Allianz Global Investors

JANUARY 2026

Fixed Income Forward

2026: momentum uninterrupted

Key takeaways

- The themes behind our constructive stance remain central in 2026 – attractive starting yields, moderating yet resilient global growth and diversified return drivers.
- As central banks near neutral rates, we expect fiscal stimulus to foster risk appetite even as geopolitical risks rise. We remain focused on building resilience with globalised duration exposure, quality credit and an active approach.
- We expect yield ("carry") and currency fluctuations to be key return drivers while viewing core interest rates – particularly in the US – as a critical safety net to hedge against risk assets and provide liquidity in a downside scenario.

Global markets began 2026 by extending the previous year's gains, with riskier assets and emerging markets in the spotlight. Second only to convertible bonds in terms of performance, emerging market sovereign debt and Asia high-yield beat other fixed income assets by delivering equity-like, double-digit yearly returns in US dollar terms. Local currency bonds, especially in Latin America, performed especially well thanks to currency appreciation against the dollar. So far this year, the capture of Venezuela's president Nicolás Maduro by US forces has not disrupted but rather sustained and extended the emerging market rally.

The US dollar did benefit from some flight-to-safety support in the immediate aftermath of events in Venezuela. Nonetheless, we maintain a relatively weaker US dollar bias in 2026, believing that US interest rates have more room to compress relative to the rest of the world. Several high-carry emerging market currencies, such as the Brazilian real, still look attractive due to high real interest rates. Our constructive view on currencies extends to Asia, and in particular to trade-surplus and tech-heavy economies such as South Korea, which benefits from the artificial intelligence (AI) investment theme and a relative easing of international trade tariff concerns.

Credit spreads ended 2025 at near cyclical lows, thanks to investors' strong appetite for yield products. We expect "search for yield" behaviour to continue in 2026, as a relatively neutral to dovish outlook for core rates could help reallocate trillions currently sitting in money market funds. While spreads are indeed tight and starting yields for most credit markets are lower than at the start of 2025, we believe these yields remain decent compared to cash and are a better indicator for forward returns than spreads alone. That said, we see earnings diverging as changing policies and regulations affect industries and companies differently across sectors and regions. For example, energy and financials are poised to benefit from deregulation, while low-end consumers and sectors that rely on rising input prices could struggle.

Global high-yield bond returns were mainly driven by carry and duration return in 2025 – and boosted by exposure to emerging markets and Asia. Our calls to underweight CCC-rated bonds and overweight

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BBs paid off, particularly towards the end of the year. Throughout last year's turbulence, high-yield credit has shown more resilience than equities thanks to low defaults and high carry – a trend we expect to continue. Spreads are indeed tight, but we believe such rich valuations are partially justifiable by stronger credit fundamentals compared with previous cycles and an overall higher-quality investment universe. We monitor developments in private credit but so far see limited systemic risk and consider that greater vigilance in underwriting can offer an opportunity for credit differentiation and outperformance. We think strategic allocation to emerging market and Asia high-yield corporates can continue to offer diversification and compelling return potential.

In technology, we think the AI investment theme will require bond markets to play a bigger role, with fixed income serving as both an enabler and diversifier. The investment-grade credit market will be essential in funding AI capital expenditure needs, even as this same expansion fuels a greater concentration of risk – as in previous cycles, we expect the high-yield market to follow suit. We believe bond investors should look past the extremes of greed and fear, and approach the sector as they would any other – by diligently watching balance sheets, credit metrics and funding conditions.

Overall, we think the range of possible macro outcomes has narrowed. The probability of a sharp slowdown in growth, or a sharp rise in inflation, is in our view lower than a year ago. With most central banks closer to their neutral rates, a shift from incremental monetary easing towards policies focused on fiscal spending should keep financial conditions accommodative. That said, geopolitical risk seems to be on the rise, which we think highlights the importance of core rates to strengthen portfolio foundations. If the broadly neutral outlook were to be disrupted, we would expect core rates, particularly US duration, to behave as a hedge for risk assets and to provide liquidity during times of stress. While we prefer the front end and belly of the yield curve for now, we would not write off the long end just yet, despite concerns for fiscal sustainability. To summarise, we think the current environment calls for: globalising core rates exposure to capture divergent regional cycles; a broad toolkit for taking duration risks with curve positioning and relative value positioning; and an active and nimble approach as the rate environment evolves.

