Annual Fixed Income Outlook

An Ameriprise Investment Research Group publication

Fixed Income Research Team
December 18, 2024

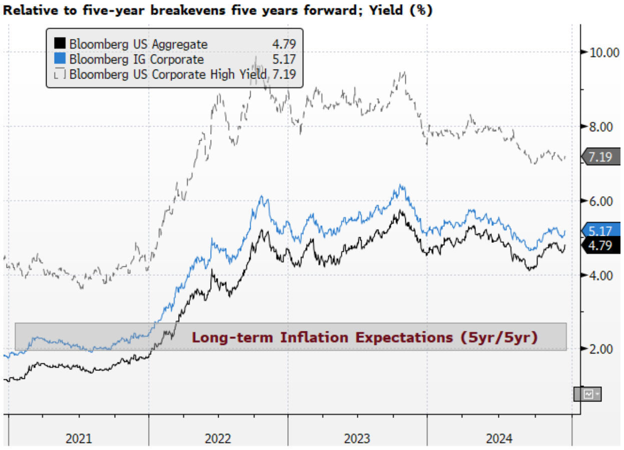
2025 Fixed Income Outlook

An attractive time to own fixed income…

The bond market has come a long way from the 1% yields of 2021 and 2022's stunningly negative total returns. Today, fixed-income investors earn coupon yields of 4.50% to 5.50% on high-quality bond investments producing a healthy level of income for investors looking to draw income from investment accounts. Healthy coupons and yields also benefit investors accumulating wealth by supporting total returns and the growth of account balances.

At 4.78% as of December 16, the Bloomberg US Aggregate Index yields nearly a quarter percent more than on the last day of 2023. At a time when most investments have high valuations, fixed income remains compelling.

Fixed Income Yields Remain Attractive
Relative to five-year breakevens five years forward; Yield (%)



Source: Bloomberg L.P.

We also compare fixed income yields to inflation levels to gauge how purchasing power might be affected. Over the past four years, long-term inflation levels, measured by five-year inflation levels five years in the future, averaged slightly over 2%, suggesting that even the highest quality fixed income investments top inflation. That was not the case in 2021, but it underscores why we see fixed income as compelling today. Clients looking to preserve capital and maintain purchasing power should consider high-quality bond investments.

Key Takeaways

- The Ameriprise Global Asset Allocation Committee's 2025 year-end Fed policy target forecast anticipates an additional half-percent of cuts next year lowering the target range to 3.75% - 4.00%.
- We forecast 10-year Treasury yields to end the year around 4.25%, near their current trading level. This sets up fixed income allocations for coupon-like total returns next year.

Recommendations

- We see more volatile Treasury markets ahead and recommend broadly diversifying high-quality fixed income allocations across Treasuries, agencies, agency mortgage-backed securities (MBS), and high-quality corporate bonds. Also consider tax-exempt municipals where appropriate
- It's a great time to own corporate bonds. The fundamentals are attractive, and easy financing conditions enable high yield issuers with healthy cash flow to refinance existing debt.
- Put excess cash investments to work in fixed income.

Our rate forecasts

Fed funds policy forecast: Our scenarios encompass how much latitude growth and inflation permit the Fed to lower policy rates toward a more neutral level. See page 5 of our *Committee Perspectives – 2025 Investment Themes* report, dated December 18, 2024, for details on the three scenarios in the chart on the left. In our Base Scenario, the Fed reduces policy rates by half a percent next year as occasional soft patches in data enable the Fed to ease restrictive policy to extend the expansion. In the Favorable Scenario, the strong growth through 2025 and firm labor markets lead the Fed to stay on the sidelines through the year, having already cut rates by a whole percentage point in 2024. The Adverse Scenario sees periods of slower growth that permit the Fed to lower its rate policy by a full percent.

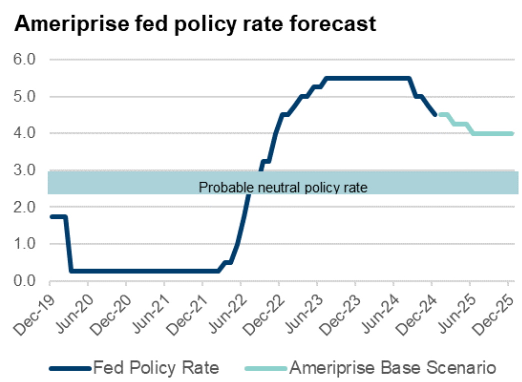
Ameriprise 2025 Year-End Forecasts (See scenarios on page 5 of *2025 Investment Themes*)		
Favorable Scenario	Base Scenario	Adverse Scenario
Fed Funds Target Range 4.25% - 4.50%	Fed Funds Target Range 3.75% - 4.00%	Fed Funds Target Range 3.25% - 3.50%
10-Year Treasury 5.00%	10-Year Treasury 4.25%	10-Year Treasury 3.00%

Source: American Enterprise Investment Services, Inc.

Ten-year Treasury yield forecast: As the Fed looks likely to cut less aggressively than at the end of September, the 3-month to 2-year segment of the Treasury curve flattened, reflecting a modest potential for Fed cuts in 2025. In our Base Scenario, we forecast 10-year yields to end 2025 at 4.25%, modestly below where they stood on December 17, 2024. Inflation of around 2%, significant net new Treasury issuance and potential growth support a natural upward slope for the 2-year to 10-year segment of the curve. In the Favorable Scenario, Fed cuts are off the table, and the steepening in the 2-year/10-year relationship leaves 10-year yields near 5.0%. Conversely, to the extent growth softens and results in additional Fed rate cuts, we anticipate 10-year yields likely settle to 3.0%.

