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WESTERN ASSET

FIRST QUARTER 2026

The Big Picture

Western Asset's latest insights on economic drivers and credit markets for fixed-income investors

Michael Buchanan, CFA

Chief Investment Officer

"We see 2026 as a year of opportunity for fixed-income investors. Improving global growth, anchored inflation, and supportive policy create a favorable backdrop. While volatility from fiscal and geopolitical developments may persist, it also opens the door for active managers to add value through selective positioning and disciplined risk management."

1Q26 HIGHLIGHTS

- Global growth is expected to continue to improve in 2026, supported by fiscal stimulus and easier financial conditions, while tariff uncertainty has receded.
- US growth benefits from tax refunds and deregulation under the One Big Beautiful Bill Act; labor market softness persists but is not recessionary.
- Inflation trends lower globally, anchored near central bank targets; US inflation progress continues despite tariff pass-through risks.
- Central banks near the end of easing cycles, with the Fed remaining responsive to labor market weakness; ECB likely on hold, BoJ expected to hike further.
- Investment-grade credit fundamentals remain strong, with issuance driven by AI-related capital needs and elevated M&A activity.
- High-yield credit supported by disciplined corporate behavior and favorable technicals; defaults remain below historical averages.
- Structured products—CLOs and agency MBS—offer attractive relative value; commercial real estate spreads remain compelling.
- Emerging markets benefit from high real yields and supportive local rate environments; active management favored in high-beta and frontier markets.
- Investor sentiment is constructive, supported by attractive yields and improving fundamentals despite lingering geopolitical and fiscal risks.

OVERVIEW

Western Asset maintains an optimistic outlook for 2026 as global growth improves, supported by fiscal stimulus and easier financial conditions. Tariff uncertainty has receded, removing a key headwind, while inflation trends lower toward central bank targets in many markets. In the US, growth is to be buoyed by deregulation and anticipated tax refunds under the One Big Beautiful Bill Act, though labor market softness persists. Europe and the UK face trade-related challenges, but stable inflation, increased defense/infrastructure spending and easier monetary provide support. Japan's persistent inflation points to further rate hikes, while China's recovery remains policy-driven amid structural headwinds. Central banks are nearing the end of their easing cycles, with the Fed remaining responsive to labor market weakness. Investor sentiment is favorable, supported by attractive yields and strong credit fundamentals. Despite tight valuations, opportunities remain across investment-grade and high-yield credit, structured products, and select emerging markets. Western Asset continues to emphasize disciplined, value-driven investing across resilient sectors.

Nicholas Mastroianni, CFA

Portfolio Manager

"Despite recent labor market softness and tariff-related uncertainty, we remain optimistic about the US macro backdrop. Fiscal stimulus, deregulation, and accommodative monetary policy are supporting growth, while inflation trends lower toward the Fed's target. Attractive yields and resilient fundamentals reinforce our view that US fixed-income markets offer compelling opportunities in 2026."

