationale for how the markets reacted. What I mean by that is if you viewed the Trump victory and the Republican sweep as positive for risk assets in general, it makes sense because of lots of the potential policy outcomes, which we can talk about more.

But generally, I would characterize it as arguably business friendly, good for capital, in some ways [it] kind of echoes the Trump victory in 2016. Again, I don't mean to make that a political statement, but I think there's good rationale for the way the markets reacted, at least so far.

D'SOUZA: Anything surprise you in the reaction, from the bond market especially, with the election clarity?

LEE: So what I would say here is if you believe that the Trump administration is business friendly and all the policy kind of measures that are likely to come through at least directionally, I would say it is pretty rational that treasury yields would be higher on that.

It means a stronger economy, all else equal. It means no, or unlikely, sunsetting of the original 2017 Tax Cut and Jobs Act legislation or the extension of that in 2026 or sometime in 2025 and no fiscal cliff, if you will, in 2026 all directionally should put upward pressure on yields. And that's one of the reasons we've seen kind of the reaction in the bond market and Treasury yields higher.

D'SOUZA: Outside of fiscal policy in things like maybe immigration policy, tariffs and trade, and/or regulatory policy, how do those things factor into the equation as well?

LEE: I think there are four overarching policy things to think about with the Trump administration. The first I already talked about. That's fiscal policy. That means probably an extension of most or all of that 2017 Tax Cut and Jobs Act, possibly some additional fiscal stimulus.

So, for example, they might increase the SALT [state and local taxes] cap. They might not tax wages coming from tips. They might not tax social security. They might make auto loan interest deductible. These are all just campaign promises, but directionally you're likely getting an extension of the fiscal policy and maybe some additional stimulus.

An aside there is the Department of Government Efficiency. This is Elon Musk and Vivek Ramaswamy. There is an outside chance that that DOGE, if you will (is the acronym), comes in and tries to cut some of the spending and the waste in federal government I think the markets rightfully assume that it's not going to have a major effect for reasons we can discuss.

So that's the first fiscal policy. The second I would say is regulatory policy, and it's very likely in most industries that we will see a lighter regulatory touch. That, in the short term, is probably beneficial to corporations, just less expense on dealing with regulation.

The third I'd say is immigration policy. I think this has probably already had some effect. I don't want to overstate it. This is tightening the border and/or potentially do deportations of illegal, especially criminal and gang activity. That has an effect on labor market supply and a suppressing effect, all else equal, on the amount of at least illegal immigration that's coming into this country.

And then the last one I'd point to, and this one is very important (they all are, but I'd say it's probably for me second-most important to fiscal policy), and that's trade and tariff policy. And here I would say if tariffs are used actively by the Trump administration and used early when he takes office on January 20th that probably means to me initial, I'd call it, maximalist starting negotiating position, meaning threaten tariffs on countries that we think are not treating us fairly in trade.

I think the 2016 playbook makes sense here, in the sense that you might get some retaliation and pushback from other countries, but for the most part (because the U.S. has so much economic weight and impact on the rest of the world), that you're not going to get a big trade war.

That's certainly not my base case. That would be detrimental for risk assets if that happened. But I think you'll get some retaliation but limited. I'd just end by saying all those things, all those policy (or likely policy) measures are likely to be neutral to inflationary or reflationary with elements of them creating some headwinds to growth.

D'SOUZA: Got it. And, Rocco, thoughts? Yeah.

ROCCO: Yeah. So, I think Rob summed it up very well in how a potential Trump policy-- because Trump is a wild card and many of these things could happen and certain things won't happen, but an aggregate I would say modestly inflationary. And that kind of brings me back to the macro regime kind of heading in.

Last year we had a very high nominal growth environment, right? There were parts of the year where we had a growth slowdown in Q3 and then kind of hitting Q4 looks expectation to be 2.5% real [GDP] with an inflationary rate in the mid-twos, puts you in a five nominal environment.

My outlook here heading into Q1 [2025] is growth is going to accelerate, and I think we're starting to see signs of that early, if you look at the service side of the economy, which remains very hot, you look at consumer spending in December. I think it's going to be particularly strong around holiday spending.

Manufacturing has been weak throughout. The impulse there would come more overseas, in my opinion, through China. And we can talk about China and whether they stimulate or not. It seems like there are signs that China is trying to stabilize their economy at least and target the growth rate that they want to target, which is 5%, which has implications for Europe and such.

But overall, I think we're still in somewhat of a modest inflationary type of environment with high nominal growth. And my point on this though when you think about kind of the regime that we could be in here with growth accelerate and inflation modestly accelerating off a low point in the mid-twos, that is actually good for risk, certainly certain parts of risk in leveraged credit and high yield.

It's good for equities in my opinion, not all but some. And so that's kind of the backdrop that I see heading in here with some, hopefully, assist maybe from Europe which is now cutting rates. If you've heard me speak before, we talked about the rate sensitivity of the U.S. economy not being very high, in my opinion.

We saw that right when rates rose. It affects certain parts of the economy, like housing, although you would expect commercial real estate and all the speculative activity, but it really didn't affect the consumer. There's much more rate sensitivity in Europe.