The shape of the Treasury curve

Cash investments and short-term yields: Fed policy anchors the front end of the Treasury curve. We believe the context for Fed rate policy for this cycle is as follows: At 0.00% to 0.25%, the Fed's rate policy spurred new projects, purchases, and financial engineering opportunities in 2020 and 2021. Coupled with multiple rounds of fiscal stimulus, it also resulted in a sharp rise in inflation that was unsustainable for a healthy economy.



Source: American Enterprise Investment Services, Inc.

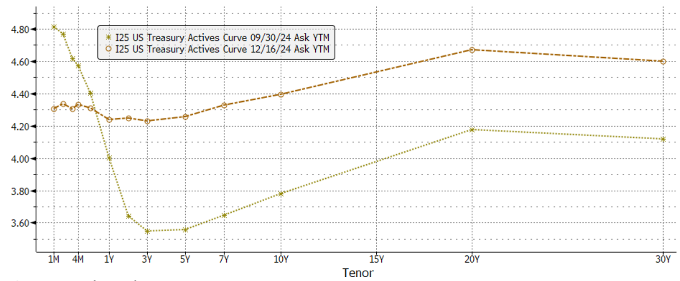
We also know that the Fed's 5.25% to 5.50% policy from earlier this year was solidly restrictive. We see this in corporate and consumer credit markets as borrowers put off financing new commitments while others struggle to meet debt payments or to refinance existing obligations.

Now that the Fed pivoted to rate cuts in September, markets likely focus on the latest financial data and contemplate the level of policy rates that neither stimulates nor slows activity. While only visible in the rearview mirror, this 'neutral rate' is likely the Fed's primary focus next year. The risk to this expectation could be an inflation updraft, or trade-induced supply chain disruption that keeps Fed policy in restrictive territory. Conversely, rising slack in labor markets and quickly decelerating inflation may lead the Fed to lower policy rates more quickly to extend the economic expansion.

Our view aligns with a more historical perspective that neutral is likely between 2.5% and 3.0%. The Fed's policy-making committee members offered views in its Summary of Economic Projections that accompanied the September policy meeting. The summary included individual forecasts that ranged from 2.375% to 3.75%. In reality, neutral policy may only be apparent in hindsight by identifying how policies impacted the economy over time. However, some investors have come to believe that the neutral pace may be higher than 3.0% suggesting Fed policy should proceed more cautiously after chopping policy rates by 100 basis points in the final four months of 2024.

Further out the curve: The pace of U.S. growth continued to surprise in 2024 and could carry over into 2025 to a degree. The chart to the right highlights how, between September 30 and December 16, 1-month yields fell as the Fed looked to cut another 50 basis points by year end, after an initial 50 basis point rate cut on September 18. Meanwhile, Treasury yields from 1-year to 30-years rose as the economy proved stronger than expected heading into year end. The result was that the front end of the curve flattened, and long-term yields rose on pro-growth prospects following the November 6 U.S. election.

Treasury curve comparison – September 30 vs December 16



Source: Bloomberg L.P.

The shape of the Treasury curve reflects that bond markets anticipate very modest prospects for rate cuts next year, and that the economy likely continues to grow with Fed policy rates above 4%. This expectation more closely aligns with our Favorable Scenario and could moderate as markets adapt to the new administration's early policy changes next year.

We anticipate a lower 2-year Treasury yield relative to the Fed's policy range given that price stability and labor markets are nearing balance leading the Fed to seek a more neutral rate policy posture. As long as the pace of growth remains steady, we anticipate the 2-year to 10-year segment of the Treasury curve will remain upward-sloping. Reaccelerating inflation would likely steepen this part of the curve as 10-year yields rise toward 5%. In contrast, slower growth and decelerating inflation may see the 2-year to 10-year segment reinvert as markets bid up 10-year Treasury prices, leading yields below 4%.

Key Fixed Income Themes

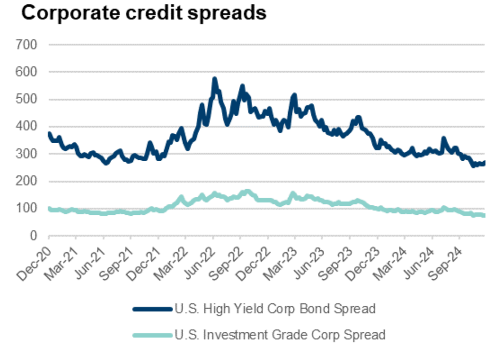
1. Short-term bond yields headed lower with Fed rates. The Fed lowered its policy range by a percent to 4.25% - 4.50% this year. Fed rate policy remains restrictive, seeking to temper growth and inflation further. Directionally, we anticipate further rate cuts over the next few years, suggesting nominal yields may be less generous. Buy them before they are gone.

Along with the Fed, the Eurozone, the U.K., and China are all moving away from high policy rates. We already see stronger growth prospects in the U.S. supporting a slower pace of Fed rate cuts relative to the pace of potential cuts in Europe and China. To the extent the Fed tracks with our forecast for a slower pace of cuts next year, U.S. yields could draw in global investors. We believe this could attract more significant investment in U.S. fixed-income markets as the U.S. dollar remains firm and bond yields attractive for carry trades. Inflows represent incremental demand when the U.S. Treasury needs to attract new buyers to fund deficit spending and to roll over existing debt.