KEY DRIVERS AND RELATIVE VALUE BY REGION

US 	Growth boosted by fiscal, monetary, and regulatory policies.	Our base case for 2026 predicts improving economic growth, supported by Trump administration fiscal policies, additional Fed easing, and regulatory changes. We believe inflation will trend lower toward the Fed's 2% goal. Labor market conditions should improve as corporate hiring rebounds after 2025 tariff uncertainty. We expect 2026 to be a "carry" type of year but with tighter valuations, so we prefer higher-quality sectors to maintain a yield advantage over client benchmarks.
EUROPE 	Resilient growth boosted by German fiscal expansion.	We expect German fiscal stimulus to support eurozone-wide growth and others to be more fiscally constrained. Inflation has been stable around 2% but trade diversion, energy, AI, and tight labor markets give uncertainty. Trade disputes and French politics may be headwinds to growth. The ECB sees policy as "in a good place" and may be on hold for much of 2026. Duration is attractive on spread (France) and for downside protection (Germany).
UK 	Expect additional Bank Rate cuts	The jobs market has loosened more than most anticipated over the course of 2025. Wage growth has slowed and is likely to cool further. This slowing allows for further progress on disinflation through 2026, as does November's budget, which included several measures that should help to lower consumer price inflation. We expect further reduction of monetary policy restriction, favouring the five-year part of the curve.
CANADA 	Policy rates hold at neutral with growth recovering	We do not rule out another rate cut from the Bank of Canada, but the market is already pricing a cycle turn. Fiscal spending will provide a boost this year but demographics, housing affordability and a possible USMCA renegotiation are headwinds. Inflation near target will keep the direction of the next rate move uncertain in 2026.
AUSTRALIA 	RBA's hawkish pivot ends easing as inflation rises above target.	The RBA soft-landed the economy, keeping unemployment low. Housing supply issues and high construction costs, driven by government infrastructure spending, have pushed up house prices and rents. A 75-bp rate cut in 2025 boosted demand, reigniting inflation above target. The RBA signaled a hawkish pivot but the market's expectation of the pace of hikes may be overdone. Exports and services remain strong.
JAPAN 	Moderately higher JGB yields are expected in 2026.	We expect further policy rate hikes and forecast moderately higher JGB yields, although we expect the upward pressure on yields to ease in 2026. Economic conditions remain favourable and inflationary pressures continue with near full employment and additional fiscal spending. However, we expect a moderation in CPI to 2% year-over-year (YoY) and more pragmatic fiscal policies than the markets anticipate.
CHINA 	Short intermediate CGB yields to remain low; Yuan to strengthen.	Market sentiment on China significantly improved in 2025, with the stock market, the Yuan, the AI breakthrough in DeepSeek, the US $1 trillion trade surplus and rare earth dominance restoring investor confidence. China's economic recovery remains tepid, with the anemic property market persisting as a drag on growth. We expect accommodative monetary policy and supportive fiscal measures like the consumer goods trade-in program to support consumer spending.
MEXICO 	Easing cycle to end in Q1 while growth to remain subdued in Q1.	Inflation has been persistent along with sluggish growth. We expect Banxico's easing cycle to conclude in Q1 with 50 bps left in cuts. We see potential catalysts for growth if President Sheinbaum is successful in stimulating public-private investments and if we see constructive developments in USMCA negotiations (signing is scheduled for July 1). While we are neutral on MXN, local rates and credit spreads remain a core overweight.
INDIA 	GDP growth likely to surpass 7% for FY2026, which ends in March	Through fiscal and monetary coordination, GDP growth is projected to exceed 7% for FY2026. However, reaching these levels in FY2027 may require additional support. After RBI's surprise 25-bp rate cut in early December, it is likely that the policy rate will remain steady in 1Q26 unless CPI inflation decelerates. We have pushed our expectations for a US-India trade deal to 2Q26. We are cautious on the Indian rupee and hold a slight overweight in duration.
BRAZIL 	Moderate growth and inflation; a cutting cycle in sight.	Growth is expected to slow to 1.5% in 2026 with fiscal policy as the main driver. The 2026 budget targets a 0.25% primary surplus, but we would not be surprised if the government utilizes its full fiscal space, arriving at a deficit of 0.5%, especially entering an election cycle. We expect the disinflation trend to continue towards 3%, driven by BRL appreciation and tight monetary policy. We are neutral BRL and overweight local rates.

Prashant Chandran, CFA

Interim Head of US-Based Emerging Markets Team

"Despite ongoing geopolitical tensions, we see a strong case for emerging markets. Attractive real yields, supportive local rate environments, and improving fundamentals continue to create compelling opportunities. Active management remains key as we navigate idiosyncratic risks, but EM debt offers diversified income potential and resilience in a shifting global landscape."

