

2Q26 Market Outlook: Quarterly CIO Webcast

FEATURING



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In the second quarter of 2026, global fixed-income markets face heightened uncertainty driven by three major themes: the Middle East conflict and its impact on energy prices, rapid AI adaptation affecting multiple industries and growing concerns around private credit markets. The war has triggered sharp increases in oil and key chemical prices, with the near-term inflationary impact pushing central bank rate expectations dramatically higher. Markets are now pricing in rate hikes rather than the cuts anticipated just months ago. We believe these moves are somewhat overdone. While near-term inflationary pressures are undeniable, longer-term inflation expectations remain well anchored. Despite tight valuations in spread sectors, strong underlying fundamentals persist. We favor adding to short-end duration and are positioned to take advantage selectively in high-quality corporate new issuance and opportunities in commercial mortgage-backed securities.

Global Economic Outlook

- Global growth faces challenges depending on the Iran war duration, though fiscal support remains robust across major economies.
- Higher energy prices act as a consumer tax and if sustained will likely slow growth and soften labor markets, leading policymakers toward accommodation.
- Near-term de-escalation appears possible given political incentives including financial market performance, approval ratings and US midterm elections.

US Economic Outlook

- The Federal Reserve (Fed) has shifted focus squarely back to inflation, with labor markets temporarily taking a backseat given the recent energy price shock.
- Despite current hawkish market pricing, we believe the next move by the Fed is more likely to be a rate cut than a hike, even though cuts have been priced out for 2026.
- The Fed's dual mandate priorities may shift again if prolonged higher energy prices lead to labor market deterioration, re-engaging the central bank's focus on employment risks.

Inflation and Rates

- Near-term inflation trajectory has shifted dramatically due to supply shocks, particularly in energy, with the eurozone more impacted than the US given greater energy dependence.

- Longer-term inflation expectations remain well anchored, and history suggests energy price spikes are generally short-lived.
- Short-term rates globally have moved sharply higher, while longer-term rates have risen to a lesser extent, resulting in yield curve flattening.

Iran War

- The conflict represents the most immediate source of volatility and uncertainty, with the top risk being inflation due to dramatic increases in energy prices and disruption to global supply chains.
- The Strait of Hormuz is critical to global energy supply, with 20% of crude oil and 20% of LNG passing through daily, while pipeline alternatives have limited capacity.
- Key chemical supplies essential to global fertilizer production and AI infrastructure buildout are threatened.
- While near-term de-escalation appears possible given multiple incentives, uncertainty remains extraordinarily high, requiring portfolio construction with significant insulation around base case views.

AI Development

- Rapid AI adaptation is creating fears of industry obsolescence and operational transformation, initially focused on software but expanding to insurance, legal, accounting, call centers and customer service sectors with successive sectors facing transformation pressures.
- Strong management teams remain the first line of defense, as evidenced by historical examples where great management navigated companies through periods of dramatic change while weaker management failed to adapt.

Private Credit

- Business development corporations (BDCs) serve as a useful proxy for examining private credit markets, showing growth mirroring broader private credit expansion.
- Structural vulnerabilities include shorter loan maturities than public markets, elevating refinancing risk, and increasing pay-in-kind (PIK) interest payments, though PIK levels are not yet alarming and some usage is by design during company growth phases.
- The primary concern is technical rather than fundamental—elevated redemption requests against illiquid asset classes offering only 5% quarterly liquidity windows, raising concerns that technical pressures could become fundamental if capital becomes unavailable for refinancing.
- Loans by non-depository financial institutions remain relatively small compared to the overall US banking system, and the broader US and European banking systems are exceptionally strong with robust capital ratios and asset quality, suggesting capacity to absorb financing if private credit faces stress.

Investment Themes

- **Investment Grade Corporate Credit:** Spread sectors have demonstrated remarkable resilience despite the recent geopolitical shocks and private credit concerns, reflecting strong underlying fundamentals. Conservative portfolio positioning from earlier this year has created opportunities to take advantage of spread-widening anomalies in secondary markets and attractive new issue opportunities in primary markets. New-issue supply remains elevated despite market uncertainty, creating attractive opportunities to add to high-quality credit.

- **High-yield credit and bank loans:** Previously compressed rating category spreads have reversed, creating opportunities to reverse earlier up-in-quality trades. Bank loans have widened more than high-yield given greater exposure to software names and LBO financing.
- **Agency mortgages:** Agency mortgage-backed securities (MBS) previously offered attractive value from 2023 through 2025, with overweight positioning paying off as they outperformed corporates in 2025 for the first time since 2018. After selling down overweights with recent spread widening, the current coupon now appears slightly cheap versus the long-run average, prompting selective buying.
- **Residential and commercial MBS:** These sectors could be major beneficiaries of private credit scrutiny, with fundamentals having genuinely turned after commercial mortgages experienced significant stress over recent years.

Q&A Highlights

- The current energy shock is unlikely to produce the same inflation outcomes as 2022 given much lower growth, less fiscal stimulus, tighter monetary policy and inflation already closer to central bank targets.
- Agency mortgage positioning was reduced after strong outperformance and further tightening in January, with selective buying resuming as spreads have widened back to slightly cheaper levels.
- Residential and commercial mortgage securities fundamentals have turned positively, with high-quality new-issue supply and valuations near mid-range creating opportunities, particularly in commercial mortgages.

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