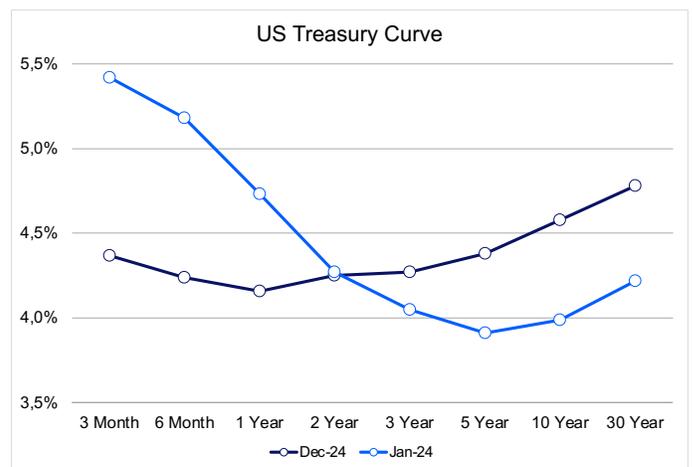


**THRIVING IN  
VOLATILITY:**

## **Advanced Analytics for Fixed-Income Success in 2025**

### **2025 Outlook: Fixed Income's Shifting Sands**

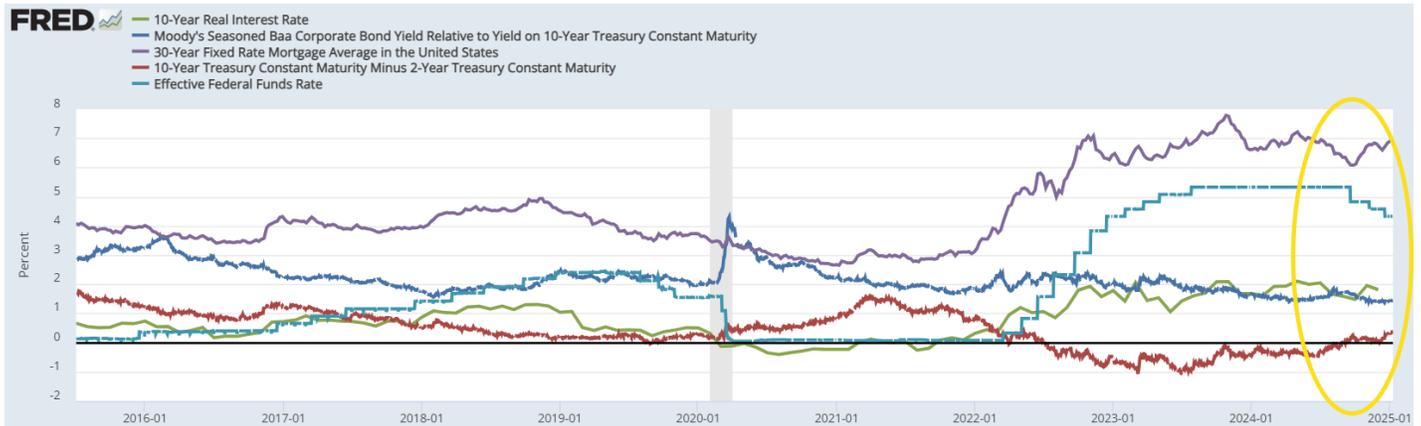
Since September 2024, the Fed's 75 basis point cut in the Fed Funds Rate—down from a tightening peak of 5.25% to 4.5%—signals growing confidence in inflation's sustainable march toward the 2% target. While this has pulled the shorter end of the yield curve downward, November's election of Donald Trump has financial markets pricing in the prospects of tariffs and fiscal expansion in 2025, pushing the longer end of the yield curve higher. Together, these forces are normalizing a yield curve that has just endured an unprecedented 25-month inversion—the longest since 1980. While this shift may boost banks' net interest margins, it also increases pressure on the unrealized losses within their fixed-income portfolios.



#### **THREE TRENDS DISRUPTING FIXED-INCOME**

Beyond the shifting yield curve, three additional market dynamics are present, which significantly reshape fixed-income investing:

- First, unlike the post-2008 era of ultra-low rates, real interest rates are likely to remain elevated even as the Fed eases its stance.
- Second, corporate credit spreads are compressed, reflecting persistently strong corporate fundamentals.
- Finally, the housing market is grappling with a stubborn affordability crisis, with 30-year mortgage rates at 7% against a backdrop of still-elevated home prices.



## Navigating the 2025 Fixed-Income Landscape: A Strategic Approach

The 2025 fixed-income outlook presents a complex array of challenges. Persistent inflation, a soft landing, or a recession—each scenario carries the potential for increased rate volatility and divergent rate paths. To successfully navigate this uncertainty, financial institutions must adopt a more sophisticated approach to Asset Liability Management (ALM).

### ADVANCED ANALYTICS: KEY TO INFORMED DECISION-MAKING

Robust scenario analysis is paramount. Moving beyond baseline projections, ALM managers must consider a wide spectrum of economic possibilities, including stagflation, recession, and CCAR stress test scenarios.

Furthermore, institutions should conduct targeted stress tests that explore the potential impact of specific events, such as a sharp rise in credit defaults or a sudden liquidity crunch in the bond market. These stress tests can reveal vulnerabilities hidden within seemingly robust portfolios and inform contingency planning.

Each scenario demands unique considerations, given its distinct impact on fixed-income investments. For example, anticipating a sustained period of high long-term rates may necessitate reducing portfolio duration,

and more granular risk assessment across all fixed-income sectors such as government, corporate, and municipal bonds. Incorporating these more advanced techniques and analytics empowers ALM managers to optimize their portfolios and achieve superior risk-adjusted returns by:

- **Optimizing Strategy:** Iterative simulations, incorporating user-defined parameters like duration, convexity, and income targets, can reveal the optimal investment, hedging, and funding strategies aligned with the institution's risk appetite and objectives.
- **Measuring Impact:** Before-and-after analysis at the portfolio and balance sheet levels clarifies the optimization's impact on key financial metrics.
- **Assessing Total Return:** A comprehensive total return metric, encompassing interest income, reinvestment income, and capital gains/losses over a defined horizon, provides a holistic view of profitability.

### PREPARING FOR THE FED'S EASING CYCLE

As the Federal Reserve shifts towards an easing cycle, the interest rate environment becomes even more unpredictable. To manage risk and secure profits, financial institutions must proactively respond to economic shifts. Integrating scenario analysis, behavioral modeling, portfolio optimization, and stress testing enhance the adaptability and efficiency of investment analytics. This strategic blend empowers institutions to identify strategies that bolster profitability, solvency, and capital adequacy.