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OUTLOOK THIRD QUARTER 2026

Quality credit still earns its place in portfolios

Anders Persson
CIO of Global Fixed Income

Tony Rodriguez
Head of Fixed Income Strategy

One of our four 2026 global fixed income themes shaping our approach centers on investing during periods of high valuations but relative economic resilience. We think the current economic environment justifies taking credit risk, but the key to success is being selective and tilting toward quality within that risk.

Key takeaways

- **Global growth remains healthy with technology investments helping to offset inflation drag.**
- **Favor higher-quality below-investment-grade segments to balance tight valuations against income needs.**
- **A transformed high yield corporate market offers an improved quality profile with attractive risk-adjusted valuations.**
- **Senior loans provide compelling floating-rate yield with improving fundamentals and active management opportunities.**
- **Preferred securities combine regulated-sector quality with attractive, tax-advantaged income.**

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Bonds prove resilient amid rate pressures

Although an interim peace deal between the U.S. and Iran has since helped ease oil prices, Middle East tensions pressured energy markets for much of the quarter, stoking inflation fears and keeping interest rates elevated. Rates rose across the yield curve during the quarter, with the 2-year Treasury yield climbing 35 basis points and the 10-year Treasury yield rising 14 basis points.

All fixed income sectors posted positive returns year-to-date as generous income levels and narrowing credit spreads (the additional yield investors earn for taking on credit risk) offset the drag from higher rates (Figure 1). Credit spreads continued to tighten across many sectors during the quarter, driven by a rebound in market risk appetite following the easing of Middle East tensions. In certain sectors, spreads narrowed to levels below those observed at the start of the year.

Oil prices and tech investment shape the outlook

Economic data has been broadly healthy. Higher oil prices have pushed inflation up without yet weighing meaningfully on growth, and tech investment continues to support expansion even as it adds price pressure. We expect growth to moderate but hold up, with inflation staying elevated before easing toward year-end.

Oil prices have been volatile in recent months. Though prices have moderated from their peak to around $70 per barrel, prior increases have already pushed global inflation materially higher — a dynamic that will continue feeding through to core inflation in coming quarters. Higher inflation erodes real income growth, which we expect to weigh on consumer spending later this year.

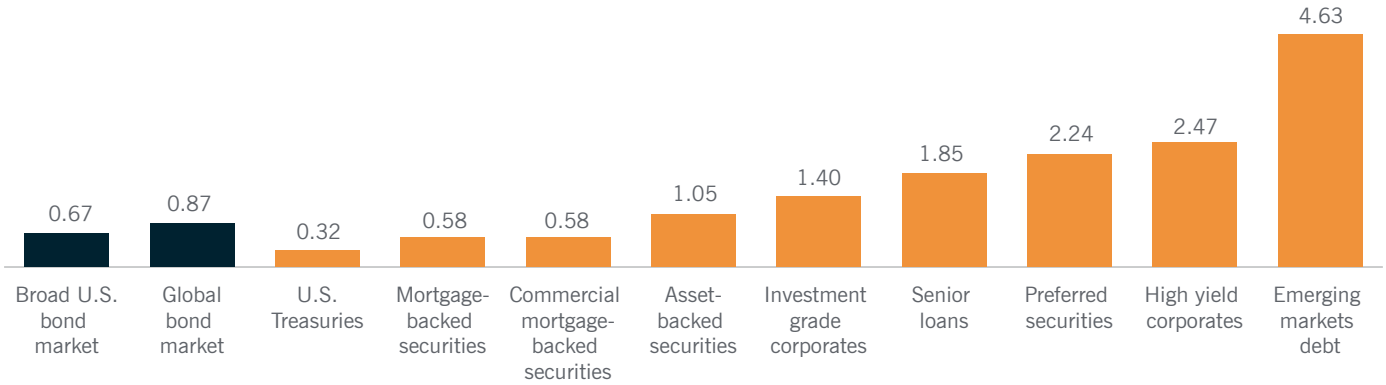
Tech infrastructure investment continues to support overall growth, with hardware and software spending surging even as residential and non-tech business investment have contracted (Figure 2). Tech demand has also lifted certain consumer prices — the software and accessories subindex rose at an annualized pace of nearly 50% through May.

Labor markets have remained resilient. The unemployment rate has edged lower and job openings have risen, though hiring expectations, the quits rate, and the hiring rate remain tepid. We expect modest loosening ahead, but from a stronger starting point than previously assumed.

We now project GDP growth to slow to just below 2% annualized and core PCE inflation to end the year around 3.0% — higher for longer than our prior forecast — reflecting persistently elevated oil prices, tech investment trends, and recent labor data.