And now Europe is cutting so maybe that can play through and you get a little bit more of a positive effect out of Europe, which will play into that kind of manufacturing piece as well. And then we just discussed China briefly. If China kind of surprises and releases some stimulus on the consumption side, which I think is key, that could be important for the outlook here.

But for me it adds up to-- and we'll get to where the 10-year [Treasury note] should trade, and I think what we've seen is just a lot of normalization, obviously a big move in rates but a lot of normalization. The 10-year should, in my mind, trade close to level nominal GDP [gross domestic product]. And right now, that's looking to be close to 5%, and that's kind of what we are positioning for here in the short term.

D'SOUZA: And speaking of the 10-year [Treasury] I guess in terms of rates, we have seen rates tick higher on the 10-year recently. You read headlines out there about the "bond vigilantes" and it hearkens back to the days of [President Bill] Clinton and James Carville and the power of the bond market.

Do either of you have thoughts on this in terms of is the bond market telling us something? Is it the bond vigilantes out there telling us something? And with rates going up are there concerns

about government debt and government deficits? Are they real and/or concerning to you all as well?

ROCCO: Yeah. So, I'd say a couple things. And first, let's start with the Fed. I'll get to the bond vigilantes. The Fed [U.S. Federal Reserve] cut [interest rates by] 100 basis points and rates rose about 100 basis points. And what I've been telling the team, in my view, I think it's a little bit of a policy error and not as big a policy error as we saw in '22, where the Fed was very dead set on transitory [inflation].

Obviously, inflation was not transitory, and inflation was above 7% at one point in time. But a policy error in the sense that I, in my personal view, don't think the Fed is all that restrictive. And I just mentioned I think the economy's pretty strong, and I don't think there were a lot of good reasons to cut as aggressively as they did.

And I think we're seeing that, and I think they will see that. And obviously, the market's catching up to that view. And if you look at the Fed cuts that are priced in for this year it's about 35 basis points, so not much. And that may all go away here in the short term if my kind of growth outlook comes to pass.

And think that's why you've seen rates move higher. Now, do deficits matter? Absolutely they do, okay? And that affects what you'd see in the bond market in term premiums and such. But to me it's more, "You tell me what nominal growth's going to be and I'll tell you where the 10-year [yield is] going to be."

Not to say that you couldn't see a government bond auction fail. That would be extreme. But certainly the level of-- buyer base or demand for Treasuries, right? If we need to talk about bond vigilantes, why they disappeared, well, there was a big buyer of Treasuries that's no longer a big buyer of treasuries, and that was the Fed.

And certainly now to get the person to buy you would expect maybe some higher-term premium in this type of macro backdrop. And that's what I see. But I don't get carried away with deficits but recognize that certainly running these types of deficits in the type of environment we're in is somewhat troubling longer term.

D'SOUZA: Rob--

LEE: Yeah. The only thing I would add here, really, I think restating what Steve said in my own words, is the first is forget policy for a second. The underlying strength of the U.S. economy is one reason the 10-year Treasury has risen in yield. Resilient consumer, more balanced but still pretty solid labor market as far as we can tell.

Underlying strength of the U.S. economy, American exceptionalism, outpacing almost every other developed country. So that's the underlying economy. From a policy perspective, monetary policy, it is possible the Fed has made another mistake.

They cut 100 basis points in the fourth quarter of 2024, including the so-called "outsized" initial 50 basis-point cut in September, because they thought monetary policy was restrictive. And I think by their standard models and definitions, and they have a lot of very smart people, I think it's a reasonable outlook or view to say that monetary policy was restrictive.

If inflation is around 2% or 3% and [the] Fed funds [target rate] at the peak was 5.25% or 5.5%, that (by the Fed model), says, "We're pretty high in inflation on the fed funds rate, and that's restrictive." I think a broader interpretation of financial conditions suggests maybe those outsized cuts and 100 basis points were unnecessary.

And what I mean by that is, well, even before the last few months stocks were at or near the highs, Bitcoin and other cryptocurrencies were doing well, home prices were near the highs, credit spreads were pretty tight, the broad interpretation of financial conditions could argue, "Hey, maybe it was premature, these 100 basis points of cuts."

So, you have a strong underlying economy. You have potentially the Fed cutting when they may or may not have needed to. And then on top of that (and we talked about this), the outcome of the U.S. election, the unified Congress and legislative branch under the Republicans, most of those things are either inflationary, reflationary, or some of them a little bit stagflationary, in my view.

I don't want to overstate that, but that's the reason you're getting higher yields. Where the rubber meets the road is, yeah, do market participants see that and are some of them worried about it? Yes. That's the bond vigilantes you talked about. I don't want to overstate that because the dollar's been pretty strong.

If you really had a crisis of confidence in the U.S. government's ability to repay, you'd probably get failed Treasury auctions or much weaker ones. And we've seen some weakness but nothing outsized. And you would arguably get a weaker dollar, and that hasn't really happened.

