AXIOMA
Wealth Management AG

2025 Fixed Income Investment Strategy

19 December 2024

Table of Contents

2024 – Summing Up

- We were right to assume that the market will rally before the first rate cut comes. In fact, for the period Nov'23-Mar'24 our Fund has demonstrated +12.3%* performance.
- US inflation has proven to be sticky, and the first interest rate cut happened only in September. So far, a 100bp decrease in the Fed funds rate was delivered. The base case scenario for rate cuts has been realized for this past year.
- Given sticky inflation and a surprise win of D. Trump in the US presidential elections, with republicans taking majority both in the Senate and the House of Representatives, inflation expectations spiked in Autumn. As a result, we finish the year with 5-year and longer-term Treasury yields even higher than at the beginning of the year.
- Even though there were no major inflows into EM bonds, the credit spreads nevertheless tightened significantly, absorbing the negative move in US Treasuries. The Fund is approaching the end of the year with 8.2%* performance as of end of November thanks to our exposure to EM fixed income.
- Volatility, throughout the year, in fixed income was not high, and we had only 2 months with negative performance.
- The case for soft-landing in the US has been strengthened throughout the year thanks to the resilient labour market and service sector.
- Geopolitical risks were always on the radar with focus both on Russia-Ukraine and Israel-Palestine conflicts.
- China was struggling to avoid a Japanese economic scenario but preferred to focus on tactical measures rather than general monetary stimulus as it doesn't want to take more debt. Neither consumers nor investors have been impressed so far.
- Regional performance diverged: Egypt was among top-performers, Latam surprised by GDP growth, but bonds were under pressure from political newsflow, EMEA and EM Asia lagged. Turkey has made great progress in 2024 which was noticed by rating agencies who upgraded the country's rating by two notches.

*net performance of B2 class shares

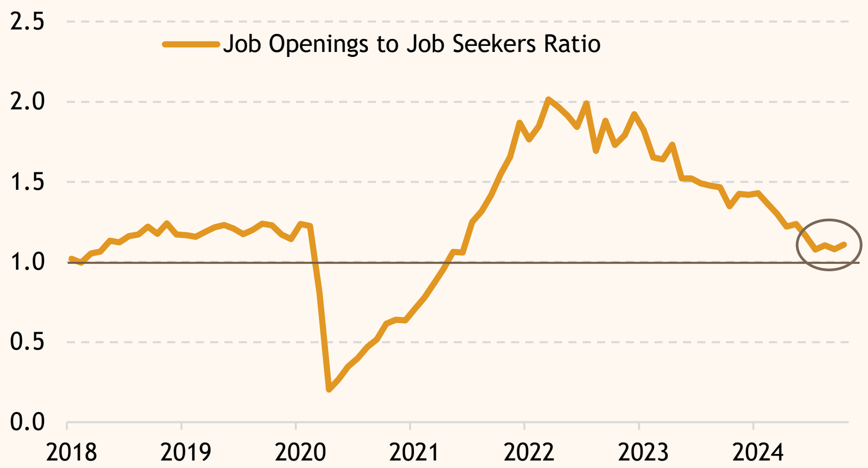
2025 – Positioning for Lower Rates

- Interest rates cut cycle continues in 2025 resulting in **lower returns on cash**. This will drive the demand for fixed income strategies that are able to **lock in higher yields**, especially EM bonds and HY.
- **US Federal Reserve** stays **data dependent**. The dot plot as of December showed a 50 bp decrease in the Fed funds rate in 2025 and another 50 bp decrease in 2026. Post US elections markets are more conservative as **futures** show only a **40 bp decrease** in 2025 and another 20 bp in 2026.
- **UST yield curve normalization** will most probably continue, and we expect only a **slight decrease** in US Treasuries yields, especially with long tenors. We focus on adding **high coupon bonds** with duration of 3-5 years.
- While tariffs definitely add to inflationary risk, there could be a scenario with only moderate tariffs hikes, with the threat of more tariffs used as a political tool to negotiate other issues. For example, narcotrafficking control through the Mexican border. However, we see this as a best-case scenario for fixed-income. Our base-case scenario shows a **high-single-digit return** in 2025.
- We are entering the **late stage of the economic cycle**, thus further US economic growth will be more dependent on robust consumption, a healthy labour market and interest rates. As concerns over the US economic growth may increase, **bonds** as an asset class **are better positioned** to withstand an economic slowdown or a light recession.
- **EM bond** valuations **look fair** on average, but one could always **find value** in improving macro or micro stories, where valuations do not yet reflect the changes.
- **In a best-case scenario** where the Fed turns to a less restrictive monetary policy or risk appetite gives rise to large inflows into EM debt, EM bonds credit spreads may tighten providing for a price upside additional to the current yield, thus reaching **low-double-digit return** in 2025.
- **Geopolitical risk** is still elevated with a focus on Russia-Ukraine and Israel-Palestine conflicts, but there are hopes that Trump will bring a truce to the Russia-Ukraine conflict. At the same time, increased tensions between US-China or US-Iran may spark bouts of volatility, which will keep **creating opportunities** in the market.