2. Credit conditions are attractive for investment. Overall, the corporate credit environment remains relatively benign, given the availability of capital to refinance short-term debt maturities and strong U.S. employment. High-yield corporate issuance is up more than 50% this year compared to last, and high-yield spreads fell to a new 17-year low of +253 basis points on November 12, 2024. Strong demand from investors seeking to put money to work supported primary market demand throughout 2024. Competing public and private lenders limit refinancing risk even for many high-risk issuers. While the credit environment supports a favorable outlook and low default rates into 2025, high-yield credit spreads remain historically narrow. Anytime demand seems insatiable; there remains a risk that an unforeseen geopolitical conflict or U.S. economic slowdown could make credit spreads markedly widen.

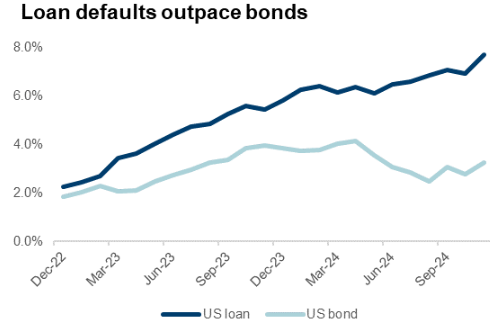
The higher default rate associated with floating-rate loans compared to bonds is due to more highly leveraged private equity financings, including leveraged dividend strategies and LBOs that tend to utilize speculative-grade floating-rate loans over high-yield corporate bonds. See chart at right. Furthermore, corporate bonds are typically issued by larger and often higher-rated companies that generally have more consistent access to the capital markets than smaller, lower-rated borrowers associated with leveraged loans. Now is an excellent time to rotate out of floating-rate loans into high-yield bonds. The credit quality is more attractive, and the fixed-rate bond coupons enable investors to lock in current investment yields rather than see loan yields fall with Fed policy cuts.

Corporate credit spreads



Source: Bloomberg L.P.

Loan defaults outpace bonds



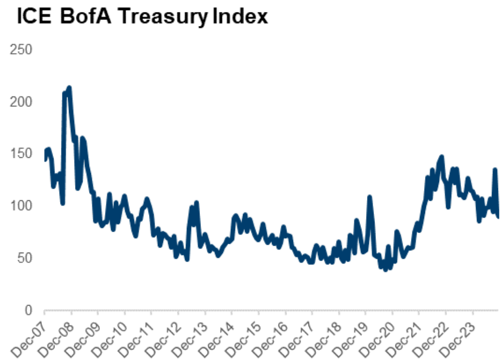
Source: Moody's Ratings

3. Treasury volatility ahead. Heading into 2025, we are watching the ICE BofA MOVE Index, anticipating that moves in interest rates could be more pronounced relative to 2024. Treasury yields may rise in 2024 as markets contemplate the new administration's plans for spending, tax cuts, and regulatory reforms. Upside pressure may be offset by geopolitical events, demand from global relative value buyers attracted to higher U.S. fixed-income yields, and trade conflicts that lead investors to buy U.S. Treasuries. Time will tell how these factors might intermingle, but we recommend that investors broaden diversity within high-quality bond allocations to chart a steadier course.

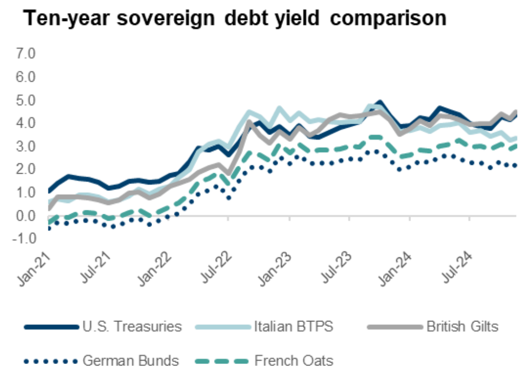
We continue to see a role for high-quality fixed income amidst this volatility. Investors using mutual funds may consider core or core plus options, spreading exposure across Treasuries, agency debentures, agency mortgage-backed securities (MBS) and investment grade bonds. Investors may also consider layering in securitized funds with commercial and residential MBS exposure that offer a unique return profile and incremental spread to U.S. Treasuries.

Globally, sovereign debt levels may move to the forefront in 2025 as highly indebted nations remain dependent on borrowing to fund deficit spending. Recall the emphasis on peripheral nations in the early 2010s and their fiscal irresponsibility. The tide may turn as the focus shifts to some of those core European nations facing higher sovereign debt funding costs as well. We have already seen sovereign debt yields rise in Germany, France, and the United Kingdom as populist leadership seeks to broaden deficit spending with new initiatives. At the same time, meager growth their capacity to repay for debt. Measurably slower growth in Europe and a fractured political backdrop within nations and across the Eurozone set sovereign debt markets up for higher volatility.

Slowing global growth can dampen tax receipts, expand deficits, and complicate repayment of elevated debt levels for many developed and emerging economies. We anticipate more "Liz Truss Moments" where sovereign debt yields jump when asked to fund populist spending plans. The U.S. could eventually fall under similar conditions if corrective actions aren't taken. *Mary Elizabeth "Liz" Truss served as Britian's Prime Minister and Leader of the Conservative Party from September to October 2022, before resigning amid a government crisis, making her the shortest-serving prime minister in British history.*



Source: Bloomberg L.P., ICE



Source: Bloomberg L.P.

Ameriprise guidance on corporate sectors and individual bond issuers

In addition to our constructive view on corporate bond investments we outline on page 3, we recommend focusing on select industries within each sector. In the remaining pages, we frame up our guidance for each sector and provide individual company recommendations that can be used to construct individual bond portfolios and to recommend replacement for ladder strategies. Please see our coverage list below and our latest *Corporate Bond Recommended List* report for specific securities we recommend.