D'SOUZA: You've said in the past as well about the Fed being data-driven. I think they've said that as well. They want to continue to be data-driven overall. So [Fed chair Jerome] Powell's saying, "More restrictive," you all are saying, "Not so sure they were restrictive." Where's the data discrepancy here? Is there one or is it just interpretation--

ROCCO: Well, I think they're starting to question it now, kind of what the neutral rate should be, and they don't know. I think no one really knows. They're feeling their way. But, especially now, after Trump won and you have these potential policy implications on top of what we just talked about, my guess is they're questioning it now.

You saw that in the last [post-FOMC meeting] press conference. There was a lot more uncertainty there, and they're kind of feeling their way. I think they will still be data-dependent, and they do have a dual mandate [to contain inflation and foster full employment], right? So, if the labor market weakens and we're wrong, they'll respond to that.

But right now, it's not looking that way, and so that's why you've seen all these cuts get priced out. But there's a difference though, and the Fed obviously cut 100 [basis points]. There's a big difference between cutting, holding, and then raising rates. And we can touch on this now or later, but we said late last year (and maybe it was a little bit more controversial but I'm starting to hear

more people talk about it), that a hike isn't-- I always think of outcomes in these very uncertain and the probability distribution that I would actually have a hike in my probability distribution at a low probability in the back half of the year.

And so, I think we're starting to hear a little more people talk about that. It's early. But it's in my probability distribution. It's one of the risks I would have for '25. Because then we talked also about the idea of what they will tolerate, right, and do they truly believe in their 2% target.

I think they do. I don't think they're going to change it. So, they'll be patient. I think they will be patient. But I don't know how much patience they will have. And you can have an idea of having too much of a good thing, right, if all these fiscal policy, new fiscal policy, gets unleashed, economy's doing pretty well, there's such an idea of too much of a good thing. And the Fed may respond to that. It's not for right here and now, but it's something to think about in the second half of the year.

LEE: Here's what I would add. So, the Fed, at the risk of stating the obvious, has a difficult job. Monetary policy works with (and we can debate this but), long and variable lags. What they saw in studying the economic data I think was, "Hey, the labor markets have normalized and are much more balanced than they were a couple of years ago."

The unemployment rate, as one important statistic, went from a low of 3.4%, which was very, very low historically, and went up to 4.2%. that's the last read as of this moment. Three or four months ago people were talking about the Sahm rule. The Sahm rule is, "Okay, the three-month moving average of the unemployment rate was 0.5% higher than the lows of the last 12 months." So they saw a softening labor market. They know that monetary policy works with a lag. They wanted some insurance cuts because they don't want to be overly restrictive.

On top of that, and you mentioned this, inflation's come down. It's made a lot of progress. CPI [the U.S. consumer price index] topped out in mid-2022 at around 9%. And now, depending on whether you use headline or core [inflation measures] and what month you're looking at, we're around 2.5% to 3%.

So, you see some softening of the labor market or normalization. They saw inflation making very good progress. They think, or thought, they were in restrictive territory. It's not completely irrational that they did that. Remember, three or four months ago the 10-year Treasury [yield] was 3.6%. Market participants were worried about a downward spiral in the labor markets. So, it's not 100% clear, and I'm not here to be a Fed apologist or defend them. You know what we think and how we're positioned.

ROCCO: Yeah, they do. I agree, Rob, they do have a difficult job. I don't want to be kind of super critical of it. And by the way, what we're talking about here (and I mentioned this up front), when I say inflation accelerating it's not from 2% to 7%. We're not talking about 2022. We're talking about from 2.3% to maybe 2.7% or 2.8%, year over year. And there's nothing wrong with that actually in the kind of growth environment that you're in. The '90s were a good time to invest. It just probably doesn't mean that your 30-year [Treasury bond yield] should be at 3%, okay, in that environment. That's all.

And there's certainly a lot of attractive things that you can do. We'll talk about it in fixed income in that environment that we have been doing in our portfolios. But what always surprises me, and I think you kind of look at it even coming into this year, I think if you look at the average of 50-plus economists, what they expect the 10-year [Treasury yield] to be, the average I think for this year is below where we are now, which has been I think always the case in these last two or three years.

So, they've been wrong. And I think the high point, someone has 5%. And then I also see all these inflows into the bond-- there's been a bond bear market, right, on the rate side, obviously not so-- credit's been strong here recently. And you look at that and you see all these flows into TLT [the iShares 20+ Year Treasury Bond exchange-traded fund], right? TLT is the longer Treasury ETF-.

And that's always surprising to me because if you pull up the TLT [ETF price] chart right now, it's a bad looking chart, right? And usually when you see those types of charts you don't really see inflows associated with that. But there's a lot of people, my point is, who are still trying to bottom-tick rates from a yield perspective.

And personally, from a sentiment perspective, from that perspective, I'd love to see that change. I'd love to see that change and more people recognize kind of the environment that we're in before we actually want to cover duration here aggressively in our portfolios.

D'SOUZA: Well, I guess so duration's one aspect of it, right? Another aspect here is credit, right? We've talked about this a bit in the past as well recently that across the spectrum of fixed income yields, relatively speaking versus a couple of years ago, a lot higher, relative and absolutely, but spreads remain tight and have been tight for quite some time. So how do you think about that?

