



FIXED INCOME DEEP DIVE • MARCH 2026

Inflation will be back, with a vengeance

KEY TAKEAWAYS

- The Middle East energy shock threatens to lift inflation while weakening growth, complicating the outlook for central banks.
- Rate-cut expectations are giving way to a more hawkish policy outlook; we favour 2–3-year USD and EUR bonds to limit duration risk.
- Credit spreads still offer insufficient compensation for deteriorating conditions, reinforcing our preference for liquid, high-quality single-A and double-A issuers.
- CHF bonds offer relative resilience, while TIPS provide an attractively priced hedge against renewed inflation.

ENERGY SHOCK & INFLATION

The escalation in the Middle East has triggered what may be the most severe energy shock in modern history. Even under the most optimistic scenario of a swift end to the conflict, a return to pre-war energy prices is likely to take at least six months. As a rule of thumb, the IMF estimates that a sustained 10% increase in oil prices could add around 40 basis points to global inflation. At the time of writing, Brent crude prices have risen by roughly 50% since the end of February, implying an increase of about two percentage points in global headline inflation. This effect is likely to start appearing in the data within the next month, with a peak potentially occurring within three months. At the same time, higher energy prices pose a downside risk to economic growth. Rising fuel costs effectively act as a tax on consumers by reducing disposable income and putting pressure on household budgets. Businesses, in turn, face higher input costs and potentially tighter financing conditions, particularly if interest rates rise. The IMF estimates that a 10% increase in oil prices could reduce global output by around 0.1% to 0.2%.

MONETARY POLICY

In this environment, central banks face a complex policy dilemma. Traditionally, policymakers tend to look through temporary inflation spikes caused by supply shocks, such as increases in energy prices. Since higher interest rates cannot directly boost the supply of oil or gas,

tightening monetary policy in response to such shocks risks unnecessarily weakening economic activity – thereby reinforcing the drag already imposed by higher energy costs. However, the situation becomes more complicated if elevated energy prices persist long enough to unanchor inflation expectations. In that case, central banks may feel compelled to tighten policy – or at least signal a willingness to do so – in order to prevent energy-driven inflation from spilling over into the broader economy. Unfortunately, though not surprisingly, research suggests that inflation expectations tend to react disproportionately when consumers have recently experienced high inflation. Given that the global economy is only just emerging from an inflation shock, expectations may be particularly sensitive to renewed price increases, making a broad-based shift to a more hawkish monetary policy more likely. The Bank of England was the first to change course, withdrawing last week its guidance that the next move in rates would likely be downward, thereby accelerating the repricing of monetary policy expectations on both sides of the Atlantic. Prior to the outbreak of the Iran conflict, the ECB was expected to keep rates on hold, while the Bank of England was projected to deliver three rate cuts in 2026. At the time of writing, markets are instead pricing in multiple rate hikes for both central banks. Expectations for the Federal Reserve have shifted in a similar fashion, with earlier projections of two to three rate cuts in 2026 having largely disappeared. Even the SNB, which has long grappled with deflationary pressures, is now expected to raise rates one to two times by year-end.

RATES & CREDIT

As a result, government bond yields have risen globally, particularly at the short end of the curve (e.g. US 2yr Treasury yield +50bps since end of February), which is most sensitive to changes in monetary policy. Looking ahead, risks are increasingly shifting toward medium- to long-term maturities. On the one hand, a rise in inflation and inflation expectations would increase term premia and may force central banks to turn more hawkish (which would drive up short-term rates further). On the other hand, higher short-term rates constrain governments' ability to issue debt on favorable terms, potentially rekindling concerns about debt sustainability and pushing up the risk premia demanded by investors for holding longer-dated bonds, especially in the US and France. **Overall, we expect elevated volatility and a continued upward trajectory in yields, and therefore limit duration risk while focusing on maturities in the two- to three-year range.** Meanwhile, credit spreads for investment-grade corporate bonds reached historically tight levels in January and have widened since then (US investment-grade spreads YTD +10 bps). In our view, spreads remain too tight to fully reflect the risks to the economic outlook and the potential increase in default risk associated with a protracted energy crisis. Moreover, current dislocations in private credit and CLO markets are likely to spill over into corporate bond markets as long positions in CDS contracts are trimmed at a record pace. **We focus on high credit quality, notably single-A and double-A rated issuers.**

PORTFOLIO IMPLICATIONS

- **Curve Positioning:** Given the persistent uncertainty surrounding inflation and monetary policy, 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, we favour the 2- to 3-year segment in USD and EUR, which in our view offers the most attractive risk-reward profile.
- **Credit Exposure:** Given still-rich valuations, shifting supply-demand dynamics, and market dislocations in less liquid corners of the credit market, we concentrate exposure at the short end of the curve and prioritise the highest-quality, most liquid 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 in the long term, supported by a significant inflation differential and its status as a safe-haven currency. If the SNB intervenes on a larger scale, it will, in our opinion, be primarily to slow down the appreciation trend. Overall, CHF bonds should remain relatively insulated from global volatility, as pressures on term premia are expected to remain more contained than in other markets.
- **CLOs:** In our view, the asset class offers attractive risk-adjusted returns, stronger covenants and diversification benefits relative to private debt and traditional fixed income. The recent spread widening – triggered by the sell-off in private debt – further strengthens the case for CLOs. We are particularly constructive on CLOs backed by robust underlying loan fundamentals, which offer an attractive illiquidity premium without introducing additional duration risk. With spreads trading at a premium to comparable corporate bonds (in USD BBBs at around 375–400 bps), we view CLOs as an attractive yield enhancer within a diversified portfolio.
- **Bank AT1s:** European bank AT1s look attractive in our view despite still trading near historic spread highs, 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.
- **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 single-A rated 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.
- **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.

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