Sector commentary table of contents:

CONSUMER		
Food & Beverage		
Anheuser Busch InBev	ABIBB	A3/A-
McDonald's Corp	MCD	Baa1/BBB+
Tyson Foods Inc	TSN	Baa2/BBB
Retailers		
Amazon.com	AMZN	A1/AA
Autozone, Inc.	AZO	Baa1/BBB
Costco Wholesale Corp.	COST	Aa3/A+
Home Depot	HD	A2/A
Target Corp	TGT	A2/A
Wal-Mart Stores	WMT	Aa2/AA

ENERGY		
Energy Services		
Baker Hughes GE	BHI	A3/A-
NOV Inc	NOV	Baa2/BBB
Oil & Gas		
BP Plc	BP	A1/A-
Chevron Corporation	CVX	Aa2/AA-
Renewables		
Equinor ASA	EQNR	Aa2/AA-
NextEra Energy Capital	NEE	Baa1/BBB
NextEra Energy Inc	NEE	Baa1/A-
Utilities		
Florida Power & Light Mtge	NEE	Aa2/A+

FINANCIALS		
Bank Holding Companies		
Bank of America	BAC	A1/A-
Goldman Sachs	GS	A2/BBB+
Non-Bank & Captive Finance		
BP Capital America	BPLN	A1/A-
BP Capital Markets, Plc.	BP	A1/A-
CNH Industrial Capital LLC	CNHI	Baa2/BBB+
John Deere Capital Corp	DE	A1/A
Financial Technology		
Fiserv, Inc.	FI	Baa2/BBB
Global Payments Inc.	GPN	Baa3/BBB-

HEALTHCARE		
Distribution		
Cencora, Inc.	COR	Baa2/BBB+
McKesson Corporation	MCK	A3/BBB+
Medical Equipment		
Abbott Laboratories	ABT	Aa3/AA-
Boston Scientific Corp	BSX	Baa1/BBB+
Medtronic, PLC	MDT	A3/A
Stryker Corp	SYK	Baa1/BBB+
Pharmaceuticals		
Merck & Co	MRK	A1/A+
Health Care Services		
Laboratory Corp of America	LH	Baa2/BBB

INDUSTRIALS		
Aerospace/Defense		
Lockheed Martin Corp	LMT	A2/A-
Intrastructure & Construction		
MasTec, Inc.	MTZ	Baa3/BBB-
Manufacturers		
Ball Corporation[1]	BALL	Ba1/BB+
CNH Industrial NV	CNHI	Baa2/BBB+
Deere & Company	DE	A1/A
Minerals & Mining		
Freeport-McMoran Inc	FCX	Baa2/BBB-
Freeport-McMoran Corp	FCX	Baa2/BBB-
Environmental Services		
Waste Connections Inc.	WCN	Baa1/BBB+
Construction Materials		
Martin Marietta Materials, Inc.	MLM	Baa2/BBB

TECHNOLOGY		
Communication Services		
AT&T Inc.	T	Baa2/BBB
Comcast Corporation	CMCSA	A3/A-
T-Mobile US	TMUS	Baa2/BBB
Information Technology		
Apple Inc.	AAPL	Aaa/AA+
Microsoft Corporation	MSFT	Aaa/AAA

[1] High Yield Issuer * Under Review

See page 2 for further explanations

Consumer

Stephen Tufo | Director

Reaching an inflection point….

Last year, we recommended that investors overweight consumer non-discretionary and staples and underweight consumer-discretionary, favoring mass merchants that promote deep-discount value-oriented goods. We expected relatively high interest rates, sticky inflation, the threat of a potential U.S. recession and a volatile election cycle to dampen the demand for non-essential purchases.

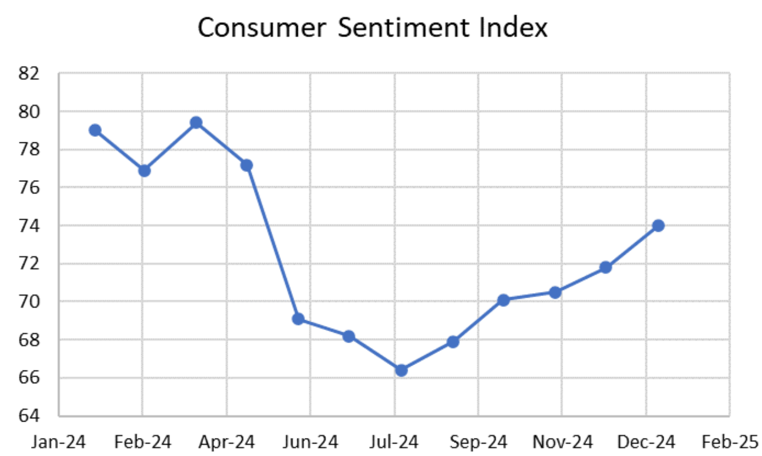
With the Fed starting to cut rates, a relatively civil transfer of presidential power expected in January, inflation continuing to fall and the threat of a US recession considerably easing, we believe the outlook for the U.S. consumer is gradually improving. Furthermore, real wages are once again outpacing core inflation, which should improve consumer sentiment and help grow disposable incomes.

Consequently, we recommend investors Equalweight both consumer discretionary and non-discretionary. While we expect U.S. economic growth to remain constructive and consumer sentiment to improve throughout the year, we believe 2025 will be a year of gradual transition for the U.S. consumer as consumers continue to cope with food prices roughly 20% higher than pre-pandemic levels. We see consumer staples still leading the way in early 2025, but we expect the economy to transition to more discretionary spending and bigger ticket items as the year progresses.

Key Takeaways

- Equalweight consumer non-discretionary and discretionary on improving outlook.
- Consumer sentiment should improve through 2025 on real wage growth and declining interest rates.
- The favorable outlook for the U.S. economy should translate into increasing demand for discretionary purchases into the second half of 2025.
- The credit environment should remain relatively constructive for consumer companies next year with modest year-over-year comparable sales growth beginning to pick-up for non-discretionary positioned consumer companies.