US Economic Outlook - GDP

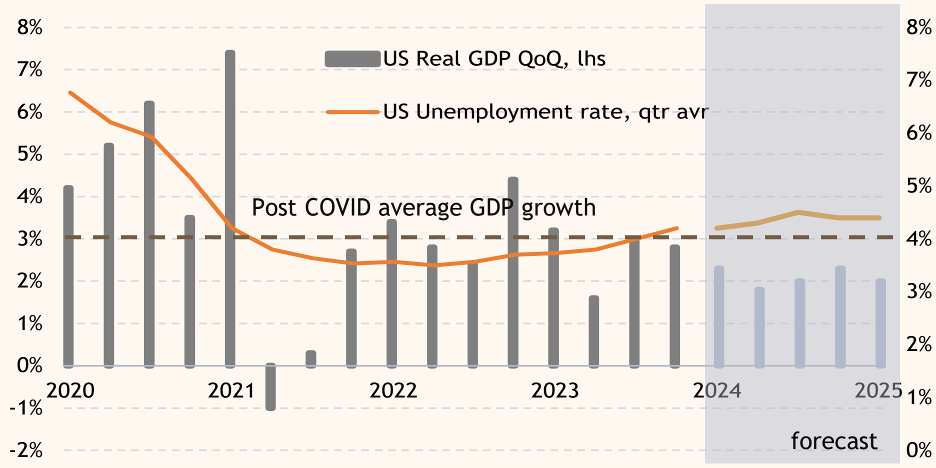
- Soft-landing, that is avoiding a recession, is still the main scenario.
- But slowing growth will be more difficult to maintain as there is no margin for errors. Further road ahead may prove bumpy.
- Lower rates should ease pressure on businesses and indebted households while blanket tariffs and limits on migration would increase the risk of stagflation in the US.

Chart 1: Job market is now balanced and further cooling is unwelcome



Source: Bloomberg, 9 December 2024

Chart 2: US economy has so far avoided recession, but average growth pace is slowing leaving no margin for errors

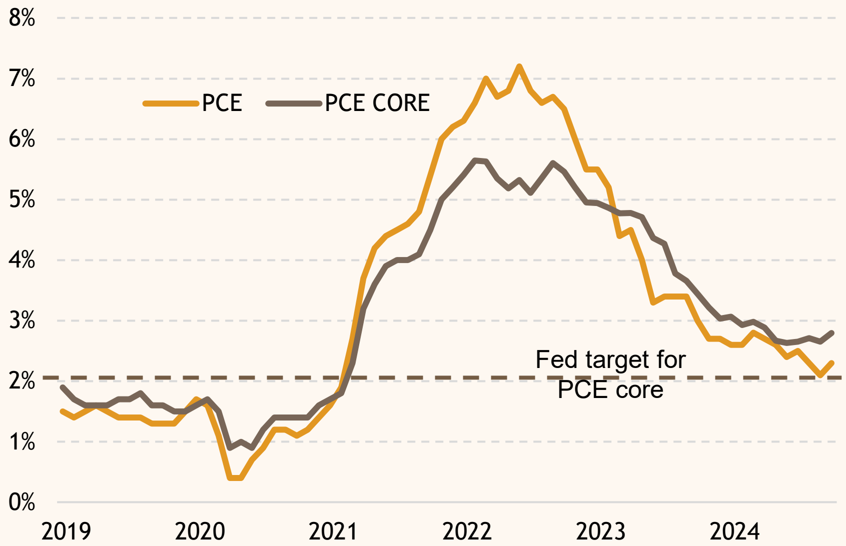


Source: Bloomberg, JP Morgan; 9 December 2024

US Economic Outlook - Inflation

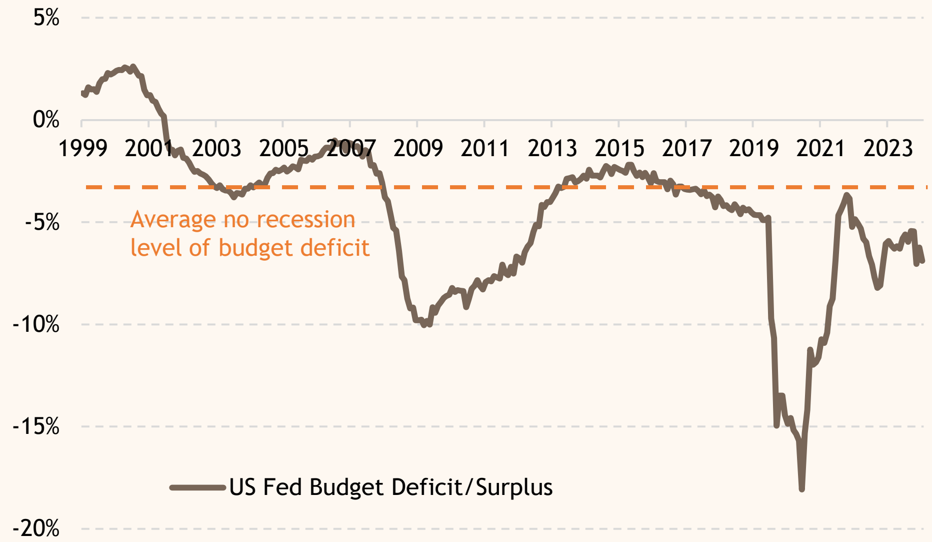
- Disinflation pace has decelerated, and inflation is still hovering above the Fed's target. Inflation has proven to be sticky while higher tariffs and a budget deficit are considered to be pro-inflationary.
- 60% tariffs on the Chinese imports will lead to a forecast 95% decline in imports. If this increase in tariffs is applied to the remaining imports, this would result in a moderate increase of 0.2% in the PCE index, assuming this increase is passed through to consumers.
- The budget deficit has thus far not gone to pre-COVID times and is expected to be 6.4% in 2025 and 7.3% in 2026 as a result of an extension of existing policy.