ROCCO: Yeah, listen, in fixed income there's a lot of math. Some of it's complex, some of it's simple. You have positive real [inflation-adjusted] yields across the maturity spectrum. That's a great thing, right? And we take an asset class like high yield, it's always depressed me to invest in high yield when you had a 3% coupon or 4% coupon.

I wouldn't call that high yield and on top of that tight spread. Now clearly you have tight spreads, but you have a starting yield after kind of the moves in December of 7.4%. So, I think that could be a reasonable expectation of what your return will be.

Now, we never really have coupon years [i.e., when returns exactly mirror a bond's coupon]. We know that. They're rare. And there'll be always something that surprises us. But that's a reasonable expectation, and you can kind of work through the math of what you expect on duration, what you expect on default loss.

I personally think default loss is going to be very low this year. And, as I mentioned up front, in a high nominal growth environment you want to own the riskiest stuff. And high yield's some of the riskiest stuff in fixed income. So, I think that's a reasonable expectation.

And one of the opportunities that we saw when we talked about it in the last outlook in the last podcast we did was that triple C opportunity that kind of came to pass for us. Now it's kind of less clear if there's a big opportunity in triple C.

Certainly, [spreads] can tighten from here. So, your swing factors there in that return may be a little bit more muted. But that's a good starting point. And then if you look at kind of how we've been positioned in the department (and we said this in the last podcast, I think it's mostly been right), is we like the front end.

We feel we're not getting paid to extend out, to go out the curve, and things are dynamic and changing. And we touched on term premiums and those are changing and are in motion right now. Maybe there'll be a point in time where we do go out the curve.

But right now, we feel the best carry opportunities are on the front end. So, if I think about an asset class like high yield, it's short high yield. If I think about securitized products that you look at a spread over your overnight rate, those are relatively attractive in what you're getting for that type of credit quality.

So, you think of things like triple A [AAA-rated] CMBS [commercial mortgage-backed securities] or triple A CLO [collateralized loan obligations] or even things further down the credit spectrum within CRE [commercial real estate] or within CLO or in ABS [asset-backed securities]. That's been our preferred habitat. So those floating-rate instruments combined with short high yield and less so 30-year high-quality investment-grade bonds.

And mortgages too I think have suffered in this environment. And we can touch on mortgages, and Rob obviously is a mortgage expert. Mortgages have suffered. The carry's good, but you have a lot of rate volatility as well on top of that. And there's obviously technical [factors] in the mortgage market that are not as favorable as some of these other credit markets, which we can get into.

D'SOUZA: So, you touched on quality in terms of the triple C ratios and relative value there that we saw and realized. You talked about the maturities, relatively speaking, in general terms shorter in your mind is where there's a lot of value right now. Some of the sectors maybe around securitized [product]. Are there any other sectors or industries that either of you are looking at as far as opportunities right now in terms of pockets of where to look for some great potential returns in fixed income?

LEE: Sure, I'll answer that question in a moment. I just wanted to add one thing. So, perspective and a study of history matter. You're right. Credit spreads are pretty tight nominally. Versus long history that's true in investment-grade corporates. That's true in high-yield corporates. That's true.

The history that one needs to look at and I think is wise, "Can spreads stay at these levels or at relatively below-average (long-term average) levels for reasonably long periods of time?" Any study of history suggests yes. And why does that happen?

It all comes down to the fundamentals and the technicals. The fundamentals are strong. Corporate America is profitable. I don't want to paint too broad a brush, but corporate America is profitable. Debt service coverage ratios, leverage ratios, not every single part of the market, but pretty healthy corporate America.

It's tied to the high nominal GDP that Steve talked about. It's tied to the resilience and the underlying strength of the U.S. economy that we talked about. All those things matter. And a little perspective helps. So just because spreads are tight it doesn't mean one should be, run for the hills, underweight aggressively.

It also doesn't mean though you need to be heroic in some of your positioning. Steve talked about some of the positioning and the opportunities that we have. The last thing I'd say, on yields (the all-in yields), versus the tighter credit spreads perspective matters here too.

So the 10-year Treasury, if it's between 4.5% and 5% recently, look at a 40-year history. You know where it is? Around that range. It really depends on where growth and inflation and policy are. So I'll pause there and then--

ROCCO: What is normal, right? To me, -this is very normal, and we're just going back to normal. What was abnormal? The COVID period was somewhat abnormal. The Fed buying all these bonds, abnormal. Doesn't mean you have to overreact, it's just a normalization. Now, that normalization process, there could be some casualties. And there have been some casualties, and maybe there'll be more casualties if base rates tick higher.

And we can talk about that too. But that's the way I view it. And I agree, this is a market you can control your beta, and you want to control your beta, but you'll have to make sure that as active managers you have enough if you're bullish that you can keep up with both indexes and peer groups.

LEE: In terms of industries of sectors, getting back to your question, I'll use two from the investment-grade corporate universe that we like now. The first is utilities. Now, everybody who's paying any attention knows that artificial intelligence, especially [generative] AI, is a thing.