As illustrated in the accompanying chart, consumer sentiment, after weakening in the first half of 2024, has begun to improve since mid-year. Consequently, the demand for staples outpaced the demand for discretionary goods for most of 2024 when retailers like **Walmart (WMT: Aa2/AA, Corporate Bond Recommended List)** and **Costco (COST: A3/A+, Corporate Bond Recommended List)** outpaced discretionary retailers like **Home Depot (HD: A2/A, Corporate Bond Recommended List)** and **Macy's (M: Ba2/BB+, Not Rated)** that continue to report negative comparable sales. Consequently, as sentiment continues to improve into 2025, consumer companies that produce, manufacture, distribute and market more non-essential goods should see an improvement in demand for products and services. While sentiment has improved from the June 2022 readings of 50.0 to 74.0, it remains substantially below pre-pandemic levels of 101.0 in February 2020.



Data source: University of Michigan Consumer Sentiment Index sourced froim Bloomberg LP

We recommend that investors Equalweight off-price retailers and mass merchants like Walmart**, TJX (TJX: A2/A, Not Rated)** and Costco that promote a wide array of high-value oriented merchandise as consumers continue to stretch disposable incomes. Furthermore, we also recommend investors Equalweight retailers like **Target (TGT: A3/A-, Corporate Bond Recommended List)**, **Amazon.com (AMZN: A/A2, Corporate Bond Recommended List)** and Home Depot that may benefit from a gradual rebound in the demand for discretionary goods like apparel, home furnishings, electronics, appliances, and leisure products in 2025 as consumer sentiment continues to improve due to the positive factors mentioned above.

Energy

Gas is good….

Jon Kyle Cartwright | Senior Director

As we prepare for a new U.S. President, uncertainties surrounding the longevity of U.S. sanctions against Russian energy exports looms heavily over our 2025 energy price forecast and energy investment recommendations. As a result, we suggest that investors equally weight the energy sector in aggregate.

With that caveat in mind, it's been nearly three years since Russia invaded Ukraine, world crude oil markets have adjusted, Western oil production has increased, and oil tanker traffic has been rerouted to Europe. Unless global production pulls back, we would expect NYMEX per barrel spot oil prices to continue to head towards the $60s as markets try to find some semblance of normality.

Europe is still working to replace pre-war Russian gas import volumes. However, even if Russian hostilities end tomorrow, we believe the E.U. will remain committed to ending Russian fossil fuel imports over the coming decade. As a result, we expect European natural gas prices (i.e., the ICE Dutch TTF Spot Natural Gas price) to continue to hover around US$10 above the NYMEX Natural Gas current futures contract for some time.

Our outlook on the Energy Service subsector remains stable. Our favorite Energy Service Companies include **Baker Hughes (BKR: A3/A-, Corporate Bond Recommended List) and NOV Inc (NOV: Baa2/BBB, Corporate Bond Recommended List).**

Key Takeaways

- The Russian war on Ukraine and Europe's desire to end Russian oil & gas imports could cast a wide shadow over global energy markets through at least 2030.
- From our vantage point, U.S. and Global economic growth remains lackluster, which could stabilize motor fuel demand.
- Lacking conviction on where European oil and gas prices are heading, we recommend clients divide energy investments between energy subsectors: oil & gas production, energy services, renewable power producers, and electric utility issuers.

Our stable outlook on the integrated oils and exploration & production sectors remains unchanged. Our favorite Oil and Gas Producers include BP **Plc (BP: A2/A-, Corporate Bond Recommended List)**, **Chevron Corp (CVX: Aa2/AA-, Corporate Bond Recommended List)**, and **Equinor ASA (EQNR: Aa2/AA-, Corporate Bond Recommended List)**.

We believe the Western World may need to divert natural gas demand away from electric generation by building even more renewable power stations as substitutes. We should point out that the speed at which renewable generation expands in the U.S. over the next four years will depend on what policies the new presidential administration decides to implement.

However, over the long haul, renewable power is cheaper to produce than hydrocarbon-fired electric generation, and over time, we expect Wind, Solar, and Wave power to grow and eventually dominate the electric generation space. Our favorite renewable energy company is NextEra **Energy Capital Holdings, Inc. (NEE: Baa1/BBB+, Corporate Bond Recommended List)**, and our favorite electric utility is **Florida Power & Light Company (NEE: Aa2/A+, Corporate Bond Recommended List)**, both of which are subsidiaries of **NextEra Energy, Inc. (Baa1/A-).**

Financials

Jon Kyle Cartwright | Senior Director

This beach is safe to surf….

The worst may be over for Strategically Important Financial Institution (SIFI) banks after five U.S. bank failures and the demise of Credit Swiss in 2023. Since then, regulators have compelled larger banks to pivot away from growth in favor of boosting capital and tightening risk management standards.

As a result, the average SIFI reported adequate capital levels and improved credit profiles in 2024. With that said, we continue to recommend corporate bond investors maintain an equal weighting on SIFIs until the 2025/2026 regulatory environment solidifies. Our favorite SIFI banks include **Bank of America (BAC: A1/A-, Corporate Bond Recommended List) and Goldman Sachs (GS: A2/BBB+, Corporate Bond Recommended List).**

The fallout from rising office building loan defaults is still accumulating, and office space vacancy problems could continue well into 2025 as leases expire and the work-from-home movement refuses to dissipate. At the same time, there appears to be a shrinking number of lenders willing or able to refinance office building loans with reasonable terms, which may further contribute to the problem throughout 2025.