Figure 1: Despite rising rates, all sectors posted positive returns

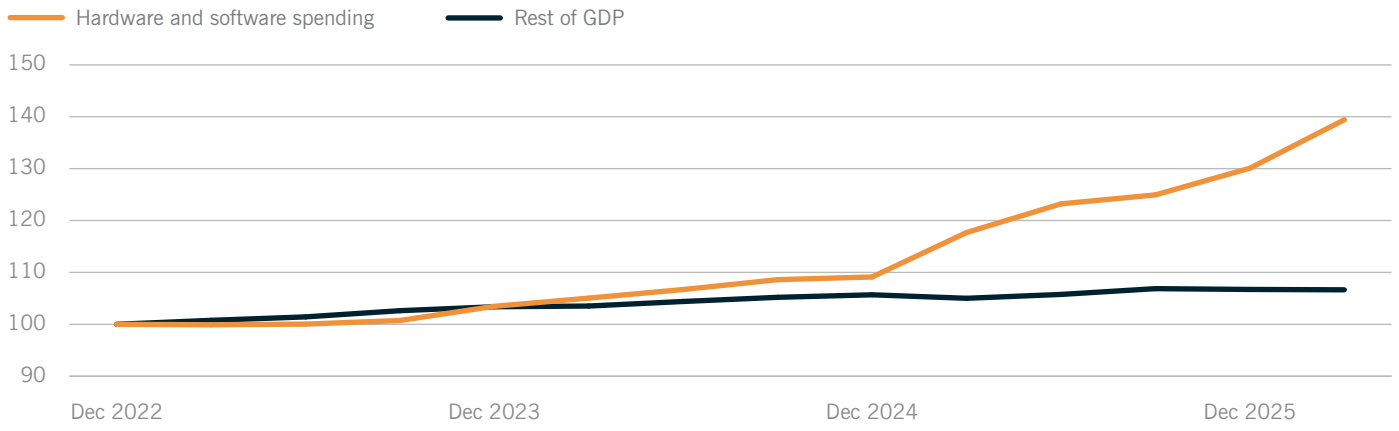
Second quarter 2026 total return (%)



Data source: Morningstar Direct, 30 Jun 2026. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad U.S. bond market:** Bloomberg U.S. Aggregate Index; **global bond market:** Bloomberg Global Aggregate Index; **asset-backed securities:** ICE BofA AA-BBB US ABS Index; **commercial mortgage-backed securities (CMBS):** ICE BofA AA-BBB US Fixed Rate CMBS Index; **emerging markets debt:** JPM EMBI Global Diversified Index; **high yield corporates:** Bloomberg U.S. Corporate High Yield of 2% Issuer Capped Index; **investment grade corporates:** Bloomberg U.S. Corporate Index; **mortgage-backed securities:** Bloomberg U.S. Mortgage-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **senior loans:** S&P UBS Leveraged Loan Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index.

Figure 2: Tech spending has dominated U.S. GDP growth

U.S. GDP since year-end 2022



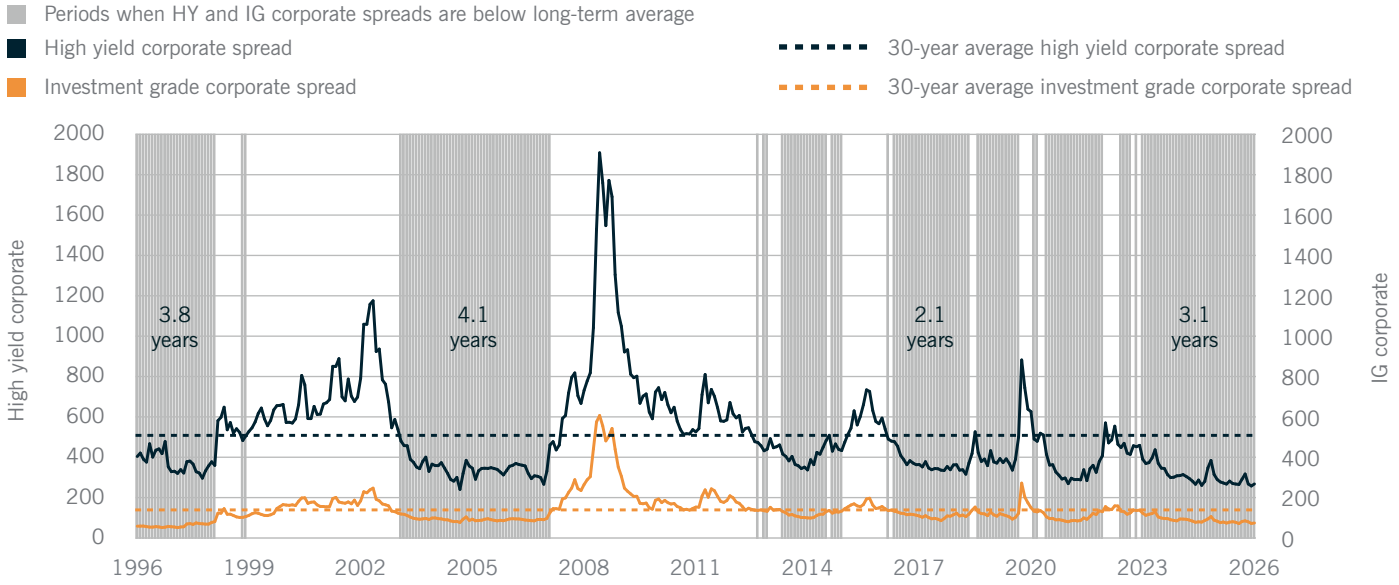
Data source: Bloomberg, L.P., 31 Dec 2022 – 31 Mar 2026. GDP is indexed to 100 as of 31 Dec 2022.

