



FIXED INCOME DEEP DIVE • DECEMBER 2025

The end of the cutting cycle

KEY TAKEAWAYS

- The global easing cycle is approaching its endpoint, while renewed inflation and fiscal pressures could push long-term yields higher in 2026.
- We favour 3–5-year USD and EUR bonds and prefer inflation-protected Treasuries over nominal bonds.
- Rising corporate issuance and fading monetary support increase the risk of wider credit spreads; we remain defensive, favouring high-quality BBB issuers and waiting for better entry points.
- CHF bonds remain a defensive allocation, while selected EM bonds, European bank AT1s and CLOs offer opportunities to enhance yield.

MARKET REVIEW

Corporate bonds attracted strong inflows again in 2025. Still-elevated yields, expectations of monetary easing, resilient corporate fundamentals, and a broadly benign default environment supported demand, including from non-traditional investors. These inflows helped keep credit spreads near historical lows despite issuance close to record levels (USD 1.7 trillion of US investment-grade bonds, just below the 2020 peak of USD 1.8 trillion). Government bond yields diverged across the Atlantic: the US 5-year Treasury yield fell by 65 basis points (bps), while the German 5-year Bobl and Swiss 5-year SARON rose by 13 bps and 15 bps, respectively. This divergence, combined with structurally lower carry, weighed on the relative performance of EUR- and CHF-denominated bonds. As of 31 December (total returns, local currency), USD IG bonds returned +7.8%, compared with +3.0% for EUR and +0.4% for CHF. High-yield bonds outperformed on higher carry, delivering +8.5% in USD and +5.1% in EUR.

MONETARY POLICY

In early 2025, the global rate-cutting cycle gained momentum and, together with AI-driven equity enthusiasm, provided an important pillar for global risk markets. **As the year progressed, however, the easing cycle in most industrialised economies moved closer to its endpoint.** In the euro area and Switzerland, policy rates were left unchanged at recent central bank

meetings, with market pricing suggesting a prolonged pause rather than further significant easing. A somewhat different dynamic has emerged in Australia and Canada, where policy rates were also held steady at the most recent meetings, but market pricing points to modestly higher rates by late next year. Japan is further advanced in the cycle. At its December meeting, the Bank of Japan unanimously raised the policy rate by 25 bps to 0.75%, pushing yields higher across the curve and lifting the 10-year Japanese government bond (JGB) yield to its highest level since the 1990s. The main exceptions remain the US Federal Reserve (Fed) and the Bank of England (BoE), where the pivot toward a more accommodative stance still appears relatively intact. Both central banks continue to emphasise labour market conditions amid persistent inflation uncertainty, and markets continue to price in further rate cuts over the coming year.

INFLATION & DURATION

Inflation rarely declines in a linear fashion, and we believe the risk of renewed upward pressure on prices and rising long-term rates in industrialised economies in 2026 is not fully reflected in current market pricing, particularly in the US, the world's benchmark rates market. Continued expansionary fiscal policy, pressure on Federal Reserve independence, a weaker US dollar, and delayed inflationary effects from tariffs and restrictive migration policies suggest that inflation risks could re-emerge more forcefully in 2026. Empirical evidence shows that economies with recent inflation experience, such as the US, tend to exhibit a stronger response of inflation expectations following adverse shocks. This increases the risk that currently well-anchored long-term inflation expectations could re-anchor at higher levels, pushing medium- to long-term yields higher. At the same time, major Western economies – notably the United States and France – remain locked into structurally persistent deficit policies. Rising interest burdens are intensifying concerns about debt sustainability, while confidence in policymakers' willingness to implement fiscal consolidation and structural reforms is eroding. As a result, investors are likely to demand higher term premia, particularly at the long end of the curve, leading to steeper yield curves. Japan may represent an additional source of upward pressure. As the largest foreign holder of US Treasuries, further increases in JGB yields could encourage capital repatriation, creating a headwind for US Treasuries and amplifying upward pressure on global bond yields. **Against this backdrop, we expect elevated volatility in medium- to long-term bonds across developed markets and see superior risk-adjusted value in maturities of up to five years, where duration risk is more contained and return profiles are more predictable. Within our Treasury allocation, we also favour inflation-protected securities over nominal bonds.**

