August 2025

Active Fixed Income Perspectives—Monthly Pulse

Key takeaways

1. **Higher tariffs and labor market weakness raise the risk of an economic slowdown. Near-term Fed action is likely.**
2. **U.S. rates are fairly valued at current levels and provide a hedge against recession risk.**
3. **Rising slowdown risk amid the late-cycle environment, combined with tight valuations, reinforce our up-in-quality bias in credit.**
4. **Municipals present strong fundamentals and, in longer-term bonds, robust relative value for tax-sensitive investors.**

Our outlook: Mounting risks warrant caution and discipline

While the U.S. economy has remained largely resilient year to date, downside risks have increased. Tariff rates are settling above recent forecasts, and the labor market has shown meaningful signs of softening, likely pulling the Fed from "wait-and-see" mode to ease in the near term. As trade policy increasingly weighs on the economy, our base case outlook anticipates a slowdown in growth—without tipping into a recession—and a rise in inflation through the balance of this year.

Trade policy is crystallizing but above our recent projections. We expect the effective tariff rate in the U.S. to rise to near 17%, still well below the initial proposals in April, but well above levels from the beginning of this year. So far, tariffs' inflationary and growth-dampening effects have been limited, with a realized tariff rate of only 6% year to date. That reflects import front-loading, substitution, and delayed implementation. However, as higher tariffs filter more heavily, rising consumer prices are likely to inhibit demand and growth.

The labor market is flashing warning signs. The latest data release showed low job creation and material downward revisions that brought the three-month job growth average to just 35k, below the 50k–75k threshold needed to keep unemployment steady—suggesting a potential inflection point. Employment data is a lagging but critical indicator that can turn quickly, thus justifying close monitoring.

The Fed's balancing act is becoming more complex. While inflation is likely to increase near term, we expect the Fed to look through tariff-driven inflation and prioritize labor market stability if needed, as long as inflation expectations remain anchored. Given softening labor data and a potentially dovish shift in the Fed's reaction function—evidenced by dissents in the latest meeting and changes in membership—we anticipate a 25-basis-point rate cut in September, followed by another later this year, assuming current labor trends hold.

Our active positioning: Up in quality and poised to act on market moves

U.S. rates are fairly valued with room to rally if conditions worsen. U.S. rates continue to offer attractive real yields. In the coming months, economic softness and Fed easing may push yields lower. Our portfolios are tactically long duration to capture value if this occurs.

Global shifts create opportunities. Outside the U.S., our portfolios are positioned to benefit from economic and policy shifts, including increased defense spending in Germany, improving fundamentals in peripheral Europe, and rising growth and inflation in Japan.

Credit is healthy but limited by tight valuations and slowdown risk. A strong Q2 earnings season underscores solid credit fundamentals that warrant a modest credit overweight. However, tight spreads relative to history and late-cycle risks support an up-in-quality bias. We currently see pockets of relative value in structured products like ABS and CMBS, short-term financials, and select non-U.S. issuers. Higher supply in the coming months may provide a valuation opportunity to add to credit risk, barring a notable economic decline.

Municipal bonds offer great value. Municipal fundamentals are robust, and an increase in issuance this year has led to better valuations. This value is most pronounced for high-quality, long-term municipals, where yields are nearly that of Treasuries, offering a substantial tax-equivalent advantage. Our active portfolios are overweight credit, with a modest overweight to duration to act as a hedge.

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