Buy quality bonds

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- **Why?** (1) US yields look set to decline by the end of the year as the US economy cools and the Fed starts cutting rates again. (2) We expect government and investment grade debt to deliver mid-single-digit returns over the next 12 months and more in an economic downturn. (3) Medium-tenor quality corporate bonds can deliver stable and decent income.
- **Why now?** (1) The rate-cutting cycle has not yet run its course, in our view, with the Fed likely to ease by 100 basis points over the coming year. (2) Against this backdrop, we believe current yield levels offer an opportunity to lock in durable portfolio income. (3) By diversifying portfolios with select medium-tenor quality corporate bonds, investors can lessen the impact of potential market swings in riskier assets on overall performance driven by tariffs, geopolitical conflicts, and concerns over economic growth and sovereign debt sustainability.

We prefer quality fixed income, which remains an important part of portfolio diversification for investors, providing liquidity, income, and portfolio stability.

Quality bonds
Given cash's long-term underperformance versus other asset classes, we see quality bonds as a credible alternative for investors seeking durable portfolio income. Historically, the probability of bonds outperforming cash rises with longer holding periods—from 65% over 12 months to 82%, 85%, and 90% over five, 10, and 20 years, respectively. We expect mid-single-digit returns for medium-duration quality bonds in US dollar terms over the next 12 months. Quality bonds also look appealing in a downside scenario. If US economic growth disappoints and data weakens, we expect quality bonds to rally, potentially delivering significant capital gains.

We see an attractive opportunity to lock in carry yields from investment grade (IG) corporate bonds with medium tenors. Our "Quality income" investment theme is driven by three key factors: (1) the ongoing global central bank easing cycle, (2) very tight spreads on riskier bonds, and (3) the importance of careful bottom-up selection in an environment of heightened economic and political risks.

Select credit opportunities in APAC and Europe
CIO recommends a selective approach, focusing first on building a "core" allocation to higher-rated, less cyclical, and domestically oriented issuers—especially outside the US, where companies generate most revenues at home and are less exposed to US trade and tariff policy risks. Sectors such as banking, utilities, telecommunications, and real estate continue to offer attractive yields and sound credit profiles, in our view. CIO also sees value in select capital goods and defense companies, given anticipated infrastructure and defense spending in Europe.

For investors with a higher risk tolerance, CIO highlights opportunities in select subordinated bonds and BB rated "rising star" candidates, which can enhance portfolio yields and offer capital appreciation potential. We believe investors would do well to avoid fallen angel candidates, M&A-exposed names, expensive cyclicals, and distressed credits.

In Asia, we also see opportunities in Asia investment grade credit, underpinned by elevated yield levels of above 5% and tailwinds from a declining interest rate environment. We are also comfortable with modest Asia HY exposure as part of a diversified portfolio, given sound fundamentals and limited risk of a broad-based default cycle.

Sector-wise, we think Asian bank credit continues to offer good value given its solid capitalization profiles and benign asset quality. Aside from Hong Kong banks, we are generally willing to take on more subordination risk for yield pickup. Within Asia IG, we like Korea IG and select Indonesian IG as stable carry plays. In the Asia HY space, we like the Macau gaming sector due to its solid fundamentals. We are also comfortable with some improving credits in the commodity space.

Appendix

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Version A/2025. CIO82652744