Chart 3: Disinflation pace has decelerated, while inflation is still above target



Source: Bloomberg; 9 December 2024

Chart 4: US is running at extremely high budget deficit for a no recession period, and it should be financed

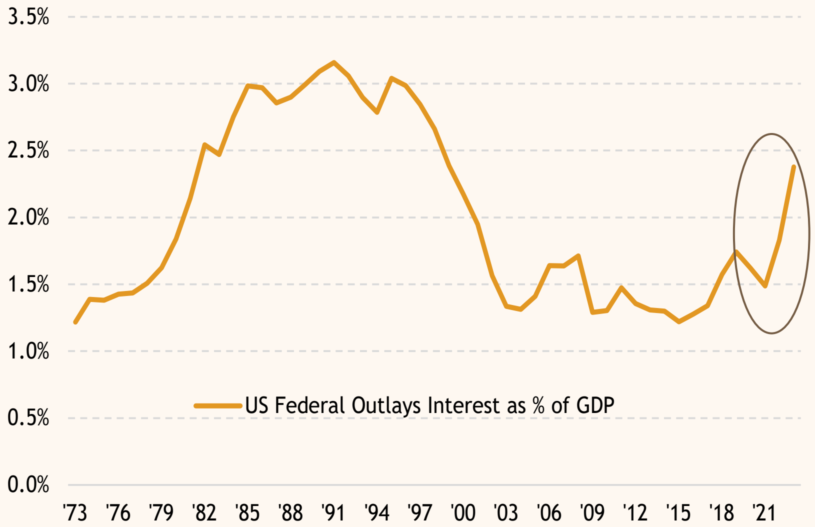


Source: Bloomberg; 9 December 2024

US Monetary Policy – Balance Sheet

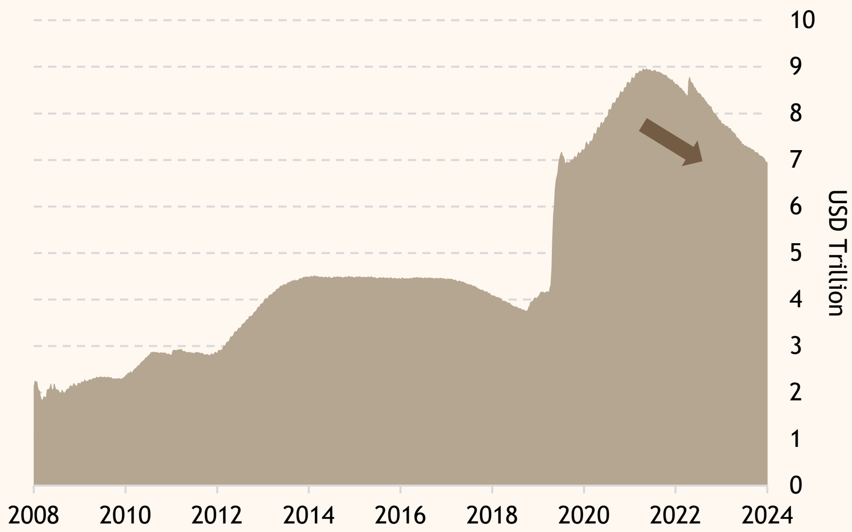
- The average interest rate on marketable public debt has been rising. Given the huge amount of refinancing for US Treasuries in 2025, this could lead to a further increase in the interest expense as a percent of GDP, assuming that the treasuries are not monetized by the FED.
- The Fed haы managed to reduce the balance sheet by USD 2 trl in 2 years. The big question is whether the Fed will proceed with QT? It's widely anticipated that QT will be ended by 2Q25, after which the coupons and maturities will be reinvested along the curve.

Chart 5: Interest expense burden is spiking for US even in no-recession reality



Source: Bloomberg; 9 December 2024

Chart 6: When will Fed have to stop QT?