WESTERN ASSET SECTOR THEMES	FUNDAMENTALS	TECHNICALS	VALUATIONS
Investment-Grade (IG) Corporate Credit			
US: Fundamentals healthy, Q3 earnings resilient. Corporations highlighting divergence between low- and high-end consumers. Valuations have less margin of safety (IG OAS 75 bps). Strong technical backdrop could weaken; elevated debt issuance in '26 to fund AI capex plans; M&A pipeline growing in every sector. Money center banks remain the safe place to play offense in a defensive way while we wait for opportunities.	🟢	🟢	🔴
Europe: Fundamentals continue to be resilient, supported by a positive growth backdrop. Higher issuance is expected from increased AI-related borrowing and US domiciled issuers. However, demand for credit remains firm. Spreads are rangebound, close to post-GFC tights, leaving less margin for safety. Pockets of opportunities remain in financials, utilities and select property companies.	🟢	🟢	🔴
AUS: IG credit remains well bid. Slower deal flow recently is resulting in primary deals being heavily oversubscribed. The back up in yields is attracting offshore demand for AUD debt, supporting technicals. Fundamentals are healthy; issuer quality is stable. We continue to prefer shorter tenors for carry in regulated utilities/infrastructure. Banks remain strong, and we're comfortable investing across the capital stack.	🟢	🟢	🟡
High-Yield (HY) Corporate Credit			
US: Sturdy credit fundamentals persist and technicals are favorable as capital access remains readily available with the focus on refinancings. Expect deregulation to further fuel M&A, historically a tailwind for HY spread compression. Valuations optically on the tighter side but the asset class is higher quality today. Maintaining a yield advantage versus benchmarks with the expectation that defaults trend lower.	🟢	🟢	🟡
Europe: Fundamentals continue to be overall positive with low default rates. Net supply continues to remain manageable but could pick up if M&A increases, AI-related capex increases, or with bank loan refinancing. Continue to focus on BB/B rated issuers with a bias toward telecom/cable, and select consumer and capital goods companies. Valuations are fairly tight so investors should generally expect an income-type return.	🟢	🟢	🔴
Bank Loans			
Given compressed spreads, higher current yields, favorable technicals and historically lower volatility, loans stand out on a carry per unit of volatility basis. We expect loan fundamentals to be stable with defaults modestly lower this year from lower interest costs and a gradually improving economy. We expect CLOs to be the primary source of loan demand against a relatively limited new issue supply backdrop.	🟡	🟢	🟢
Collateralized Loan Obligations (CLOs)			
Issuance in 2025 is on pace to match last year's record, supported by ETF inflows, foreign demand, and strong participation from US banks and asset managers. Net issuance is rising but remains modest. Bank loan fundamentals are stable, with CLO collateral metrics improving. Robust issuance and range-bound spreads may set up another carry-driven year with pockets of convexity opportunities in 2026.	🟡	🟡	🟢
Mortgage and Consumer Credit			
Agency MBS: Yield and spreads have narrowed but remain attractive on a risk-adjusted basis compared to high-quality corporate credit bonds. With current mortgage rates around 6%, prepayment risk increased in recently originated mortgages with rates above 6.25% but the bulk of US mortgage borrowers remain locked in sub-4% mortgage rates, which supports the fundamental backdrop.	🟢	🟢	🟡
NARMBS: We maintain a cautious outlook for home prices considering that both existing and new home supply increased meaningfully in 2025. Continued downward pressure on housing affordability has weakened borrower demand. Collateral performance measures remain positive and continue to provide strong fundamentals to residential securitized credit.	🔴	🟡	🟢
CMBS: Demand for on-the-run CMBS remains robust. New-issue activity is near record supply with lending competition limited. Fundamentals are steady to improving across most property sectors; however, we remain cautious on the hospitality market. CRE property price growth trend is firmly positive. Beta to broader market credit products has increased but spreads remain wide to historical credit relationships.	🟢	🟡	🟢

WESTERN ASSET SECTOR THEMES *continued*	FUNDAMENTALS	TECHNICALS	VALUATIONS
ABS: Consumer fundamentals are challenged for lower credit consumers while high credit consumer performance shows stabilization. Higher inflation and fiscal policy changes are expected to have a disproportionate negative impact on lower-end consumers. Our primary focus remains staying up in quality on consumer credit and specialty sectors with positive fundamentals.			
Inflation-Linked			
US: While real yields are elevated relative to the past two decades and represent good value, they are unlikely to fall substantially with expected growth near potential. Declines in inflation outside of tariff effects and unquestioned Fed credibility should keep investor interest subdued.			
Japan: The current level of 10-year breakeven inflation at 1.75% looks reasonably cheap given the structural labor shortage and elevated underlying inflationary pressure.			
Municipals			
Public Finance fundamentals remain impressively strong, with resilient balance sheets and low default rates. Robust reinvestment demand contributes to a positive technical outlook and supports carry and near-term returns. Valuations are full but opportunities remain and disciplined positioning allows us to expect attractive income while maintaining measured upside potential.			
Emerging Market (EM) Debt			
Sovereigns: EM sovereigns (both IG & HY) have continued to tighten and valuations look rich. Despite continued rotation out of US assets, no visible tail event in risk markets is supportive of holding positions for now. We still favor frontier market sovereigns over IG counterparts given cheap valuations and attractive carry, with key idiosyncratic credit stories built on a fundamental turnaround and IMF support.			
Local EM: We expect strong performance with continued tailwinds (accommodative US monetary and fiscal policy, a gradually weakening USD, continued inflows). Moderation in tariffs should be supportive to local growth, easing capex uncertainty. We favor local rates markets in Latin America and South Africa given high real yields and declining inflation, where central banks have room to cut if there's a global slowdown.			
EM Corporates: Spreads are close to historical tights, but balance sheets and fundamentals continue to look strong. Supply has broadened and strengthened with outflows turning to inflows. We remain cautiously optimistic with tight valuations prompting us to seek value in primary markets and be more tactical with issuance.			