And when I say a thing, I mean meaningful, potentially very impactful, but at the very least massive amount of money getting spent investing in everything from the right GPUs and semiconductors and chips to the data centers and the hardware.

And to power all of that you need electricity generation and sometimes in massive quantities, especially in the exponential nature of the spend and requirement to train these models. That has implications. We like utilities. We think not every utility but certain of them provide attractive opportunities. So that's the first.

I think that secular trend or at least the momentum behind it (we can debate whether it's secular, the momentum behind it), in the foreseeable future is still pretty solid and strong. The second is banks. So, we had, what I call, a mini crisis in retrospect, but a regional bank crisis in spring of 2023. We're almost two years past that. And it was a hairy time certainly and not every regional bank made it. But the ones that did probably strengthened. The Fed came in, with help of the Treasury, and established programs which, if need be, they could roll out again.

But it's also about the fundamentals. The fundamentals are that banks are in pretty good shape. The yield curve is no longer inverted. I'd say loss expectations, loan loss provisions, NPLs [non-performing loans], the underlying credit quality even with a

good part of commercial real estate loans (not all of it and there's some hairy stuff), in pretty good shape.

Profitability's pretty high. Net interest margins are decent. The regulation is probably going to be lighter under a new Trump administration, and likely M&A (for those who are involved more in the capital markets, kind of the money center banks and the ones that are more capital markets-focused) probably a tailwind on fees. So, I'd say those are two industries within investment-grade corporates that we think are appealing.

D'SOUZA: Utilities and banks.

ROCCO: Yeah, I'll touch on this. It's much easier to talk about this if you were doing equities. You just have much more positive convexity, and certainly in a really compressed spread market sometimes the name of the game is just avoiding bad things.

We can touch on some of that too. I'd say a couple things though from a long perspective. One would be things around the data center. Tangential to that would be natural gas as a bridge fuel. There's been a lot of talk of nuclear [power], and nuclear's a great kind of base fuel for power plants and such, but it takes a long time to permanently build nuclear, and it's a very difficult process.

Not saying it won't happen, but what's very clear is [one] clean bridge fuel will be natural gas. That's one. There are certain gas opportunities within high yield. As we know, high yield is about 15% energy [based on the composition of the ICE BofA U.S. High Yield Index], so there's plenty of energy opportunities within high yield that we're taking advantage of there.

Fiber, industrial, there's companies in high yield that we like that are tied to that, into the data center. And then even in commercial real estate, right, what's great about our process, we can go into our multi-sector strategies and our core and core-plus strategies, short duration strategies, buy a lot of CRE.

It's tied to data center, maybe "mezz" [mezzanine financing] and even triple A. That works there too. And as Rob mentioned, we do like banks. I do like regional banks. There are some regional banks that dip down into high yield that are coming back into investment grade that we think are very attractive.

In the consumer sector, a lot of that's compressed so we have to look for opportunities there. And then what we're avoiding is -- now, it's no surprise, a lot of the interest rate-sensitive stuff here. So kind of longer duration, interest rate-sensitive stuff, which would be kind of in building products and parts of housing.

It's not necessarily bad, but it just may take longer in this rate environment to get that going again. When you think about moving and housing starts and what's needed to get that activity rolling, higher rates slow that down for sure. So that's kind of what we're thinking about from a sector perspective.

D'SOUZA: You mentioned some of the challenges out there that we're seeing bits and pieces of here and there. There was an article recently around bankruptcies in the U.S. being at a 13-year high. You see discussions about traditional default rates then also now something that seems to be more and more prevalent, the idea around LMEs, or liability management exercises. How do you kind of make sense of all this, Steve? Is this sort of something newish to be thinking about or thinking about in a different way? Or how do you make sense of all that--

ROCCO: Yeah, well, we joke that nobody defaults anymore, which is true. You got to be in really bad [shape] to default because you've seen all these LMEs, and I think that will continue. And let's touch on a couple different things here. One is I mentioned up front high-yield default rate is very, very low.

And the high-yield index [the ICE BofA U.S. High Yield Index] is the cleanest [in terms of credit quality] it's ever been in my career. That's not to say it won't change. I think it will modestly change this year, and we can talk about the return of M&A and dividends and such that will cause that, which is starting to happen.

And this gets into kind of the "animal spirits" [present in the market]. But it'll take a long time to change that. A good rule of thumb for defaults, you look at the distress ratio in high yield, things that trade above 1,000 [basis points in] spread, right now that's about 4%. The rule of thumb, about a third of that's in your default rate 12 months out.

Right now, you're default rate's sitting right around there. It's sitting low ones [in the low-1% range]. It's very, very low. That's what I said up front. I think you have a very low default rate in high yield. And obviously you combine that with my top-down view of high nominal [growth], it's hard to get all those defaults, right, and then obviously the LMEs.

And some of those obviously count as technical defaults, right? So you can look at hard default and default with distressed exchange, but both those numbers are very low in high yield. Not so true in loans. This is one of the things that people are talking about.

