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Positioning Fixed Income Portfolios for Rising Growth Risks

- While our base case remains that the US economy will continue to expand in 2025, recent economic and market data suggest the downside risks to this base case are growing.
- There are two simple ways to position fixed income portfolios for a possible slowdown: extending duration and holding an up-in-quality bias.
- The costs of taking these defensive moves remain relatively low now that the yield curve is positively sloped, and credit spreads remain narrow.
- In terms of portfolio construction, adding duration and increasing quality in fixed income are some of the most-efficient ways to provide some "insurance" against further declines in equity markets.

In our 2025 Outlook, we highlighted the probability that economic growth would continue through 2025, aided by solid consumer income growth and the upside potential of increased corporate investment. In the last several weeks, however, cracks have emerged in that façade of strong growth. While it remains our base case that growth will indeed persist, the risks of a slowdown—or, less likely, recession—are indeed growing. Evidence for this assessment comes from theory, economic data, and the behavior of financial markets in recent weeks.

The theory behind economic risks is simple: swings in policy, particularly around government spending and tariffs, make it tough for firms to invest. As a simple example, imagine a tech contractor that designs data centers for government clients. Today, many federal agencies are cutting budgets in hard-to-predict ways. Our canonical contractor will not invest in new servers when s/he is unsure whether the government might cancel planned projects. The longer the uncertainty lasts, the bigger the economic effects.

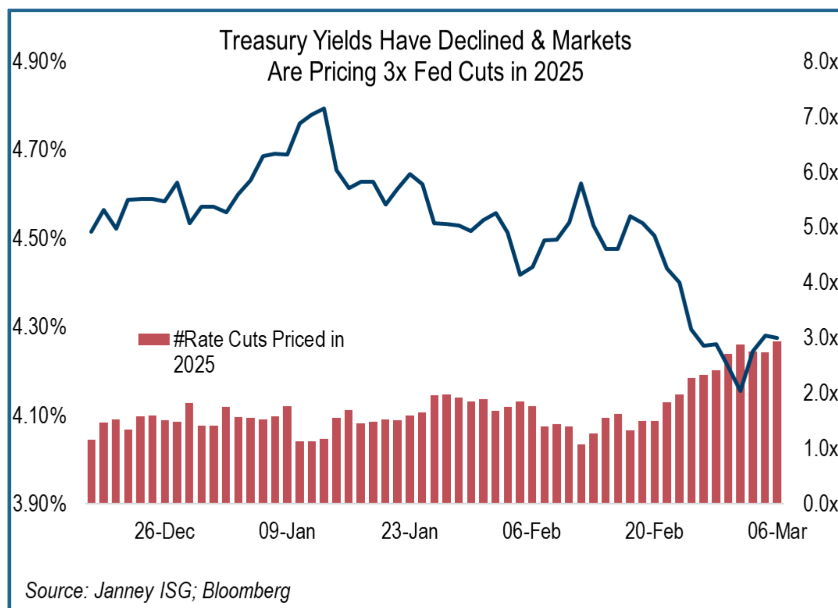
The experience of economic data is a bit more nuanced than the theory, but growth numbers are deteriorating. Policy uncertainty first flowed into sentiment surveys and more recently into "hard" data. On the survey side, American consumers have turned more cautious. The University of Michigan Consumer Sentiment Index fell to 64.7 in Feb 2025, down from 74.0 two months earlier. On the hard data side, the trade balance worsened ahead of potential tariffs, falling to an all-time low of -$131 billion in January. In combination, these factors are contributing to economic slowing in 1Q, with one measure of aggregate economic activity, the Atlanta Fed's GDPNow Index (a real-time estimate of economic growth), dropping to the lowest since the COVID-19 recession. While the GDPNow print launched many headlines, the drop in the index probably exaggerates the economic softness to date.