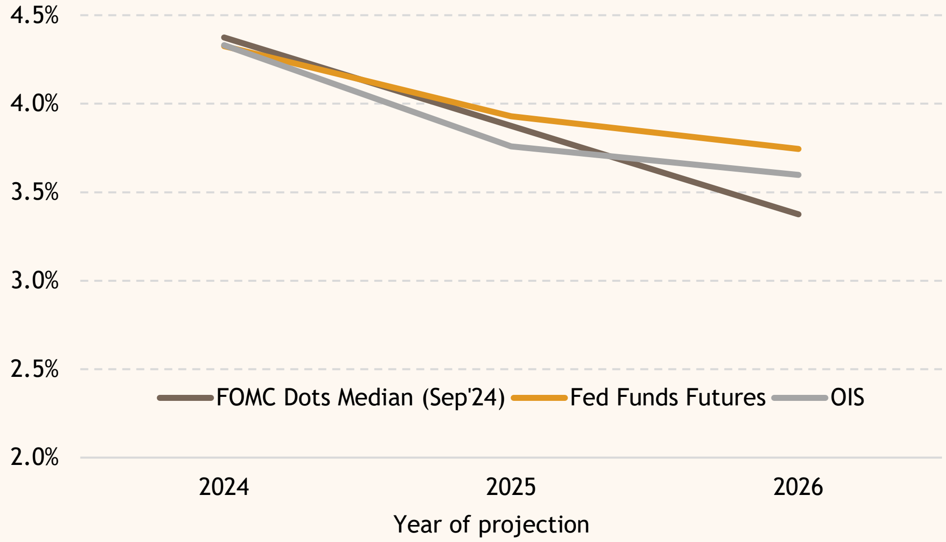


Source: Bloomberg; 9 December 2024

US Monetary Policy - Fed Rate & UST

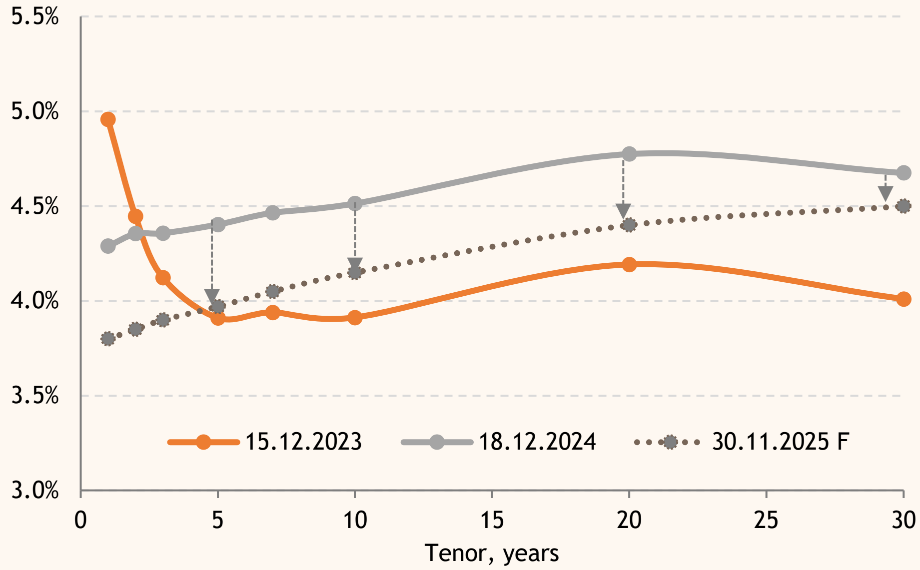
- The Fed has started to decrease the interest rate in September'24 and has delivered a 100 basis points cut YTD as of December 19. Market participants forecast 40 bp worth of cuts in 2025, which will lead to a 3.9% Fed rate as of end of 2025.
- At the same time the neutral level of interest rates is perceived to be around 3%, leaving some room for further rate cuts.
- However, given the yield curve normalization, the decrease in longer duration Treasuries yields may be less than cuts. We forecast about -40 bp for 5-year and 10-year in base-case scenario.

