



Mid Year Outlook

From Global Fixed Income

The macro backdrop for bonds remains constructive—in our view, yields are attractive in real terms—but navigating H2 2026 requires careful attention to duration risk, fiscal dynamics, and idiosyncratic credit risk. The balance of 2026 remains an income story more than a capital gain trade.

1. A hawkish Fed and a flatter curve

An acceleration in inflation and a newly hawkish Fed has led to a significant flattening of the Treasury curve. With the Fed increasingly likely to raise rates, some additional curve flattening may lie ahead, but we do not expect inversion as recession risks remain muted. In addition, longer-term yields should remain above 4% on a combination of deficit concerns and expectations that strong productivity growth can lift trend growth. The practical implication: we believe intermediate maturities (5–7 year) may offer the best risk-adjusted value, especially as monetary tightening is now close to fully discounted, while going too far out on the curve carries meaningful term premium risk.

2. Credit spreads leave little margin for error

After years of spread compression, investment-grade credit valuations offer very little cushion. With credit spreads

1. Barclays

approaching historical lows¹, corporate bonds offer limited compensation for the additional risk — and as capital-intensive AI projects proliferate, the potential for credit stress, especially among lower-rated issuers, rises. High-quality government bonds are once again able to play their traditional role as a portfolio stabilizer — if markets become choppy or growth disappoints, we believe they can help provide valuable risk mitigation. Our implication for the rest of 2026: favor quality over yield-chasing, be selective in credit, and use volatility spikes as entry points rather than reasons to extend risk indiscriminately.

3. Caution in CMBS conduits, opportunities in SASB

CMBS is one of the most bifurcated corners of fixed income in 2026. Office and data centers will keep driving single-asset/single-borrower (SASB) issuance, though weak office demand may push conduit delinquencies higher — and rising leverage will increase risk in large CMBS and CRE CLO deals unless credit protections improve. On the constructive side, the CMBS market achieved post-GFC record issuance in 2025 on improved liquidity and sentiment, with property valuations

finally stabilizing after a three-year slide². Meanwhile, a new growth engine is emerging: data centers have become a core property type within US SASB CMBS, and financing demand for data centers will likely rise as AI infrastructure buildout accelerates. The playbook for H2 2026: we believe investors should favor senior tranches and trophy assets while maintaining caution on office and retail exposures.

4. Carry is the story in leveraged credit, but caution is warranted

High yield bonds and leveraged loans are broadly offering positive returns in 2026³, but the story is firmly one of income rather than spread compression. Investors are reasonably compensated for credit risk amid moderate default expectations, though valuations are fair overall rather than cheap. Default rates remain moderate but are diverging — high yield bond defaults are drifting down toward ~3.5%, while leveraged-loan defaults are climbing toward ~5.5%.⁴ The key risk is AI-driven disruption at the issuer level: markets have increasingly focused on the potentially negative impact of AI on a range of issuers, particularly those in the software and B2B services sectors, where loan and bond prices are coming under pressure as investors reassess business models for potential obsolescence. Our view: we like the carry offered in both bonds and loans and would size them to the

rate path. Floating-rate loans offer attractive income while front-end rates stay elevated and sit senior in the capital structure; BB/B bonds lock in all-in yields and provide better convexity if the Fed eventually eases. In both, we stay up in quality — the rising loan default rate and the concentration of AI-exposed software and B2B issuers in the loan market reward issuer selection rather than reaching for spread. We approach spread tightening as an opportunity to reduce risk while we would view potential spread widening as an opportunity.

5. Emerging markets is still a bright spot, but country specific

We believe EM debt stands out as one of the more compelling opportunities in H2 2026, reinforced by more favorable public-sector debt dynamics compared with developed-market counterparts. Many emerging market central banks raised interest rates early in the cycle, and with inflation in several countries now falling, some local currency EM bonds offer high real yields.⁵ This is particularly true in Latin America with countries like Brazil and Chile. Asian net energy importers such as Indonesia and Thailand face headwinds from higher oil prices tied to the Middle East conflict.

2. KBRA (Kroll Bond Rating Agency)

3. Morgan Stanley

4. Morgan Stanley

5. MacKay Shields

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