

A game of carry

Credit markets demonstrated resilience in the first half of 2026 despite geopolitical tensions in the Middle East, interest-rate volatility and strong primary market activity. Spread compression and carry supported returns, with all major credit segments delivering positive performance. High Yield (HY) and Emerging Markets (EM) credits generally outperformed Investment Grade (IG) and Developed Markets (DM) credits.

Looking ahead, market volatility is likely to remain elevated as investors navigate the Federal Reserve's policy path, inflation trends and the US midterm elections. While the economic backdrop remains broadly supportive, uncertainty surrounding growth, labour markets and interest rates could lead to periods of spread widening and market dispersion.

In this environment, carry should remain an important driver of returns, reinforcing the need for disciplined credit selection. We continue to favour high-quality issuers and maintain a neutral duration stance. Within DM, we prefer IG over HY, given the late-stage credit cycle and relatively less attractive valuations in the HY segment.

Across EM, we remain neutral on both Asia and Latin America, where valuations appear broadly reasonable. Within EM sovereigns, we see selective opportunities in Africa and continue to favour Latin America relative to other regions. By contrast, we remain Underweight Central and Eastern Europe, the Middle East and Africa (CEEMEA) credits, where valuations do not adequately compensate for emerging risks and deteriorating fundamentals in certain markets.

Overall, a focus on quality, carry and selective opportunities remains key for navigating credit markets in the second half of 2026.

Rates and US Treasuries

The US Treasury yield curve flattened during the first half of 2026 as markets reassessed the Federal Reserve's policy outlook. A more hawkish tone from the Fed, including higher projections for future rates, has reduced expectations for near-term rate cuts and increased uncertainty around the path of monetary policy.

While the Fed's stance raises the possibility of further rate increases, we expect policymakers to remain data dependent, particularly as they balance inflation risks against economic growth considerations. At the same time, limited forward guidance under the new Fed leadership could contribute to greater interest rate volatility in the months ahead.

Against this backdrop, we maintain a neutral duration stance. A portfolio duration of approximately three to seven years provides flexibility to navigate changing market conditions while balancing potential risks and opportunities arising from shifts in interest rates and bond yields. As volatility persists, diversification and active duration management will remain important components of portfolio positioning.

Developed Markets

DM corporate credit has remained resilient, although performance has lagged EM peers. Within the US, IG fundamentals remain broadly stable, while HY credit metrics have weakened, with leverage rising and interest coverage declining. Despite some widening, US HY valuations remain relatively rich compared with historical averages.

In the Asia-Pacific, Japan has overtaken China as the largest offshore bond issuer in 2026, supported by BOJ policy normalisation and rising corporate capital expenditure. While increased issuance may create occasional spread pressure, the market continues to benefit from a steady pipeline of high-quality issuers and attractive yields. Australia has also seen record bond issuance, although strong investor demand has helped keep spread widening contained.

Looking ahead, we expect higher issuance levels, ongoing AI-related capital expenditure, M&A activity and interest-rate volatility to drive greater performance dispersion across credit markets. While DM HY spreads have widened modestly relative to IG, valuations remain less compelling than historical norms.

As such, we maintain a neutral stance on DM IG credit, supported by relatively stable fundamentals and attractive carry, while remaining underweight on DM HY due to richer valuations and late-cycle credit risks.

Emerging Market Corporates

Robust global growth, elevated commodity prices, and attractive carry have supported the outperformance of EM corporates relative to their DM peers. Although spread buffers have narrowed, EM US Dollar corporate bonds remain comparatively less sensitive to rising interest rates, albeit with notable differences across sectors and regions.

Selective exposure to high-quality EM bonds can enhance long-term portfolio diversification; however, near-term US Dollar strength may present a headwind to EM fund flows, given the historically negative correlation between the US dollar and EM asset performance.

Asia

Asian credit markets lagged most EM peers in the first half of 2026, reflecting their lower-yielding and more defensive characteristics. Performance was mixed across the region, with Hong Kong, India and Malaysia among the stronger performers, while Indonesia and the Philippines underperformed.

Despite the relative underperformance, we maintain a neutral stance on Asian corporate credit. The asset class continues to benefit from shorter duration profiles, strong domestic funding support and favourable market technicals. With corporate fundamentals remaining broadly stable, carry is expected to be the primary driver of returns in the second half of the year. We see attractive opportunities in higher-quality BB-rated credits and selected subordinated bonds of stable IG issuers, which offer additional yield without materially increasing credit risk.

Looking ahead, bond issuance is expected to increase in markets such as South Korea, Indonesia and India. India's primary market could become more active as a key Reserve Bank of India USD-INR swap facility expires at year-end. Given relatively low issuance levels over the past year and supportive underlying market conditions, new issues coming to market at wider spreads may present attractive entry points for investors.

Overall, Asian corporate bonds continue to offer a compelling combination of quality, income and diversification, with carry remaining a key source of returns amid a more volatile global interest-rate environment.

Emerging Market Sovereigns

Looking ahead, we maintain an Underweight stance on EM sovereigns while continuing to favour a broadly defensive positioning. Encouragingly, carry remains attractive, and overall EM fundamentals are stronger than during previous periods of global market stress.

We remain neutral on duration, with a preference for reform-oriented sovereigns and higher-quality high-yield credits rated BB- and above, particularly where external financing requirements remain manageable.

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