Chart 7: Fed will continue easing, BUT…



Source: Bloomberg; 18 December 2024

Chart 8: … BUT UST yield curve will most probably continue its normalization

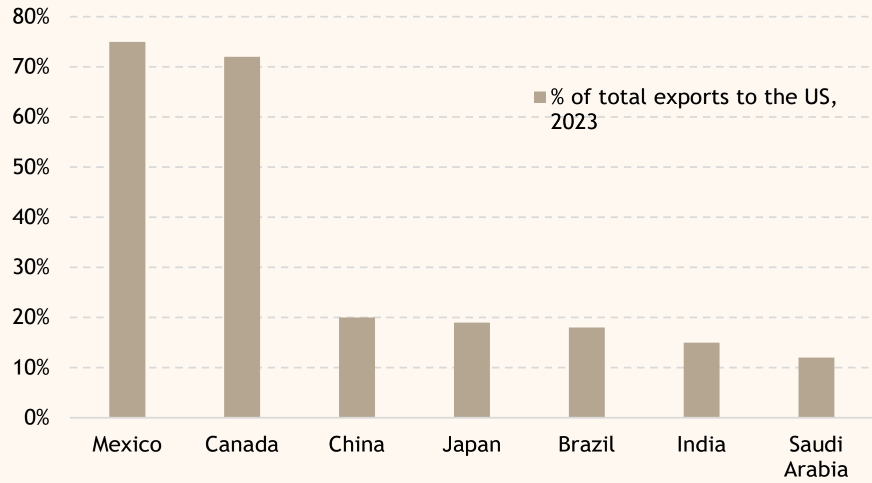


Source: Bloomberg; 18 December 2024

Emerging Markets Outlook

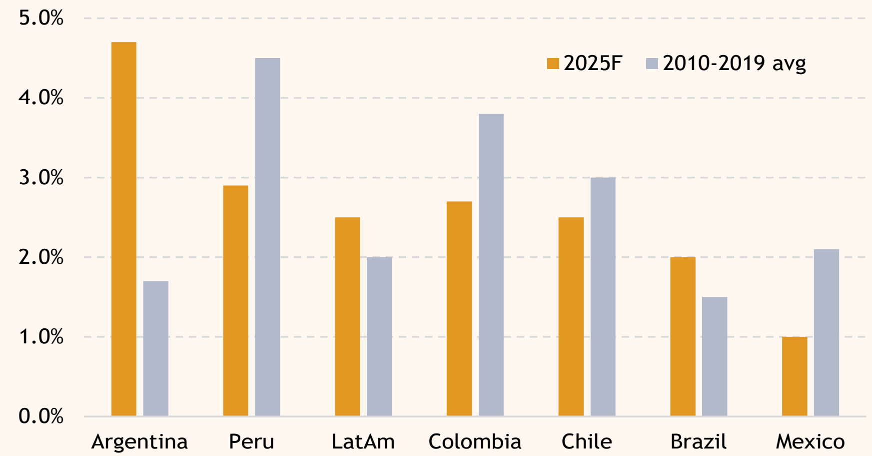
- Possible policy changes by the new US administration are the main risk for EM and are likely to dominate macro developments, as EM countries are greatly dependent on global trade. Among the countries that will experience the hardest hit will be Mexico and Canada, and only after those will be China. However, recent news show that Trump may considerably change the initial plan if he can meet other goals, for example, control of narcotrafficking in Mexico. Given this, we expect the biggest hit will be on China with estimations of -1% of GDP growth to 2024F of 4.8%.
- In contrast to manufacturing exporters in EM Asia which could face the spillover effect from the US-China 2.0 trade war, EM commodity exporters in LatAm and South Africa should not be materially affected. In LatAm disinflation is expected to continue and fiscal deficits to improve, however social spending demands, and other political issues may put pressure on the macro picture and valuations.
- However, low leverage, a strong private sector balance sheet and limited external borrowing needs underpin EM resilience.
- In CEEMEA region Turkey's and Egypt's performance will be driven by domestic factors such as success with curbing inflation, as well as structural reforms. The Gulf Cooperation Council [GCC] economic performance will be again the result of oil price dynamics. An increase in public spending will make oil exporting countries more sensitive to changes in oil prices.