Well, [the default rate on] high yield is sub 1.5%, loans are about 4.2%, and if we could pull up a chart here (which we can't), you would see the loan being up and to the right. And a lot of that if you think about kind of the high-yield index being clean, the loan index was the index that absorbed a lot of the private equity activity, a lot of the sponsor deals that are obviously more highly levered.

At a time where base rates were lower and now you have higher base rate and floating, your coverage ratios are dropping. So, this is true in loans. It's true in parts of private credit as well. And so, I think that divergence will continue, and the pressure will continue to be on these companies as rates tick higher or move higher if that's going to be the outlook here.

The good news is what's more detrimental to the loan market and the private credit market would be more of a stagflationary environment where your top line isn't growing but your bottom of interest expense still is. I don't see that in the intermediate term. So, if you can get the top line growing with the bottom growing maybe your DSCR [debt-service coverage ratio] can somewhat stabilize.

But that's something you would worry about. And there was certainly their fair share of bad lending in the loan market. That said, you look at loan returns and we talk about what's the opportunities in floating rate, loans were up probably 8.6% last year.

That's pretty good. So, for an active manager kind of coming in there (and you can pick your spots), we like a lot of the large parts of the loan market but recognizing that in a large swath of the loan market obviously, CLOs are the big buyer there.

It's kind of "adult swim." And so, we've just have to be very careful there. And so that's something I see. We haven't talked about PIK deals. There haven't been a lot of PIK deals or pay-in-kind. You may see more of that when you see the [special] dividend deals.

I think our expectation is you'll see more dividend deals (you started to see it in Q4) especially with financial conditions where they are. And a lot of these private equity-owned companies, they're looking for exits, right, whether it's a traditional IPO or dividend. So, it's all set up for them to do that, as long as things are doing pretty well. So, I think you'll see that, and you'll see your fair share of LMEs, mostly on the loan side, as well.

D'SOUZA: Rob?

LEE: The only thing I'd add here is, besides repeating the strong fundamentals and in most sectors of the bond market pretty prudent underwriting over the last few years, there's a resilience and robustness there. The only thing I'd add on LMEs, liability management exercises (and this may be a little self-serving), is, Steve said it, it's adult swim.

You better have deep, fundamental research. You better have professionals who are expert in understanding what can happen. It's definitely adult swim. This is not for the faint of heart. And being very detail-oriented, having the knowledge and expertise, being willing and able to do that very hard work of studying and reading the documents, protecting one's investors and clients from potential negative implications from LME or other [things] is a very important thing.

Steve's the real expert on leverage credit and thus LME. The one thing I would add is (and this might date me a little bit), I remember the old days when liability management exercise meant you have some upcoming short-term maturities, and you need to extend them out to give you more time so you don't have imminent default if you're having problems in your business and your cash flow. LME now is something different.

ROCCO: That's right.

LEE: It has morphed into, "Are certain groups of creditors, lenders, doing something that is detrimental to another group?" That's what it means now. And Steve is 100% right. When the documents and the covenants that (this is all the detailed credit work that I mentioned before), are written loosely enough that it allows this type of behavior, you better be the sharp end of the stick.

You better be doing that detailed research, reading, and understanding late into the night and being proactive, and then if you have to be reactive at times, having the bandwidth, the wherewithal, the expertise, the relationships, the experience to handle all that, that's what differentiates one active manager from another.

ROCCO: This is a very good point Rob is making because what we're talking about here, traditionally, right, in the bankruptcy, you have a first lien, maybe a second lien, you have an unsecured, right? The unsecured, probably the equity, right, in the future. And the first lien, there's a dip and you may get full recovery on your first lien and such.

What we're talking about here now, what's different is, you have first-lien loan holders or bond holders fighting with other first lien loan holders or bond, trying to benefit one holder group in the first lien at the expense of the other.

And that's hard, right? That's difficult, right? That's a difficult situation to be in, right? And maybe that will change. And certainly these things ebb and flow. Generally speaking, we're always flowing to something looser.

But over time there's things-- people, the market adjusts, right, and there's certain blockers that go into covenants and certain things that were done to people that are in documents that won't be able to be done before but then the market always finds a way to do different things that are not favorable. It's just the nature of things, right? It's a classic collective action problem when you think about covenants. But that's what we're talking about here. That's different than 10, 15 years ago.

D'SOUZA: You mentioned earlier one of the sectors or industries you liked would be the banks, and part of the rationale I think was around maybe M&A picking up a little bit in the future if that's right and then some discussion of animal spirits-- private equity [PE] looking to return capital and look for exits for their clients in PE-land. And we've seen, what, $2 trillion-plus of dry powder now sitting on the sidelines. So, you think that gets put back to work this year or in the near future?

ROCCO: Absolutely, I do. I think it's a big story. I think it's going to be one of the challenges kind of figuring out these levering events and do you want to buy. You may like a credit that was three turns of leverage now it's going to six. Kinda what do you want to do there?

It may lead to some of the index deterioration. We'll see. I think you're going to see more M&A. You've already seen it at the start of the year. And I think you're going to see a more bold type of M&A, where maybe a number one player tries to buy a number three player, which would be very beneficial for the number one player, obviously.