CREDIT MARKETS

With respect to corporate bonds, we expect 2026 to be a challenging year. After several years of deleveraging, corporate balance sheets are generally strong. That said, meaningful headwinds are emerging as the technical backdrop – namely supply-demand dynamics – is turning less supportive. Net corporate bond issuance is likely to increase by 5-10% versus 2025 in both the US and Europe. This trend is being reinforced by the spending surge in AI, with hyperscalers refinancing unprecedented amounts in bond markets. Estimates suggest that AI-related supply alone could reach USD 250 billion in the US market. In addition, historical evidence shows that credit spreads typically widen toward the end of a rate-cutting cycle, as fading monetary tailwinds increase the required compensation for credit risk. Against this backdrop, we expect credit spreads to widen from today's razor-thin levels in 2026, with excess returns versus government bonds likely to be small or negative. **Accordingly, we prefer to wait for more compelling entry points before increasing credit risk, maintain a clear quality bias – targeting high quality triple-B issuers – and pursue negative selection within portfolios by reducing exposure to issuers most vulnerable to a deterioration in market conditions.**

PORTFOLIO IMPLICATIONS

- **Curve Positioning:** Given the persistent uncertainty surrounding inflation, we expect volatility to increase in the medium- to long-dated segments of the yield curve and believe that the risk of higher yields outweighs the likelihood of a sustained decline. Against this backdrop, and given the current steepness of credit yield curves, **we favour the 3- to 5-year segment in USD and EUR**, which in our view offers the most attractive risk-reward profile.
- **Credit Exposure:** **Given rich valuations and shifting supply-demand dynamics, we take a clearly defensive stance on credit risk.** Within Investment Grade, we favour triple-B rated bonds, where spreads decompressed relative to single-A in 2025. In High Yield, elevated event risk and spreads near multi-decade tights argue for a conservative positioning. We concentrate exposure at the short end of the curve and prioritise the highest-quality segments of the market to reduce drawdown risk in the event of a spread correction.
- **Swiss Franc Bonds:** The Swiss franc is expected to continue its appreciation trend, supported by a significant inflation differential and its status as a safe-haven currency. Overall, **CHF bonds should remain relatively insulated from global volatility**, while term premium pressures remain more contained than in other European markets.
- **Emerging Market (EM) Bonds:** EM corporate hard-currency bonds continue to trade at a spread premium to developed market (DM) peers of comparable quality. Focusing on BBB+ and single-A issuers offers selective opportunities to enhance yield while diversifying defensive exposure into EM, supported by improving credit metrics and positive rating trends. As most EM hard-currency debt is USD-denominated, a weaker dollar – as we expect – reduces issuers' debt burdens and further strengthens credit profiles. **In local currency markets, we maintain a strong preference for the renminbi, which we view as undervalued by approximately 20–30% versus the USD.**
- **Bank AT1s:** European bank AT1s look attractive in our view despite trading near historic spread tights, as this overlooks the sector's substantial post-GFC balance-sheet strengthening and widespread ratings upgrades. Nearly half of the USD 270bn AT1 market is now investment-grade, yet **these bonds still yield 50–100bp more than similarly rated corporates due to technical factors, notably their exclusion from global bond indices** and the absence of forced buyers. Looking ahead to 2026, supply dynamics are highly supportive, with most upcoming calls already pre-financed and new issuance set to be scarce in this segment of the market. M&A represents a key upside catalyst, as overcapitalised European banks face regulatory resistance to large buybacks, enjoy ECB support for consolidation, and increasingly pursue acquisitions as the fastest route to capital optimisation. Finally, prospective regulatory changes to AT1 structures are likely to grandfather existing instruments, creating scarcity value, which could support spreads as these legacy bonds approach their call dates.

- **Inflation-Indexed Government Bonds:** Inflation-indexed government bonds, such as US Treasury Inflation-Protected Securities (**TIPS**), **provide an attractively priced way to hedge against upside inflation surprises** and potential shifts in long-term inflation expectations.
- **CLOs:** In our view, the asset class offers attractive risk-adjusted returns, stronger covenants and diversification benefits compared to traditional fixed income. We favour CLOs with strong underlying loan fundamentals, which provide an attractive illiquidity premium without adding duration risk. **With spreads trading wide to comparable corporate bonds (BBBs at 350-375bps), we see CLOs as an attractive yield enhancer in a diversified portfolio.**

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