Chart 9: Trade exposure to the US



Source: ResearchGate; 10 December 2024

Chart 10: LatAm GDP growth is higher than pre-pandemic

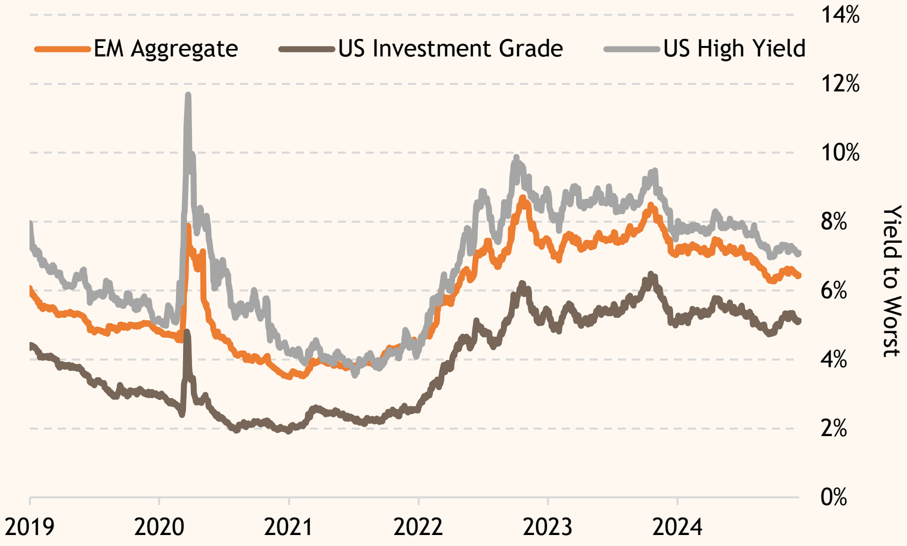


Source: UBS; 27 November 2024

Bond Yields and Credit Spreads

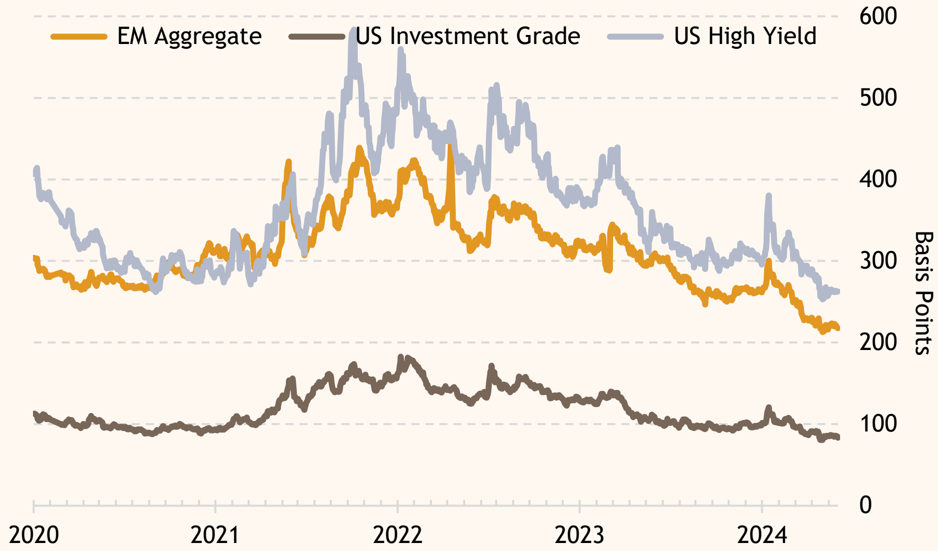
- Bond yields still fluctuate at considerably high levels, giving a chance to lock in high rates.
- Credit spreads, however, don't offer much price upside potential. General decreasing level of yields may underpin demand for EM and HY as a result of the search for higher yielding bonds. And vice or versa, increase in geo-political or political uncertainty, prospects of a recession in US or material deceleration of growth pace in China can lead to credit spreads widening. In case of EM aggregate index, reversal to a 4 year mean credit spread will lead to 100 bp widening, that is around -0.5%-0.0% total return in 12 months perspective given high current yield.

Chart 11: Yields remain appealing being still above 5-year averages…



Source: Bloomberg; 10 December 2024

Chart 12: … however spreads reached post-COVID minimums, leaving not much space for price upside



Source: Bloomberg; 10 December 2024

Our Investment Convictions

- We plan to keep the **duration** of our fixed income portfolios at an **average of 5-6 years**, as we see potential to lock into higher yields with a conservative downside risk coming from UST curve normalization.
- The potential for further credit spreads tightening is limited, however **current yield of 6%-7%** looks **appealing**.
- We keep the **major part** of the portfolio invested **in EM** with focus on **high-quality bonds** and continue to prefer corporates **with revenues in USD**. We believe emerging-market hard-currency bonds still offer decent risk-reward profile.
- In the **developed economies** we **add subordinated bonds** of well-established companies or banks, however we plan to keep those below 10% of the portfolio.
- The base-case scenario for the US economy is a soft-landing which is not supposed to provoke a large pick-up in US HY default rates next year, however this is true until the input variable changes. In this case a spike in defaults usually happens quickly. That's why we leave HY strategy to HY specializing Funds, which by nature expect 5%-10% of defaults in their portfolios.
- At current valuations, we like **Latin America**, which is away from the main geo-political issues, continues reforms and have **yields compensating those risks.** We keep **selected** issues with price upside potential from **Asia, Middle East and Africa**, while issues from **Developed Europe** and **North America** will counterbalance EM risks, thus playing an important role in **diversification**.
- We continue to **avoid** investing in bonds of **Chinese issuers**, the main risks of which, in our opinion, are the opacity of corporate decision making, as well as the complexity of legal structures.
- Moving forward into the economic cycle, **selectivity** remains **top priority**, and we continue to use bottom-up approach for the search of investment ideas, as well as monitoring companies to avoid problematic positions.

Selected Issuers

- **Braskem** (BB+/BB+) is a leading petrochemical company, with industrial units spread across Brazil, Mexico, USA and Germany. It is controlled by Novonor Group, while Petrobras, Brazilian state oil company is a significant minority shareholder (owns 47% of voting shares). The company has lost its IG rating in 2023, but since then demonstrated a gradual recovery. The company has enough liquidity to cover debt over the next 5 years. We believe Braskem provides a good risk/yield ratio. Braskem's USD-denominated bonds maturing 2030 and 2050 currently trade at yield-to-maturity of 8.5% and 9.1%, respectively.
- **Societe Generale** (A/A) is a multinational bank based in France with an annual revenue of almost EUR 30 billion. The bank remains well capitalized with the Tier 1 common equity ratio at around 13.2% and maintains a relatively low nonperforming loan ratio of around 3.3%. The bank has a conservative strategy with loans/deposits ratio at 86% and cost efficiency ratio at around 70.3%. Overall, the bank remains a safe and solid bet for risk averse investors. While we remain with a positive view on this bank, political uncertainty may lead to a heightened country risk thus putting pressure on all French bonds, even those denominated in USD. We like Societe Generale's perpetuals which provide investors with a nice premium to senior bonds and have a higher next coupon which makes it too expensive for a bank to keep in the market and thus limits maturity for investors. For example, its perpetual with coupon 5.375% is trading currently at 8.6% to a call in 2030.
- **Ecopetrol** (BB+/BB+) is a leading, state run, integrated oil company in Latin America, specifically Colombia. The company maintains a relatively low level of leverage with the current net debt to EBITDA ratio at around 2.0x and the EBIT to interest expense ratio at around 4.5x. Cashflow generation remains positive, with the company maintaining more than enough cashflow generation to cover their interest expense. Furthermore, there are no major upcoming bond redemptions until 2029. Ecopetrol USD denominated bonds with maturity in 2032 are currently trading at a yield-to-maturity of 8.2%.
- **Office Cherifien des Phosphates** (BB+/BB+/Baa3) is among the top three global phosphate fertilizer producers, and it has access to roughly 70% of the world's phosphate reserves. The company is 94% owned by the Government of Morocco. Net debt to EBIDTA is stable at around 2.3x, and the company maintains a strong cashflow generation. The company's cash is enough to cover redemptions in 2025 and 2026. OCP's financial results depend on fertilizer prices and thus could be volatile. The company has positive outlook from S&P, if it is upgraded, the issuer will move from HY into IG universe which could drive rally in prices. The company has several USD-denominated bond issues, the one maturing in 2031 is currently trading at around 6.25% yield-to-maturity and the longest one, with maturity in 2054, has a yield-to-maturity of 7.3%.