Globally, the outlook remains constructive. Europe is growing near 1.0%, with the U.K., Japan, and China also expanding. Developed market core inflation has fallen to 2.4% year-over-year, near its lowest since 2021, and global recession risk remains low.

Rich valuations call for a quality tilt

Credit spreads remain near historical lows, and security market valuations are undeniably rich. It is worth noting, however, that spreads have stayed below average for extended periods since 2012, interrupted only by brief volatility spikes (Figure 3). Derisking portfolios prematurely may risk sacrificing the income advantage credit sectors provide.

Figure 3: Credit spreads often remain compressed for extended periods



Data source: Bloomberg, L.P., 30 Jun 2026. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index; **high yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index.

We balance tight valuations against income needs by favoring higher-quality segments of below-investment-grade markets: BB and B rated high yield corporates, senior loans and preferred securities. This approach captures enhanced yield while maintaining moderate overall risk, avoiding the most vulnerable CCC rated segments.

The quality tilt within these three sectors can help investors maintain income potential while managing downside risk. Each sector also carries specific attributes that position it well in the current environment.

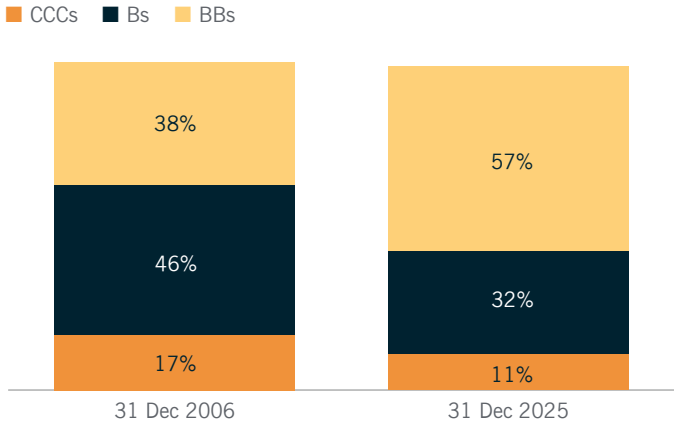
High yield has undergone a quality revolution

A transformed market. The high yield bond market today looks very different than from what it was before the 2008 financial crisis. Back then, the market was dominated by private-equity-backed leveraged buyouts: smaller companies with aggressive capital structures, elevated leverage and limited transparency. Post-crisis regulations pushed the riskiest borrowers out, leaving a higher-quality pool of established, publicly traded companies with stronger finances. These companies access the capital markets for general corporate purposes or strategic acquisitions rather than financial engineering.

Improved quality profile. Today, nearly 57% of the high yield market is made up of BB rated bonds — the highest quality tier within high yield — up from just 38% before the crisis (Figure 4). The riskiest tier, CCC rated bonds, has shrunk from 17% to 11% of the market. With the overall quality of borrowers meaningfully improved, default rates sit at a historically low 1.3%, well below the long-term average of 3.2% as of 30 June 2026, according to JPMorgan.