That could become a super strong number one player taking out the number three. And you've actually seen an example of one of those things happen today even. So, I think you'll see a lot of that. I put that all in the animal spirit bucket. And I think that's all rational actually for the time being kind of given the appointments that we're going to see in the FTC [the Federal Trade Commission] and such.

So that is I think one of the stories to start the year. And I think it's going to make our jobs a little bit harder, at least from a high-yield perspective of trying to figure out how much we're willing to embrace of that at a tight-spread level, because the history of dividend deals is not a great history, especially the PIK toggle variety.

I'm not saying that's going to be the first iteration. What you'll see first is some of the best probably, some of the stronger companies. But that's also tough too. You own something that was six turns of leverage, went to three, you rode that down. You made your money for your clients. "Hey, now it's gone back to six again." That second time around you have to really think long and hard if you want to be there for that part, the next part of that story. But you'll see a lot of that, I think.

LEE: Here's the only thing I'll add. It's pretty clear that regulatory policy (for the most part, not every industry), is going to be easier. It's going to be looser. That's neither good nor bad. I don't make a moral judgment as an investment professional.

That directionally, maybe with some exceptions, is very likely to happen. When you tie that to the boost to animal spirits that Steve mentioned, it's pretty clear what is likely to happen. Something could hit out of the blue and derail that, but (I don't know if I'm allowed to mention a lot of the)-- if U.S. Steel and Nippon [the proposed acquisition of U.S. Steel by Nippon Steel], which might be a special situation, if Tapestry, Capri, [the proposed merger between Tapestry and Capri Holdings] there's so many examples where—[the] Kroger/Albertsons [proposed combination], you could talk to Steve in great detail about these, and I'm not making a judgment of what's right or wrong from an antitrust, regulatory point of view, it is pretty clear that the bar is not going to be quite as high to get those things done.

And that creates risks and opportunities all around. If, as an example, the larger (and in many cases), investment-grade-rated companies are buying smaller high-yield companies, that could in some cases be good for high yield because you get absorbed into larger, more stronger capital structure, less leverage.

But depending on how that's financed that could increase the leverage and the burden to service debt by investment-grade corporates. It doesn't mean we're running scared. It means these things need to be thought through industry by industry, company by company. But the direction's pretty clear.

ROCCO: And the point I'll make there, that's a good point, I think and this gets into kind of sentiment a little bit too because you've had a lot of strong years post-COVID. Obviously, '22 was a bad year. '23 was a very good year. '24 was a very good year in stocks and credit as well.

Normally when you've seen this you see a lot more M&A, right? You see a lot more aggressiveness. We haven't seen a lot of that at all. So, my point on this is I think it'll happen, but you're starting off a very low base, right? And if you go back to 2007 in the lead-up to the Financial Crisis, man, you have a long way to go before you get to that level, right?

So it's just getting started. Some of it will be good, right, as you make the point that there'll be IG [investment-grade rated] companies buying high yield. You've already seen that, private equity companies taking out high-yield bonds that may have to come out. Some of it may be bad with certain leveraging, dividend deals, and such. But it's just getting started. And that's what's so unique about this cycle because by now I think you would've seen it. And so, you have a long way to go before that's kind of flashing red from a sentiment kind of perspective.

Because when you think about, what's a good indicator for default? The amount of triple C issuance in the index and look out two years. And that's going to be your defaults, right? And you haven't seen any triple C issuance in the index, right?

It's been much lower and shrinking. But that can all change. But it'll take a long time to get back to what I even consider what is normal actually in terms of M&A and dividends and triple C issuance. So we have a long way to go. It's just getting started.

D'SOUZA: Gotcha. And then if we think about this idea of convergence between the public and the private credit markets, and we've seen quite an evolution of the private markets over the last, call it, 10, 12 years or so, now with CFOs having the optionality to issue in either or both markets, how do you see that evolving as far as an opportunity? Or someone like us, who's playing in both markets, how do you see that as sort of playing out--

ROCCO: Yeah, well, I think you definitely want to have ability to execute at both sides. I think sponsors will appreciate that and value that. I think the game that's being played will be one of volatility. So, what I mean by that is in a low-volatility environment, which we generally have been in here this year (or last year into this year), the syndicated loan market, it's a cheaper, a better way to finance yourself versus going private.

But where you'll value that private opportunity will be in a higher-vol environment where you need that certainty, right? And so, I think in a low-vol environment, which we have, it's not surprising to me that we've seen a lot of syndicated loan issuance, a lot of private deals going public.

That will flip in a higher-vol environment where companies are going to value the certainty of dealing with one or two lenders, but they'll have to pay a higher price for that. And that relationship will be traded actively. And that's what you're seeing, right?

I think the average private deal right now, probably 475, 500 [basis point] spread. Syndicated loan market, you're 300 or even lower than that. So, the benefit right now is to syndicated market, but that could change. So that's what I imagine sponsors, treasurers and such and CFOs will be thinking about when they think about this kind of convergence. But I think, as an investor, as a firm, we want to be on both sides of that, and we are now.