The lion's share of loan default risk associated with domestic office-building loans appears to be in the hands of non-SIFI Regional Banks, which have less regulatory supervision than SIFIs. Even though we believe the regional banking subsector is now refocusing on strengthening its risk management standards and fortifying loan portfolios against losses, the risk from problem office building loans is still intensifying. With that said, we'll wait for a traditional early cycle recovery that includes robust bank loan growth before increasing our weighting on the Regional Banks from underweight to equal.

We recommend portfolios overweight notes issued by captive non-bank finance companies with loan portfolios structured to weather deep industry down cycles and adverse economic conditions. The captive non-bank finance companies on our corporate bond recommended list have demonstrated histories of sustaining their financial strength, managing economic & industry cyclicality, navigating regulatory policy changes, mitigating geopolitical risk, and upholding conservative financial management practices, all while retaining superior loan underwriting standards able to withstand the cyclical nature of their customers businesses. We believe the sector will continue to generate stable and predictable cash flows and improve credit profiles. Our favorite captive non-bank finance companies include **BP Capital America (BPLN: A1/A-, Corporate Bond Recommended List)**, **BP Capital Markets Plc (BPLN: A1/A-, Corporate Bond Recommended List)**, **CNH Industrial Capital (CNHI: Baa2/BBB+, Corporate Bond Recommended List)**, **and John Deere Capital (DE: A1/A, Corporate Bond Recommended List)**.

After decades of using leveraged buyouts to fund mergers and acquisitions, the Transaction & Payment Processing Services subsector of the Financial Technology (FinTech) group has distilled down to a few investment-grade issuers. We expect this subsector to continue to de-lever, streamline product offerings, and rely increasingly on organic growth. This should allow the group to improve credit metrics and produce predictable organic growth through at least 2027, which could result in credit rating upgrades in 2025 or 2026. As a result, we recommend overweighting this rapidly growing subsector that is quickly consolidating into a small number of higher-quality participants. **Our FinTech favorites include Fiserv (FI: Baa2/BBB, Corporate Bond Recommended List) and Global Payments (GPN: Baa2/BBB-, Corporate Bond Recommended List)**.

Key Takeaways

- In aggregate, we recommend investment-grade bondholders equally weight the financial sector early in 2025 while remaining exposed to a select group of financial subsectors.
- Our weightings could change as we better understand how financial regulations will unfold in the future.
- Long-term bond investors should remain exposed to Strategically Important Financial Institutions (SIFI) Banks.
- We believe investors should underweight regional banks exposed to office building loans.
- We think bond investors can safely buy and hold bonds issued by a select group of Captive Non-Bank Finance companies.
- We suggest bond buyers have a relatively oversized exposure to the FinTech - Transaction & Payment Processing Services subsector.

Health Care

Who's going to pick up the tab….

Stephen Tufo | Director

Given the aging global population, we expect the demand for health care services will remain robust into the next decade. Developments in Pharma, Biotech and MedTech have substantially improved quality of life, made once debilitating chronic diseases more manageable, and helped reduce inpatient hospital stays. However, innovation and improving medical outcomes at heightened demand levels come at a significant cost. Whether it's private payors like insurance companies and managed care organizations or government agencies like Medicare and Medicaid, the objective is the same: providing high-quality care while finding ways to reduce costs. Consequently, we anticipate this somewhat fiscal tug-of-war to go on indefinitely as healthcare providers try to meet their financial objectives and payors seek to manage the increasing strain on resources.

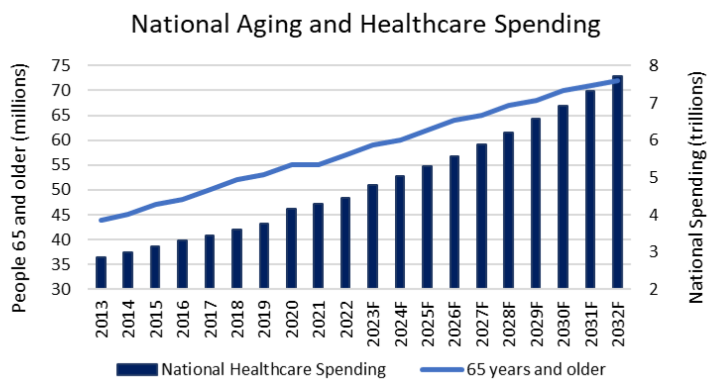
The Centers for Medicare & Medicaid Services (CMS) expects national healthcare spending to grow by roughly 5% annually from $4.8 trillion in 2023 to $7.7 trillion by 2032 as the U.S. population 65 and over, increases to about 72 million, or over 20% of the total population (*see accompanying chart*). Furthermore, CMS estimates that annual per capita health care spending is expected to increase from roughly $14,400 in 2023 to over $22,000 by 2032, outpacing personal income growth, while health care spending as a percentage of U.S. GDP is expected to increase from 17.6% to 19.7% over the respective period. As we near the end of the decade, we expect healthcare spending partially related to increased incidences of chronic disease associated with the elderly, like diabetes, cardiovascular disease, arthritis, and Alzheimer's, will garner an increasing share of disposable income and overall government spending.

Key Takeaways

- We recommend investors equalweight the investment grade fixed income health care sector in 2025 while tactfully selecting issuers well positioned to thrive given the growing uncertainties related to public policy and payor cost containment efforts.
- We expect the overall sector to remain somewhat volatile through 2025 as ongoing cost containment efforts offset the favorable outlook for secular demand.
- We believe subsectors that help reduce costs while providing improved medical outcomes including MedTech and Drug Distribution will be well-positioned to benefit from current industry dynamics.