Figure 4: Quality shift has transformed the high yield landscape

U.S. high yield market composition



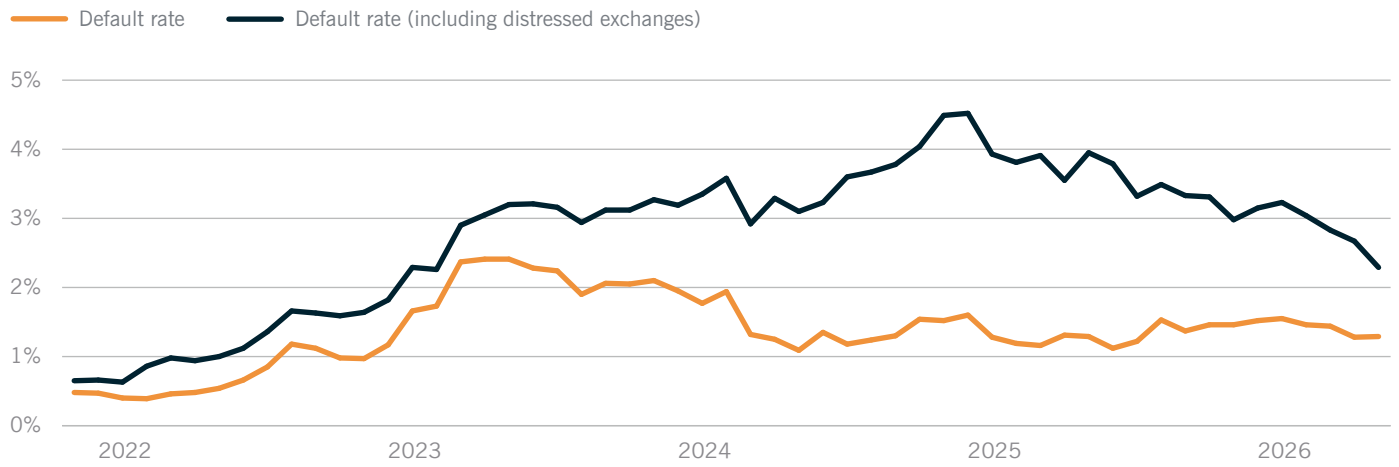
Data source: BofA Global Research, 31 Dec 2025. Data reflects credit quality dispersion of the ICE BofA U.S. High Yield Index. **Performance data shown represents past performance and does not predict or guarantee future results.**

Attractive risk-adjusted valuations. Credit spreads reflect the underlying borrower risk profile — and when that risk profile improves materially, comparing current spreads to historical averages becomes misleading. While valuations appear tight, they remain attractive relative to actual default risk when adjusted for today's higher-quality market composition. We believe any material high yield spread widening would require macroeconomic deterioration rather than a weakening of credit fundamentals. Active management remains critical as dispersion across industries creates meaningful differences in issuer risk that passive exposure cannot navigate.

Senior loans offer floating-rate yield and opportunity

Compelling yield with floating-rate protection. Senior loans currently offer yields above 8%, making them among the highest-yielding options in liquid fixed income. Because their interest rates float with the market, yields will remain elevated if rates stay higher for longer — a benefit that is difficult to replicate elsewhere.

Figure 5: Senior loan default rates have declined from 2024 peaks



Data source: JPMorgan, 31 Dec 2021 – 30 Jun 2026. **Performance data shown represents past performance and does not predict or guarantee future results.**

A stable foundation beneath the noise. Like the high yield market, the overall health of the loan market is improving. Away from the software-related volatility, the underlying credit picture remains intact. Default rates have dropped to 2.3% in mid-2026, down significantly from a peak of 4.5% at the end of 2024, as weaker borrowers have worked through their difficulties (Figure 5). Strong demand from large institutional buyers through robust collateralized loan obligation (CLO) issuance continues to provide technical support for the market.

Opportunities for active managers. Not all loans are performing the same way. Higher-quality BB rated loans have seen only modest spread widening year-to-date, while CCC rated loans have experienced more significant price declines — some to levels last seen during the pandemic. This bifurcation is more pronounced in loans than in high yield today, making security selection the primary driver of return rather than broad market exposure.

Preferred securities deliver regulated-sector stability

Quality rooted in regulated industries. About 85% of preferred securities are issued by banks, insurance companies and utilities — heavily regulated, financially strong industries. Banks are well-capitalized and have passed rigorous stress tests, insurers hold near-record surplus capital and utilities benefit from surging electricity demand driven by AI data centers.

Although preferred securities carry an average credit rating of BBB, the companies issuing them are typically rated three to five notches higher. Investors gain exposure to fundamentally strong businesses while earning a yield premium for holding a subordinated position in the capital structure. Issuer overlap with high yield corporate bonds and senior loans is also limited, since those markets have minimal exposure to banks and insurance companies.