René Ledis

Research Analyst

"Energy markets remain supply-driven. Geopolitical developments—such as the recent US intervention in Venezuela—could influence supply dynamics further. The domestic US industry remains capital disciplined with strong balance sheets. We favor natural gas and midstream infrastructure for their stronger fundamentals, while remaining cautious on oil producers amid volatility and policy uncertainty."

WESTERN ASSET INDUSTRY THEMES	
Industry	Key Observations
Auto & Related	Market weight in global Autos (IG & HY) remains prudent as fundamentals may weaken due to tough YoY comparables while current administration policy is slowing EV adoption, raising asset impairments for OEMs/suppliers. Tight valuations and the risk of rating downgrades are already reflected in our portfolios.
Banks	We continue to overweight the strongest European and US banks based on their de-risked business models, robust balance sheets and still-stringent regulation. "Defensive way to play offense" as 10-year senior banks still trade wide of IG Credit index.
Energy	Capital discipline prevails. Balance sheets are repaired; liquidity, strong. The oil market is supply driven; we see non-OPEC growth, OPEC+ defending market share, and return of Venezuelan barrels medium term. Natural gas fundamentals are better positioned (LNG and domestic power demand). We're underweight oil, overweight natural gas and midstream.

WESTERN ASSET INDUSTRY THEMES *continued*	
Food & Beverage	Sales are being sustained by inelastic demand and easing input cost pressures in 2026, although consumers remain value-oriented and continue to shift spending to private label. The food sector remains defensive in an uncertain economic environment, so we remain underweight due to rich valuations.
Gaming	US and Asia gaming fundamentals remain sound, though we are monitoring for demand or spending shifts. Recent onsite trips show softness mainly among lower-income tiers. Macau and Singapore growth remain on track, with mid to high single-digit gross gaming revenue gains expected in 2026.
Health Care	We remain underweight IG and equal weight HY health care. Managed care headwinds to persist and we expect 2026 to be a year of stabilization with earnings growth resuming in 2027. We expect hospital volumes to remain steady into 4Q25 and guidance to reflect steady Directed Payment Program (DPP) approvals offset by the expiry of enhanced subsidies.
Metals & Mining	Commodity demand is firm and increasing due to infrastructure investments. Producer discipline resulted in underinvestment and supply constraints. Capital discipline is loosening by necessity but still requires higher prices and geopolitical/policy stability. Watchpoints of tariffs and China demand remain. M&A reemerging. Overweight copper.
Pharmaceuticals	We are underweight IG and marketweight HY pharma. The tariff and MFN impact has been derisked and appears to be manageable; we expect more IG M&A activity in 1H26. In HY, we are focused on names with visible credit catalysts (i.e., rising stars, liability management exercises (LMEs), M&A, etc.) and downside protection.
Retailing	Retailers that operate with size and scale continue to gain market share in 2026 thanks to their unique ability to offset tariffs by negotiating with vendors and selectively absorbing the price increases. Consumer spending remains choiceful and value-oriented due to modest real wage gains, but we remain underweight as valuations remain rich.
Telecommunications & Media	The competitive environment will remain challenging, but we continue to like the largest telecom/cable issuers given their defensive traits, recurring revenue and strong FCF. Legacy media remains plagued by cord-cutting and weak ad trends, which have forced some to take strategic action and pursue M&A.
Telecommunications & Media (European)	Telco price pressure remains. Small EBITDA growth on cost cutting. We see challenges in French, UK, German and Swiss names, and resilience in Dutch, Nordics, Spain and Italy. We are selectively overweight to avoid M&A risk. The Digital Networks Act offers support. Media is an underweight due to AI risk, cord-cutting and low ad spending.
Transportation	We expect lower fuel costs to be a tailwind for margins and free cash flow in early 2026, further improving credit statistics and potentially resulting in more upgrades by the rating agencies. We remain selectively overweight as results, specifically air travel, should benefit from consumers prioritizing experiences over things.
Utilities	Load growth is observed. Capital budgets increasing with AI/DC build cycle. Higher negative free cash flow and "all sources" funding required. Debt issuance is growing annually despite companies managing to downgrade thresholds. Regulatory relationships are key amidst affordability concerns. Underweight but selectively participating in new issues.
Utilities (European)	European integrated utilities are expected to post largely stable earnings in 2026, driven by growth in regulated activities and offset by normalizing generation earnings. Elevated energy transition capex will require significant bond issuance, but investments are increasingly focused on lower-risk regulated assets and financed conservatively.

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