We expect payor groups and government agencies to increasingly seek to constrain spending as these secular trends continue to take hold. The Inflation Reduction Act (IRA), signed into law in 2022, aims to reduce Medicare drug-related spending by approximately $240 billion from 2022 to 2031. The overall financial impact of the price negotiations associated with the IRA, which will begin to take effect in 2026, is expected to have a modest impact on industry profitability over the near term and ramp up over time, assuming the new incoming administration continues to support the current public policy.

Aging population to drive healthcare spending higher



Data source: CMS

Consequently, while we recommend investors Equalweight the health sector, overall, we suggest investors overweight health care industry segments outside the crosshairs of public regulators and those that deliver true economic value to the overall health care ecosystem. Specifically, we recommend investors overweight MedTech companies like **Boston Scientific (BSX: Baa1/BBB+, Corporate Bond Recommended List)**, **Medtronic (MDT: A/A-, Corporate Bond Recommended List)**, **Stryker (SYK: Baa1/BBB+, Corporate Bond Recommended List)** and **Abbott Labs(ABT: Aa3/AA-, Corporate Bond Recommended List)** that through minimally invasive surgical solutions and medical devices help reduce the overall financial and social burden on public and private payors while delivering improved medical outcomes. Furthermore, we recommend investors tactfully overweight drug distributors like **McKesson (MCK: A3/BBB+, Corporate Bond Recommended List)** and **Cencora (COR: Baa2/BBB+, Corporate Bond Recommended List)** that operate under very low margins while providing essential logistics and management services to pharmacies and health care providers through their vast economies of scale and enhanced operating efficiencies. Alternatively, we recommend investors underweight Pharma within health care due to pricing pressures and impending patent cliffs associated with some of the industry's most profitable drug therapies.

Industrials

Choose wisely….

Jon Kyle Cartwright | Senior Director

Key Takeaways

- We recognize that, in aggregate, average U.S. and global industrial profits and credit qualities have yet to begin a long-term recovery.
- However, we suggest investing in the industrial subsectors already showing signs of an early recovery.
- Therefore, we recommend long-term bond investors overweight the Industrial Sector by selectively investing in the Aerospace/Defense, Agricultural Manufacturing, Infrastructure Construction, and Copper Mining subsectors.

As a rule, when economies begin early cycle recoveries, industrials become increasingly attractive investments and less so as economies slow or slip into recession. While we can't confirm that a new early cycle recovery has begun, several Industrial subsectors may be entering their own upcycles and are, therefore, worthy of a second look.

In the Aerospace/Defense subsector, we believe there's an ongoing need for Western-allied countries (with or without the U.S.) to bolster national defense capabilities to counter mounting threats from adversarial nations, which could sustain weapons demand for another 25 years. **Our favorite Aerospace/Defense issuer is Lockheed Martin Corp (LMT: A2/A-, Corporate Bond Recommended List), the planet's largest (by revenue) defense contractor.**

Infrastructure Construction got stuck in a downcycle after the COVID-Recession, but 2025 could be different.

We believe there are early signs of a cyclical recovery in public and private non-residential construction projects, including AI server farms, commercial warehouses, communication hubs, LNG terminals, power stations, ports, bridges, roads, and other public works projects.

Regarding Office Buildings, vacancies are still rising as leases expire and the work-from-home movement refuses to dissipate. As a result, we aren't expecting a resurgence of new office construction anytime soon.

Residential construction in the U.S. could be ready to emerge from its post-COVID lull. There's nearly a universal acceptance that America has a housing shortage. If the U.S. avoids a major recession and the Fed continues pushing down interest rates, we could soon see a new domestic housing construction upcycle that could produce sustainable benefits for the Infrastructure construction sector in late 2025 or 2026.

Our favorite infrastructure construction ideas include Baker Hughes (BKR: A3/A-, Corporate Bond Recommended List), CNH Industrial (CNH: Baa2/BBB+, Corporate Bond Recommended List), Deere & Company (DE: A1/A, Corporate Bond Recommended List), Martin Marietta (MLM: Baa2/BBB+, Corporate Bond Recommended List), MasTec (MTZ: Baa3/BBB-, Corporate Bond Recommended List), NOV Inc (NOV: Baa2/BBB, Corporate Bond Recommended List), and Waste Connections (WCN: Baa1/BBB+, Corporate Bond Recommended List).

In the Industrial Agricultural Equipment Manufacturing space, despite the short-term negative effect of the current farm income downcycle, moving from mechanized to precision farm equipment could be a long-term investment theme that lasts through the end of the century. Farmers could enjoy cost savings from intelligent, autonomous, and semi-autonomous precision farming equipment and techniques that not only reduce the need for farm labor but can also till, plant, monitor, harvest, and apply water, fungicides, herbicides, insecticides, pesticides, fertilizers, and other agricultural chemicals to target areas as small as one square inch and only in the exact amount each plant needs, thus avoiding costly and wasteful applications. At the same time, precision farming techniques promise to boost crop yields and help farmers feed the world's growing population. **Our favorite Agricultural Equipment Manufacturers are CNH Industrial (CNH: Baa2/BBB+, Corporate Bond Recommended List) and Deere (DE: A1/A-, Corporate Bond Recommended List).**

In the Minerals and Mining sector, we believe there's a long-term secular shift in copper demand as the need for copper wire from renewable power generation and electric vehicles begins to eclipse the available supply, causing copper prices to rise. **Our favorite copper miners are Freeport-McMoRan Inc. (FCX: Baa2/BBB-, Corporate Bond Recommended List) and its affiliate Freeport Minerals Corporation (FCX: Baa1/BBB-).**

Technology

Leveraging the growing digital ecosystem…

Stephen Tufo | Director

While investors were captivated in 2024 by the rapid growth in AI technologies, we believe that in 2025, stakeholders will be increasingly focused on assessing the potential for AI commercialization and proven use cases. Leading technology companies like **Apple (AAPL: Aaa/AA+, Corporate Bond Recommended List)**, **Microsoft (MSFT: Aaa/AAA, Corporate Bond Recommended List)**, AWS, a subsidiary of **Amazon (AMZN: A1/AA, Corporate Bond Recommended List)** and **Alphabet (GOOGL: Aa2/AA+, Not Rated)** are rapidly integrating AI into their product and servicing offerings and are well positioned to benefit from emerging AI technologies.