Fixed income market performance

Indicative market indices Data as at 31 December 2025	Total return Full year 2025 (%)	Total return Dec 2025 (%)	Yield-to- worst (%)	Effective duration (years)
Global convertible bonds	21.55	0.50	-2.0	1.5
Global emerging-market sovereign bonds	14.30	0.72	6.8	6.6
Asian high yield	10.79	0.90	8.1	2.9
US investment grade	8.50	0.69	7.1	2.9
US high yield	7.83	0.21	4.8	4.8
Asian investment grade	7.77	-0.20	4.8	6.9
US aggregate	7.30	-0.15	4.3	6.0
Global aggregate	5.21	0.34	3.5	1.7
US Treasury bonds 1-3 years	5.15	0.37	5.6	2.9
Euro high yield	5.12	0.39	4.3	0.0
US floating-rate notes	4.86	-0.21	3.5	6.3
Euro investment grade	3.03	-0.19	3.3	4.5
Global government bonds AAA-AA	2.59	-0.59	3.2	7.3
Euro government bonds 1-3 years	2.30	0.04	2.2	1.9
Euro aggregate	1.25	-0.50	3.0	6.2

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 31 December 2025. Index returns in USD-hedged except for Euro indices (in EUR). Asian and emerging-market indices represent USD denominated bonds. Yield-to-worst adjusts down the yield-to-maturity for corporate bonds which can be "called away" (redeemed optionally at predetermined times before their maturity date). Effective duration also takes into account the effect of these "call options". The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or as investment advice. Past performance, or any prediction, projection or forecast, is not indicative of future performance. See page 4 for additional note on yield-to-worst.

WHAT TO WATCH

1. Latin America

Following its intervention in Venezuela, the US has issued warnings to other non-aligned South American states including Cuba, Nicaragua and Colombia. Brazil and even Mexico could be targeted too. In a positive scenario, a smooth transition of power in Venezuela could restore the country's access to bond markets and fuel further credit spread compression in the region.

2. Credit defaults

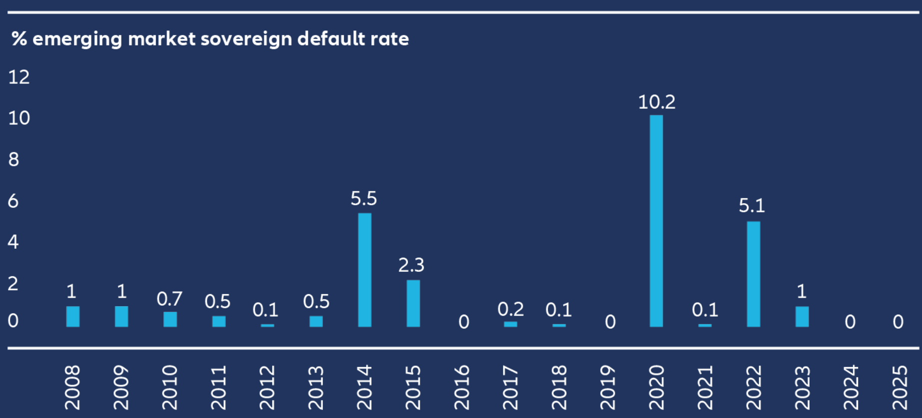
Global high yield defaults at end-September stood at 1.4%, largely from CCC-rated credits. For 2026, we estimate a default rate of around 2%, again driven by CCCs. This compares with a long-term average of 4.5%. The default landscape has improved due to higher average credit quality, weaker issuers being served by private credit, and active creditors staving off imminent defaults with pre-emptive restructuring.

3. Inflation diverges

December's inflation data from Germany and France suggest a downside inflation surprise in the euro area. In contrast, November's weaker US inflation reading may have been biased to the downside due to missing data from the government shutdown. Final readings for December will provide further clues on how inflation is diverging from central banks' targets.

CHART OF THE MONTH

No emerging market sovereign defaults for second year running



Source: JP Morgan, Allianz Global Investors, data as at 31 December 2025.
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The resurgence of interest in emerging market debt in 2025 was partly underpinned by the absence of sovereign defaults in the last two years. The positive outlook helped to drive outperformance of high-yield issuers, declining domestic rates in countries such as South Africa and Brazil, and a positive rerating of turnaround sovereign credits, in particular Egypt, Argentina, Sri Lanka and Pakistan. The turn of the year brought Venezuela into the spotlight. The country's sovereign bonds have been in default since 2017 but surged in price due to expectations that pressure from the US could restore Venezuela's access to bond markets. The main variable determining these bonds' value is how quickly oil production could be increased. Given that significant capital investment is required, and that sovereign debt restructuring would involve an extended negotiation process, we estimate a recovery value in the range of 40 to 50 cents on the dollar.

Note on "yield to worst": this represents the lowest potential yield that an investor could theoretically receive on the bond up to maturity if bought at the current price (excluding the default case of the issuer). The yield to worst is determined by making worst-case scenario assumptions, calculating the returns that would be received if worst-case scenario provisions, including prepayment, call or sinking fund, are used by the issuer (excluding the default case). It is assumed that the bonds are held until maturity and interest income is reinvested on the same conditions. The yield to worst is a portfolio characteristic; in particular, it does not reflect the actual fund income. The expenses charged to the fund are not taken into account. As a result, the yield to worst does not predict future returns of a bond fund.

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