Note: Bond Prices as of 19-Dec-2024

Our Scenario Forecasts

Our **3 market scenarios for a 12-month horizon**:

Optimistic Scenario: 5-year US Treasury yields decline by 90 basis points compared to their level as of 19 December 2024 reaching 3.5% in 12 months. Credit spreads tighten by 80 basis points, on average.

Base-Case Scenario: 5-year US Treasury yields decline by 40 basis points compared to their level on 19 December 2024, reaching 4.0% in 12 months. Credit spreads tighten by 15 basis points, on average.

Worst-case Scenario: 5-year US Treasury yields increase by 10 basis points compared to their level 19 December 2024, reaching 4.5% in 12 months. Credit spreads widen by 90 basis points, on average. We assume -0.5% loss due to potential defaults in this scenario.

Table 1: Expected total return under the strategy for a 12-month horizon by scenario

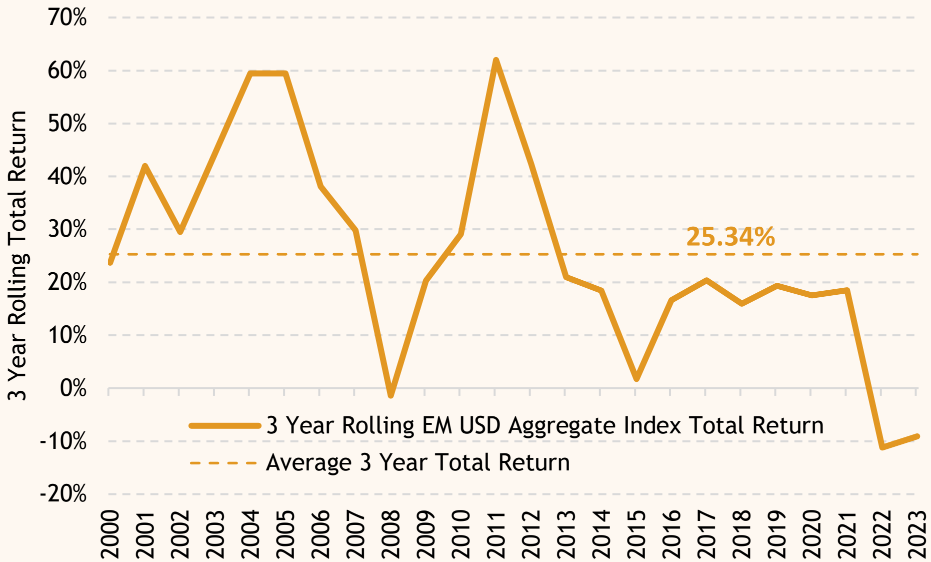
Strategy Return	Optimistic Scenario	Base-case Scenario	Negative Scenario
Coupon Component	5.2%	5.2%	5.2%
Price Change due to UST Yields Move	4.9%	2.2%	-0.5%
Price Change due to Spreads Move	4.1%	0.7%	-4.8%
Default	0.0%	0.0%	-0.5%
Total:	**14.2%**	**8.1%**	**-0.7%**

Note: Calculations as of 19-Dec-2024, based on Axioma Leveraged Bond Fund Portfolio

Longer-term Returns

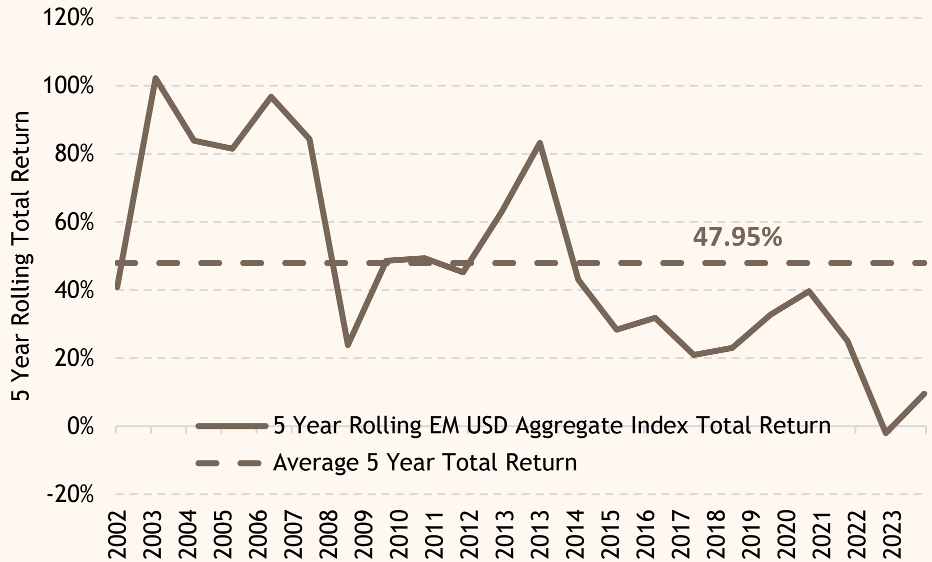
- 1-Year returns could be rather volatile, even for fixed-income strategies. That's why we advise to plan the investment horizon for at least 3 or 5 years.
- The accuracy of long-term forecasts is notoriously low. But we would like to highlight the benefits of long-term horizons for investments and calculated the 3-year and 5-year rolling total returns for fixed income, based on EM USD Aggregate Index since 1997.
- Past performance does not guarantee future results, but one can notice decent double-digit average numbers for 3-year and 5-year returns in general.