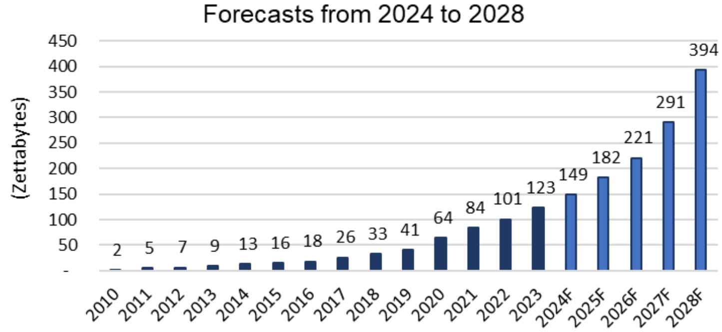
Data centers needed to store and process the amazing amount of data necessary for AI deployment are rapidly being constructed, adding to the growing volume of digital content. As such, the amount of digital data continues to grow exponentially. As illustrated in the accompanying chart, according to private market research firm Statista, the amount of data created, captured, consumed, and stored is projected to more than triple through 2028. Consequently, efficiently analyzing, processing, and managing these vast digital ecosystems will require intelligent (i.e., AI) architectures and computing applications. We expect ongoing investments in AI to fuel the subsequent need for further investments throughout the digital ecosystem to support these emerging technologies.

Key Takeaways

- We recommend investors overweight Technology based on our outlook for continued strong secular demand.
- AI will continue to fuel additional investments in cloud-based infrastructure and intelligent software-as-a-service (SAAS).
- IT providers that can store, manage, and analyze the growing amount of digital data will be well-positioned for the foreseeable future.
- Wireless and broadband providers will continue to play a vital role within the digital ecosystem.

We believe technology providers well-positioned to store, compute and transmit vast amounts of data will continue to find their IT services in high demand. We believe the proverbial "genie is out of the bottle," and there is likely no turning back. We wrote last year in our 2024 Fixed Income Outlook and continue to believe "*how businesses adapt and leverage AI and Technology overall will increasingly become a key determinant of commercial success. Enterprises that under-invest in technology leave themselves exposed to obsolescence risk and disruptive technologies. In our view, ongoing IT investments are no longer considered discretionary but essential to maintaining competitive leadership*."

Digital Data
Created, Captured, Consumed and Stored
Forecasts from 2024 to 2028



Data source: Statista 2024

We expect digital communication providers like **Comcast (CMCSA: A3/A-, Corporate Bond Recommended List)**, **T-Mobile (TMUS: Baa2/BBB, Corporate Bond Recommended List)** and **AT&T (T: Baa2/BBB, Corporate Bond Recommended List)** to benefit from the increasing demand for high-speed, low-latency digital transmission. In our view, years of heavy infrastructure investment in broadband fiber networks, 5G densification, and spectrum acquisitions should support anticipated strong demand for their respective digital data communication services for the foreseeable future. Furthermore, we expect advancements in GenAI that enable virtual reality (VR), augmented reality (AR), and mixed reality (MR) at the device level to accelerate the demand for high-speed internet service across mobile wireless and residential broadband networks over time. GenAI is a machine-learning model that understands text, audio, and video content derived from patterns learned from vast datasets generally executed in the cloud to provide enhanced user experiences.

We expect cloud computing to continue to be a growing service area for many of the nation's largest IT providers like AWS, Alphabet, Microsoft, and **Oracle (ORCL: Baa2/BBB, Not Rated)** through the remainder of the decade. The increasing adoption of AI models, including large language models (LLM) and GenAI, should increase the demand for cloud computing as these models use cloud-based AI on-demand applications and tap vast datasets to achieve specific outputs or tasks. Private market research firm Gartner projects global IT spending on public cloud services to increase from $679 billion in 2024 to over $1 trillion by 2027. Consequently, we believe we are in the relatively early stages of this IT cycle that should continue to support a healthy secular demand outlook for the leading IT industry players.

The Ameriprise Investment Research Group

Investment Research Leader

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Vice President

Strategists

Chief Market Strategist
Anthony M. Saglimbene
Vice President

Thomas Crandall, CFA, CFP®, CMT, CAIA
Vice President – Asset allocation

Jun Zhu, CFA, CAIA
Sr. Analyst – Quantitative, Asset allocation

Sumit Chugh, CFA
Sr. Manager

Amit Tiwari, CFA
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Sr. Analyst - Quantitative strategies and international

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Jillian Willis
Sr Administrative Assistant

Kimberly K. Shores
Investment Research Coordinator

Jeff Carlson, CLU®, ChFC®, RICP®, CRPC™
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Ryan Elvidge, CFA
Analyst II

Matthew Burandt
Analyst II

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Sr. Associate I

Harish Chauhan
Sr. Associate I

Ankit Srivastav
Lead Business Analyst

Pulkit Kumar
Associate I

Sameer Asif
Associate II

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Andrew S. Murphy, CFA
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Teneshia Butler
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Fixed Income Research

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