

Opportunities amid volatility:

A tactical playbook for fixed income investors



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Key points:

- The current market environment, characterized by heightened uncertainty and volatility, presents both challenges and opportunities for fixed income investors.
- While global markets contend with the implications of evolving policies, geopolitical tensions, and economic dislocations, savvy investors can capitalize on these dynamics to generate alpha.
- To navigate this environment, it is important to separate emotions from facts, focus on the impact of policy changes, and exploit dislocations within the fixed income market.

Uncertainty as a double-edged sword

Since the start of the Trump administration and subsequent policy developments, uncertainty has reached unprecedented levels. Market participants are contending with a volatile landscape shaped by trade tensions, fiscal policy debates, and shifting economic narratives. While uncertainty can impede decision-making, it also creates fertile ground for active managers to identify and exploit inefficiencies.

In order to capitalize on these inefficiencies, we believe fixed income investors should adhere to two key principles. First, investors should focus on marginal policy changes. Understanding incremental shifts in policy rather than fixating on end states is key in today's environment. Second, to the best of their abilities, investors should try to separate emotions from facts. By avoiding emotionally charged narratives investors can focus on tangible economic and market impacts.

These principles, combined with active positioning, have proven effective in navigating market dislocations in the past and provide a framework for future opportunities.

The current macro and market landscape

Evolving recession narratives

In recent months, market sentiment has wavered between fears of an imminent recession and cautious optimism. Following tariff announcements and trade tensions, recession probabilities spiked, leading to aggressive repricing of growth-sensitive credits. However, as trade negotiations continue to progress and economic data surprises to the upside, markets have begun to recalibrate expectations.

Policy uncertainty and market reactions

Policy developments—ranging from trade tariffs to budget negotiations—have driven significant volatility. Markets often react disproportionately to headline risks, creating opportunities for investors to exploit overreactions. For example, initial fears of 50% tariffs gave way to relief when expectations moderated to 15%, underscoring the importance of monitoring marginal changes rather than anchoring to worst-case scenarios.

Dispersion and dislocation across asset classes

Volatility inherently increases dispersion within and across asset classes. In the wake of the tariff announcements, fixed income markets, particularly growth-sensitive sectors, experienced indiscriminate selling, creating opportunities to identify mispriced securities. Active managers equipped to differentiate between resilient issuers and those genuinely at risk can uncover significant value both opportunistically and strategically.

Key investment themes and strategies

There are several key investment strategies that we are implementing in today's market that are highlighted below.

1. Exploiting market dislocations

Recent market dislocations have created opportunities in sectors such as high yield and energy as these credits sold off aggressively in the face of tariff uncertainty and rising recession fears. However, many issuers with strong credit profiles and limited tariff exposure were punished alongside weaker peers. By identifying these resilient issuers, investors can capitalize on attractive valuations.

For example, within the energy sector, the combination of growth concerns and increased production by OPEC led to a sharp selloff in energy bonds relative to other sectors (Exhibit 1). This was particularly acute in the higher quality investment grade, where companies with low leverage and strong cash flow generation capabilities have been indiscriminately punished with spreads of single-A rated

issuers widening over 30bps in the weeks around the tariff announcements (Exhibit 2). As active investors, this can provide an opportunity to add high-quality names at more favorable spread levels where the fundamentals have not materially changed.

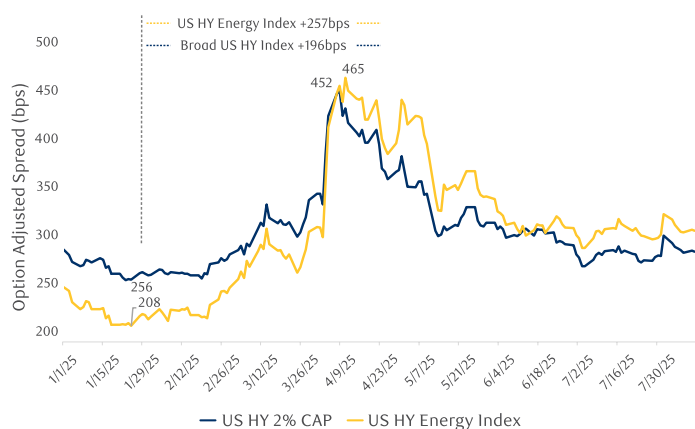
2. Curve steepening trades

Interest rate risk remains a critical consideration, particularly given the greater contribution of Treasury rates to all in yields. With the potential re-emergence of strong growth and continued resilience of the economy in the U.S., our positioning favors curve steepening trades, such as going long on the front end (e.g., 2-year Treasuries) and underweighting the long end (e.g., 30-year Treasuries). This strategy should benefit from lower front-end rates from the Federal Reserve as inflation stabilizes and employment normalizes while also benefitting from being underweight the long end of the curve, where we expect rates to remain elevated as the longer term inflation picture remains less clear. In addition, deficit concerns may drive underperformance at the long end as investors demand higher compensation for absorbing elevated supply over longer time horizons.

3. Sector and quality preferences

With uncertainty elevated, we are biased toward higher-quality, defensive sectors that are less sensitive to growth shocks. In our opinion, these sectors offer resilience in volatile environments and align with the market's preference for stability while also allowing for ample liquidity to take advantage of spread widening events.

Exhibit 1: US high yield energy spread moves versus broader US high yield index



Source: Bloomberg, BofA, RBC. Data as of 8/18/2025

Exhibit 2: US investment grade spreads during April sell-off



Source: Bloomberg, BofA, RBC. Data as of 8/18/2025

Risk management considerations

While opportunities abound, investors must remain vigilant to potential downside risks. We see several scenarios that could warrant a shift to more defensive positioning. The first is a breakdown in trade negotiations. Renewed escalation in trade tensions, particularly with key partners such as China, would likely weigh on risk assets.

Second is a budget impasse. Delays in passing the federal budget could prolong uncertainty, impacting consumer and business confidence. Lastly, a deterioration in the labor market or stickier than expected inflation could cause material disruptions. A meaningful uptick in layoffs could signal a more severe economic slowdown, increasing recession risks.

Absent these risks, the base case remains one of slower but positive growth, with markets gradually adjusting to the new policy and economic landscape.

Turning volatility into opportunity

In today's environment of heightened uncertainty, fixed income investors must remain both nimble and disciplined. By focusing on marginal policy changes, separating emotions from facts, and actively capitalizing on market dislocations, investors can uncover compelling opportunities to generate alpha.

While risks remain, we believe the current landscape offers fertile ground for active managers to add value. By maintaining a balanced approach—combining moderate risk-taking with robust risk management—investors can navigate the volatility and position portfolios for long-term success.



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