Tax-efficient income. Many preferred securities pay qualified dividend income, which is taxed at lower capital gains rates rather than ordinary income tax rates — a meaningful advantage for investors focused on after-tax returns.

Differentiation across market segments. Not all preferred securities are created equal. Institutionally oriented $1,000 par securities have significantly outperformed the more widely known $25 par retail variety — returning 6.55% over one year and 9.67% over three years, compared to 4.32% and 4.84%, respectively — while also offering lower interest rate sensitivity and greater liquidity (Figure 6). Active managers can take advantage of these market differences.

Figure 6: $1,000 par securities have delivered superior returns

Data source: Bloomberg, L.P., 30 Jun 2026. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: $25 par:** ICE BofA Core Plus Fixed Rate Preferred Index; **$1,000 par:** ICE BofA U.S. Institutional Capital Securities Index.

Integrating quality credit risk into portfolios

High yield bonds, senior loans and preferred securities work best together rather than as standalone alternatives. High yield's upgraded quality profile offers attractive valuations relative to default risk, senior loans add floating-rate income and opportunity in a dislocated market, and preferred securities bring regulated-industry stability and tax-efficient income with minimal overlap to the other two.

Diversified multisector and core plus strategies suit investors seeking active allocation across the broader fixed income markets with heavier allocations to these sectors.

Multisector bond strategies tend to be more aggressive and permit higher allocations to credit sectors. These strategies offer maximum flexibility across both investment-grade and below-investment-grade markets, including high yield corporates, senior loans and preferred securities.

Core plus bond strategies generally allocate up to 30% in higher-yielding sectors like high yield corporates, senior loans or preferred securities. This structure can deliver diversification and return enhancement while maintaining a moderate overall risk profile.

In the current environment, quality is not simply a defensive posture — it is the mechanism by which investors can stay constructively exposed to credit income while limiting vulnerability to the sectors most at risk if growth disappoints.

Outlook

Cautious optimism shapes our midyear outlook

Our macroeconomic outlook remains broadly constructive. While the Middle East conflict weighed on growth and stoked inflation, recent developments suggest both headwinds are easing. AI-related investment is supporting growth and partially offsetting oil-induced weakness, though it continues to pressure select inflation categories. We forecast U.S. real GDP growth of 1.8% and core PCE inflation of 3.0% for 2026.

Resilient labor markets, persistent inflation and hawkish central bank signals have prompted us to revise our Fed outlook. We now expect rates on hold through year-end 2026, with cuts resuming in early 2027. We expect the Bank of Japan to hike at least once more this year and further in 2027. Risks appear tilted toward an additional European Central Bank rate increase, though likely not before 2027.

We modestly favor spread sectors and credit risk, with an up-in-quality bias within asset classes. Spread volatility in the months ahead may create more compelling entry points for adding risk. We see opportunities in CLOs, senior loans, select securitized sectors, preferred securities and targeted emerging markets exposures. We now project the 10-year Treasury yield between 4.25% and 4.50% at year-end 2026.

Four themes are shaping our approach in 2026

	What's happening?	Market implications	Actions to consider
Time for a takeover: Fiscal policy outweighs monetary policy	Government spending dominates as central bank rate-cutting cycles end	Longer-term rates likely remain elevated despite policy easing	Favor positioning for a steeper yield curve over aggressive duration extension
Economic resilience: Tight spreads, but room for credit risk	Technology investment, productivity gains and strong corporate fundamentals underpin 2026 growth rebound	Spreads can remain compressed for extended periods during steady growth; premature de-risking sacrifices income	Focus on higher-quality segments within below-investment-grade sectors, like high yield corporates, preferreds and senior loans
Digging deeper for diversification: Look beyond traditional credit	Historically tight credit spreads have reduced income potential of traditional bond investments	Less-traded credit sectors provide wider spreads and different risk exposures than traditional corporates	Capture incremental yield by moving into emerging markets debt, CMBS, preferreds, senior loans, CLOs and municipals
New playbook: Developed and emerging markets converge	Political and institutional risks now affect developed markets while emerging markets have strengthened fundamentals	Traditional analytical boundaries between developed and emerging markets are dissolving	Emphasize sectors insulated from sovereign risk (securitized credit, municipals); raise strategic allocation to high-quality emerging markets debt

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Endnotes

Sources

Inflation: U.S. Bureau of Labor Statistics Consumer Price Index for All Consumers. **Global debt and yields:** Bloomberg L.P.

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