Indicator	Dec-24	Most Recent
GDPNow	2.3%	-2.4%
U. Mich Consumer Sentiment	74.0	64.7
ISM Manufacturing	49.2	50.3
Personal Savings Rate	3.5%	4.6%
Monthly Payrolls Change	307K	151K
US Trade Balance	-$98bln	-$131bln

Source: Janney ISG; Atlanta Federal Reserve; University of Michigan; Institute for Supply Management; US Bureau of Economic Analysis; US Census Dept

Financial markets have begun to price a chance—though far from a certainty—of significant economic slowing. That probability is most evident in the increased pricing of Federal Reserve (Fed) rate cuts. Short-term interest rate markets in two weeks went from pricing in an outcome of just one 0.25% rate cut for all of 2025 to three

such cuts. Similarly, long-term interest rates fell -0.4% over that brief period. Credit spreads often widen ahead of economic slowing as fixed income investors seek the relative safety of government bonds. So far, investment-grade corporate bonds have widened from December lows to +0.88% in early-March, while high-yield (HY) corporate bond spreads have widened to +2.92%. Despite the widening, both measures are quite healthy and no recession in contemporary history has begun with HY spreads less than +3.00%. Spreads bear watching but are mostly not concerning.



All three of these factors—theory, data, and markets—have deteriorated unusually quickly. As such, it is very possible that the same indicators hinting at downside risk could reverse in short order. Janney ISG's expectation is that economic growth will persist in 2025, but what has changed is the alternate case. If we are going to be wrong, it is no longer because economic growth and inflation accelerated, but rather because growth slowed and possibly even contracted.

Bond Market Positioning for a Slowdown

With economic clouds gathering, there are a handful of fixed income-specific strategies that can be useful for playing defense. Those defensive moves fall into one of two categories: out-in-duration and up-in-quality. The good news with both approaches is that the interest rate level is still much higher than it has been for most of the last decade. As such, the cost of taking defensive measures is relatively low.

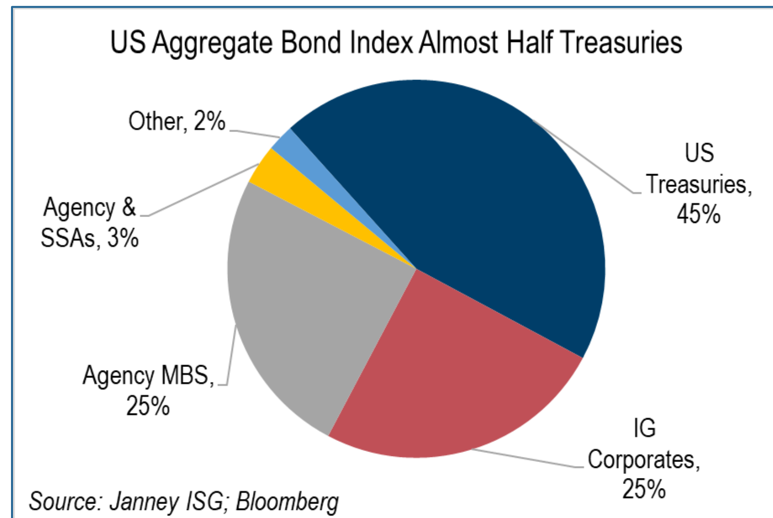
First, a preface. While interest rate markets are currently pricing in three rate cuts in 2025 for a total 0.75% reduction in overnight interest rates, history suggests the Fed will need to cut far more than that in a recession. In contractions going back to 1960, the Fed has cut by a median magnitude of 3.25%. Even if we trim the extremes (such as the Global Financial Crisis), the median is still 2.38% worth of cuts. What that implies for today is that, if there is an outright contraction in the U.S., the Fed will have to reduce overnight interest rates by more than currently priced and, as a result, intermediate to longer-term interest rates will fall from today's levels. A good rule of thumb is two-thirds of Fed cuts will "echo" out the curve, meaning that yields on longer maturity bonds will fall 1.00-1.75% if the Fed cuts by 2.25%.