Chart 13: Even 3-year total returns show high volatility…



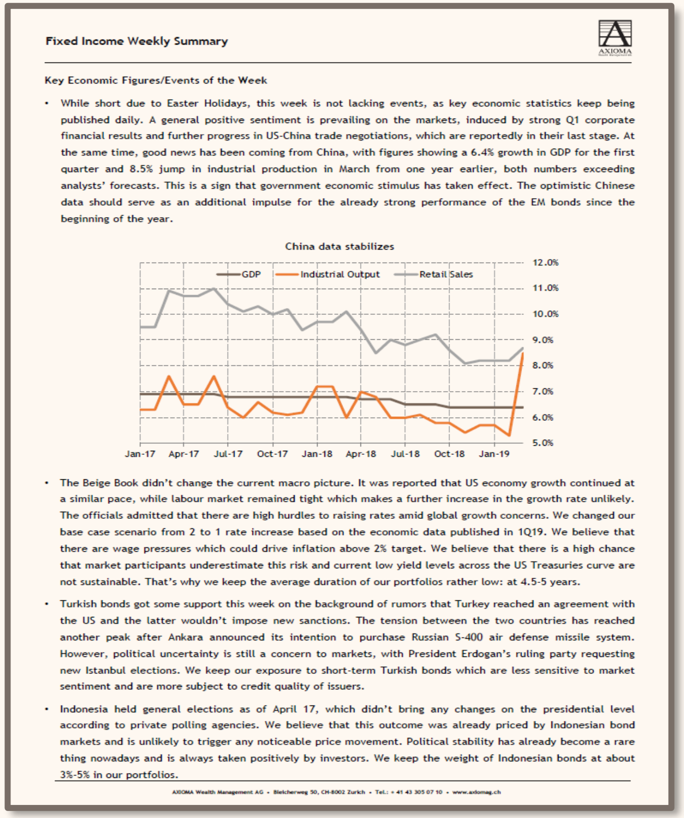
Source: Bloomberg; 12 December 2024

Chart 14: … which smoothen over longer periods



Source: Bloomberg; 12 December 2024

Stay Informed about AXIOMA's Investment Strategy



Fixed Income Weekly Summary

AXIOMA

Key Economic Figures/Events of the Week

- While short due to Easter Holidays, this week is not lacking events, as key economic statistics keep being published daily. A general positive sentiment is prevailing on the markets, induced by strong Q1 corporate financial results and further progress in US-China trade negotiations, which are reportedly in their last stage. At the same time, good news has been coming from China, with figures showing a 6.4% growth in GDP for the first quarter and 8.5% jump in industrial production in March from one year earlier, both numbers exceeding analysts' forecasts. This is a sign that government economic stimulus has taken effect. The optimistic Chinese data should serve as an additional impulse for the already strong performance of the EM bonds since the beginning of the year.

- The Beige Book didn't change the current macro picture. It was reported that US economy growth continued at a similar pace, while labour market remained tight which makes a further increase in the growth rate unlikely. The officials admitted that there are high hurdles to raising rates amid global growth concerns. We changed our base case scenario from 2 to 1 rate increase based on the economic data published in 1Q19. We believe that there are wage pressures which could drive inflation above 2% target. We believe that there is a high chance that market participants underestimate this risk and current low yield levels across the US Treasuries curve are not sustainable. That's why we keep the average duration of our portfolios rather low: at 4.5-5 years.
- Turkish bonds got some support this week on the background of rumors that Turkey reached an agreement with the US and the latter wouldn't impose new sanctions. The tension between the two countries has reached another peak after Ankara announced its intention to purchase Russian S-400 air defense missile system. However, political uncertainty is still a concern to markets, with President Erdogan's ruling party requesting new Istanbul elections. We keep our exposure to short-term Turkish bonds which are less sensitive to market sentiment and are more subject to credit quality of issuers.
- Indonesia held general elections as of April 17, which didn't bring any changes on the presidential level according to private polling agencies. We believe that this outcome was already priced by Indonesian bond markets and is unlikely to trigger any noticeable price movement. Political stability has already become a rare thing nowadays and is always taken positively by investors. We keep the weight of Indonesian bonds at about 3%-5% in our portfolios.

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- Every month, AXIOMA's fund managers provide an update on AXIOMA Leveraged Bond Fund

  Please visit axiomag.ch/fund

Your Team

AXIOMA's staff are always available to answer your questions and create a tailor-made solution for your specific requirements. Email or call us with any questions, or to make an appointment for a face-to-face meeting at our office in Zurich.

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