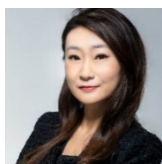


March into de-escalation

“Modern life is a product of energy. We are what we burn.” – Richard Rhodes

Key takeaways

- The **Middle East conflict** is a classic geopolitical volatility shock that risks morphing into an **energy-driven macro shock**.
- All parties want **de-escalation**, but a settlement requires protracted negotiations; in the meantime, we could see higher-for-longer core rates.
- With **financial conditions still broadly manageable**, despite rising volatility, it's **too early to turn away from spread assets and coupon “carry”**.
- Keeping **dry powder, being active** and prioritising **balance sheet strength and selectivity**, rather than broad market exposure, is crucial to navigate current market uncertainty.



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What happened in March

It was all about the war. Markets were torn between the fear of **prolonged conflict** and **sudden de-escalation hopes**, particularly towards the end of the month. The result: **higher yields, wider spreads** and a **stronger US dollar**.

Our take on investment implications

A month in, the first-order effects of conflict with Iran are evident. The most immediate is an energy shock, accompanied by supply-side disruptions extending well beyond oil, including food inflation via fertilisers and knock-on effects across plastics, chemicals, helium and other critical inputs. It is also clear that US President Donald Trump is seeking an off-ramp. Yet any meaningful settlement would require protracted negotiations with Iran. Neither further US escalation nor peace talks is likely to bring about a swift resolution, nor a reopening of the Strait of Hormuz to the bulk of international shipping – certainly not to vessels unwilling to pay Iranian tolls.

Markets remain reluctant to price in the second-order consequences: prolonged supply-chain dislocations, capital destruction across the Middle East, pressure on corporate profitability and ultimately slower growth. Such a scenario is good for no one. This helps explain recent market behaviour, and why political incentives are aligned toward de-escalation. Yet even under the optimistic assumption that the conflict were to end abruptly, **a return to a “Goldilocks” environment is unlikely**. Inflation is likely to surprise to the upside relative to expectations a month ago, while economic activity undershoots. Investors should prepare for elevated volatility across risk assets.

We can take some comfort in the generally orderly behaviour of credit markets, which helps prevent an abrupt tightening of financial conditions. The question is how to protect portfolios amid uncertainty and the rising risk of stagflation, particularly when traditional hedges become crowded with rising correlation. **For fixed income, the common thread is clear: discipline over speculation, quality carry over directional bets, active duration management over passive exposure, security selection over beta, and liquidity over illiquidity.**

In sovereign bonds, tactical opportunities are emerging selectively in countries where yields have reached compelling levels following the sharp repricing driven by the energy shock and the abrupt shift in monetary policy

expectations. However, with volatility likely to remain elevated, staying active and flexible is critical. This also argues for exposure to less crowded markets offering genuine fundamental diversification, such as China government bonds.

In corporate credit, we see more asymmetric risks and therefore remain defensive and quality-oriented. We are using market rebounds to further rotate risk toward the most resilient sectors and issuers. We continue to like floating-rate notes issued by large-cap financial institutions, which are less exposed to interest-rate volatility.

In emerging markets, while the balance of risks is tilted towards weaker economic outcomes, security selection becomes increasingly important. Smaller and lower-middle-income net-importing economies – particularly those lacking inventory buffers, domestic refining capacity and fiscal absorption capacity – are likely to be most vulnerable. Higher income economies with greater fiscal room to absorb the shock are better positioned to weather the adjustment.

Periods of geopolitical stress often feel binary in real time. History suggests they rarely are. While uncertainty remains elevated, fixed income continues to offer income, resilience and diversification – provided portfolios are constructed with discipline, selectivity and flexibility.



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CHART OF THE MONTH

China onshore bonds have bucked the losing trend of core markets



Chinese government and policy bank bonds, along with the Chinese currency, have demonstrated notable resilience. While yields of other core government bonds jumped due to stagflation concerns linked to the Middle East conflict, China’s rates and currency have remained fairly stable since the start of the Iran war. They may offer much-needed shelter during a prolonged energy price shock in which global markets struggle to absorb a renewed inflation impulse. One explanation lies in China’s starting position at this point of the cycle. While the US and parts of Europe remain in late-cycle conditions, China’s economy is running with lower inflation and greater policy flexibility. The potential for Chinese exporters to repatriate more of their earnings, and convert them into renminbi, offers another supportive dynamic. Could this conflict herald the start of a “petroyuan”-driven erosion of “petrodollar” dominance?

Source: Allianz Global Investors, Bloomberg, as at 27 March 2026. The information 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.


FIXED INCOME FORWARD | WHAT TO WATCH

1 Financial conditions

If financing remains available and orderly, economic damage from geopolitical stress tends to be delayed and absorbed. Yet if conditions tighten, the adjustment accelerates – investment slows, balance sheets come under pressure, and volatility spills across assets. Monitoring financial conditions provides an early signal of whether macro risks are contained or are developing into a broader downturn.

2 Economic data

Inflation, employment and activity indicators offer early insight into how the recent energy shock is feeding through to prices and growth. While individual releases are unlikely to be decisive on their own, the cumulative message from April data will shape market confidence, policy expectations, and investor sentiment, particularly in an environment where clarity is scarce and volatility remains elevated.

3 China's involvement

China has a clear economic incentive to limit further disruptions. Its diplomatic stance, trade flows and policy responses will signal how risks may evolve. Any shift in China's engagement, whether towards de-escalation, mediation or a more assertive posture, could have meaningful implications for how events may evolve, as well as for market outcomes.


FIXED INCOME MARKET PERFORMANCE

Indicative market indices	Total return year-to-date 2026 (%)	Total return March 2026 (%)	Yield- to-worst (%)	Effective duration (years)
Data as at 27 March 2026				
Global convertible bonds	2.49	-5.37	-1.8	1.6
US floating-rate notes	0.94	0.15	4.3	0.0
US Treasury bonds 1-3 years	0.02	-0.71	3.9	1.6
Asian high yield	-0.05	-2.99	8.5	2.9
Euro government bonds 1-3 years	-0.60	-1.21	2.8	1.9
Global government bonds AAA-AA	-0.69	-2.74	3.6	7.2
Global aggregate	-0.70	-2.32	3.9	6.3
US aggregate	-0.79	-2.49	4.7	6.0
Asian investment grade	-0.94	-2.00	5.2	4.7
Euro aggregate	-1.28	-3.15	3.4	6.2
Euro investment grade	-1.31	-2.62	3.8	4.5
US high yield	-1.32	-1.90	7.7	3.1
US investment grade	-1.43	-2.86	5.3	6.9
Global emerging-market sovereign bonds	-1.55	-3.55	7.3	6.3
Euro high yield	-1.67	-2.63	6.1	3.0

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 27 March 2026. 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.

* 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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