Recession Period	Number of Fed Cuts	Rate Cut Magnitude	Change in 10yr Yields
Apr 1960 - Feb 1961	5x	2.50%	-1.50%
Dec 1969 - Nov 1970	4x	2.00%	-1.20%
Nov 1973 - Mar 1975	*10x*	*5.25%*	*-3.00%*
Jan 1980 - Jul 1980	7x	4.75%	-2.50%
Jul 1981 - Nov 1982	*9x*	*5.75%*	*-3.25%*
Jul 1990 - Mar 1991	3x	1.75%	-1.00%
Mar 2001 - Nov 2001	6x	3.25%	-1.75%
Dec 2007 - Jun 2009	*10x*	*5.00%*	*-3.50%*
Feb 2020 - Apr 2020	5x	2.25%	-1.25%
Median Ex-Extremes*	5x	2.38%	-1.38%

*Italicized periods represent extremes; change in 10yr yields rounded
Source: Janney ISG; Bloomberg; Federal Reserve Board

Longer-term bonds have longer durations and larger price fluctuations from changes in interest rates. A decline in 5-year Treasury yields of 1.50% will result in a roughly 6.7% price increase, whereas that same yield decline for a 30-year Treasury will result in a roughly 24.5% price increase. Extending duration brings with it more risk in the bond portion of a portfolio but is a straightforward way to prepare for unexpectedly slowing economic growth or a downturn. When the yield curve was inverted throughout much of 2023 – 2024, there was a cost in the form of yield give-up for buying longer-term bonds. Today that is not the case, as the yield curve is positively sloped. As such, the cost of extending duration is lower today than it was in much of the last two years.

In addition to extending duration, trimming lower credit quality, and adding higher quality positions can help protect portfolios from periods of contracting economic activity. High-quality government bonds are the classic safe haven in a downturn, and while many individual investors have limited exposure to Treasuries, adding longer-term Treasuries is an easy way to both increase duration and improve portfolio quality. The US Aggregate Bond Index, which many funds use as a benchmark, is about half Treasuries.



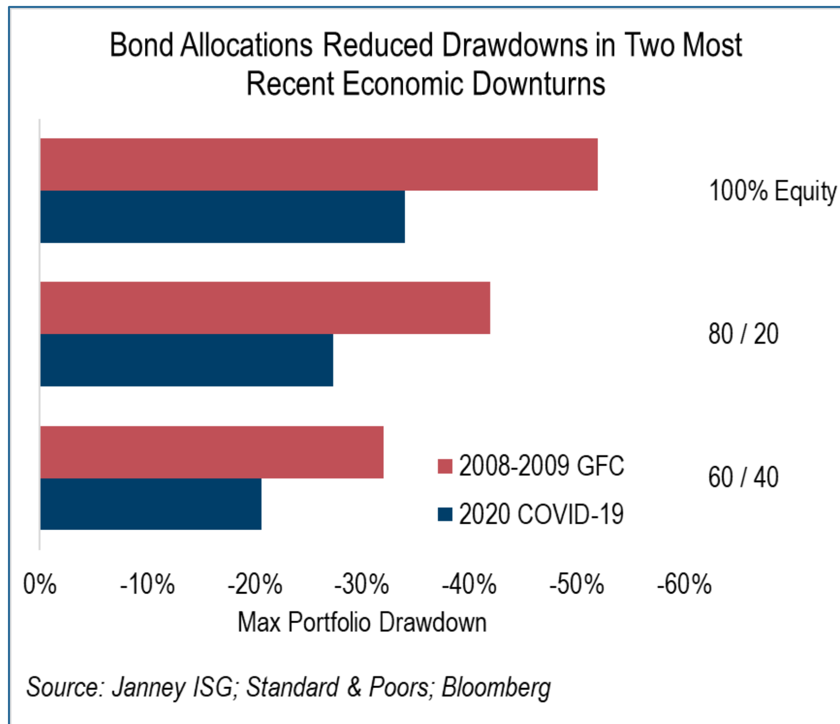
Aside from allocating into Treasuries, there are a few simple ways to improve portfolio quality. Investment-grade (IG) corporate bonds offer higher yields than Treasuries and should perform relatively well if the economy merely slows. For 2025, corporate balance sheets are generally healthy, and default rates on investment-grade debt are historically very low, even in recessions. If the Fed cuts rates, investment-grade bond prices will also rise, though likely not by as much as Treasuries. One way to improve portfolio quality is to hold an up-in-rating bias within the IG sector. About half of the IG corporate markets fall in the BBB credit ratings range, but A and higher-rated bonds tend to do better in periods of slowing. Secondarily, companies in non-cyclical industries like healthcare tend to be more stable in slowdowns. High yield corporate bonds and preferred securities meanwhile tend to perform poorly in relative terms during growth scares. And despite falling interest rates on Treasuries and IG corporates, HY corporates and preferreds often experience outright declines in value during contractions.