LEE: Here's what I would add. So, you use convergence, I'll use worlds are colliding or they're merging. In some sense any borrower, someone who needs to borrow money, a company or other, it's nice to have options, whether it's the public markets or the private markets, in some way just lending.

There are very important differences where the rubber meets the road in the detail, but in some big overarching market structure way from, let's say, a corporate borrower it's nice to be able to access at times the public markets. There are lots of advantages to the public markets.

And when those are less available or you need more certainty or more creativity on the documentation or more privacy, being able to access the private markets (in our case private credit or asset base or asset-backed finance), matters.

And for us, as investment managers and professional investors, understanding that whole market structure, that whole ecosystem matters a lot. Steve talked about the costs to the borrower and then the opportunity and the income to the investor. That matters.

We talked about covenants, and they differ from private credit to the broadly syndicated loan markets as an example. These are choices where the nuance, the detail really matters. But overarching view is in some ways (and this is the beauty of the American capital system), life finds a way, meaning if the banks get disintermediated because of regulation or other, the growth of private credit makes sense in kind of taking up that lending capacity--

ROCCO: -- andarguably healthier.

LEE: And healthier, right--

ROCCO: We know where the lending maybe should be, from a banking perspective in the next crisis, right, to have it kind of off bank balance sheets.

LEE: It's in strong hands. If the private credit end investors are locked up and they know they're locked up, getting higher yields and returns for five or eight or ten years, it's in strong hands in some sense.

D'SOUZA: Rob and Steve, thank you. That's been our investment conversation and outlook for 2025. Appreciate you being here. Always a pleasure talking with both of you.

LEE: Thanks for having us.

ROCCO: Thank you, Andy. Here's to a great 2025 for our clients.

D'SOUZA: Happy New Year, gentlemen.

Thank you all for listening. Be sure to visit the insights section of lordabbett.com to find our complete investment outlook and other market commentary.

GLOSSARY OF TERMS USED IN THIS BROADCAST

Asset-backed security (ABS) is a security whose income payments, and hence value, are derived from and collateralized by a specified pool of underlying assets.

Base rate: Variable interest rates fluctuate in line with a base rate which, typically, shifts in reaction to market factors.

A **basis point** is one one-hundredth of a percentage point.

A **bond vigilante** is a bond market investor who protests against monetary or fiscal policies considered inflationary by selling bonds, thus increasing yields.

The **breakeven inflation rate** is a market-based measure of expected inflation. It is the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity.

Bullish refers to an optimistic outlook and to a belief that certain investments may potentially increase in value in the future. **Bearish** refers to a pessimistic outlook, and generally refers to a belief that certain investment prices may fall in the future.

Collateralized Loan Obligation (CLO) is a special purpose vehicle (SPV) with securitization payments in the form of different tranches. Financial institutions back this security with receivables from loans. Collateralized loan obligations are the same as collateralized mortgage obligations (CMOs) except for the assets securing the obligation. CLOs allow banks to reduce regulatory capital requirements by selling large portions of their commercial loan portfolios to international markets, reducing the risks associated with lending.

Commercial mortgage-back security (CMBS) is a type of mortgage-backed security backed by commercial and multifamily mortgages or mortgages on commercial property.

Convexity is a measure of the non-linear relationship or the curvature of bond prices to changes in interest rates. Negative convexity is when the bond price falls, rather than increases, as interest rates decline.

Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

A **covenant** is a condition in a commercial loan or bond issue that requires the borrower to fulfill certain conditions or which forbids the borrower from undertaking certain actions, or which possibly restricts certain activities to circumstances when other conditions are met.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates.

The Federal Reserve (Fed) is the central bank of the United States. The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

The federal funds rate is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Fiscal dominance refers to the possibility that the accumulation of government debt and continuing government deficits can produce increases in inflation that “dominate” central bank intentions to keep inflation low.

Liability management exercises (LMEs) are strategies that companies employ to restructure or refinance their debt outside a formal bankruptcy process.

Mezzanine financing is a hybrid of debt and equity financing that gives a lender the right to convert debt to an equity interest in a company in case of default, generally after venture capital companies and other senior lenders are paid.

The **neutral rate of interest**, also known as r-star, is the real short-term interest rate expected to prevail when an economy is at full strength and inflation is stable.

A **payment-in-kind (PIK)** bond refers to a type of bond that pays interest in additional bonds rather than in cash during the initial period. The bond issuer incurs additional debt to create the new bonds for the interest payments. A **toggle note** is PIK bond in which the issuer has the option to defer an interest payment by agreeing to pay an increased coupon in the future. With toggle notes, all deferred payments must be settled by the bond’s maturity.

Probability distribution shows forecasted potential outcomes of possible values. The most used distribution is the normal distribution, which is used frequently in finance to estimate forecasted outcomes relative to a historical average.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

The so-called “**Sahm rule**” signals the start of a recession when the three-month moving average of the national unemployment rate rises by 0.50 percentage points or more relative to the minimum of the three-month averages from the previous 12 months.

Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation.

Term premium is defined as the compensation that investors require for bearing the risk that interest rates may change over the life of a bond.

The **U.S. Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment’s cost, current market value, or face value.

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Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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