Municipals have been a bright spot in recent years thanks to improving fundamentals. State and local tax revenues have been strong, and many issuers bolstered rainy-day funds in recent years, giving them a cushion. If an economic downturn hits, munis could face pockets of stress (e.g., regions dependent on economically sensitive revenues) but should remain broadly resilient. Importantly, any Fed rate cuts would lift muni bond prices just as with Treasuries. That said, tax-exempt bonds are not ideal trading vehicles because any market value increase would become a taxable capital gain if sold, defeating the point to earning tax exempt income. Taxability of gains in munis creates a barrier to selling, exactly when it might make sense to take gains on bonds and reallocate towards equities in a hypothetical equity drawdown.

Bonds as Portfolio Protection in a Downturn

For equity-heavy portfolios, the bond market offers a crucial line of defense against a potential contraction. After the unusual stock-bond selloff in 2022, the historical negative correlation between stocks and high-quality bonds appears to be reasserting itself. This inverse relationship, when it holds, is the foundation of the classic balanced

portfolio. Correlation between monthly returns of U.S. stocks and bonds has historically been negative during low-inflation periods. As inflation normalizes and growth becomes more of a market concern, bonds are regaining their diversifying power. A return to a negative stock-bond correlation improves the case for bonds as a recession hedge. The goal of this hedge is not necessarily to fully offset equity losses, but to reduce portfolios' overall drawdown to more tolerable levels. Lower volatility can prevent panic selling and allow investors to stay invested for the long run.



An optimal stock-bond allocation can significantly reduce portfolio volatility in recessions, though after the last two years of outsized equity gains, many client portfolios have drifted out of balance. A balanced 60/40 portfolio (60% stocks, 40% bonds) has historically weathered downturns far better than an all-stock portfolio. For example, during the 2008 crisis, a 60/40 portfolio saw much smaller drawdowns than equities alone, as Treasury bonds surged in value. Similarly, in the brief 2020 recession, U.S. Treasuries jumped, offsetting some of the equity losses. With equity valuations still high and nascent growth risks emerging, increasing the bond allocation can enhance portfolio resilience if growth does indeed slow. The exact allocation depends on risk tolerance, but even growth-oriented investors should consider holding at least 20-30% in bonds. Current high-grade bond yields (4-5%) mean that this insurance now costs less, in the sense that bonds will pay you while you wait for any drawdown.

Conclusions

Janney ISG continues to expect positive economic growth in 2025, but between policy uncertainty slowing corporate spending plans, jobs market fragility encouraging rising consumer savings, and tariffs altering international trade flows, risks to continued growth are higher today than a few months ago. Against this backdrop, a more defensive fixed income posture marked by adding duration and higher quality bonds makes sense. Since the yield curve is now upward sloping and spreads are relatively narrow, these simple approaches can serve as a slowdown hedge to a mostly-equity portfolio at low cost.

Recession or not, a shift from fixed income offense to defense should perform well if the economy indeed slows and the Fed pivots to rate cuts. And if the recently noisy pessimists are wrong and growth surprises on the upside, a bond-heavy stance will still earn income and can be adjusted accordingly. In the end, resilience through smart asset allocation is key to navigating an uncertain 2025. By heeding the warning signs and preparing portfolios today, investors can ride out a potential downturn with confidence that their bond ballast is in place, ready to stabilize the ship.

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