Allianz Global Investors

DECEMBER 2025

Fixed Income Forward

Carry shines in the absence of growth or credit shock

Key takeaways

- Without a credit or growth shock as our base case scenario for 2026, resilient income remains a central theme.
- Despite tight spreads, globally diversified credit and emerging market debt may offer a more durable path to higher income than extending maturities in core rates.
- We favour shorter term core government bonds as less vulnerable to fiscal "panic attacks", but stay active in duration, which remains (especially in the US) a reliable hedge to growth risks.

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With no US Federal Reserve (Fed) policy meeting, and economic data releases delayed by the US government shutdown, global bond markets had mostly sentiment to go by in November. As for expectations around a US rate cut in December, futures markets have changed their bets several times over the past few weeks. According to data from the CME FedWatch Tool, the odds of a December rate cut were above 90% in mid-October, then dropped below 50% in early November, only to climb back up to around 80% at month end. A December cut would bring the target range to 3.50%-3.75%.

We expect policy rates in advanced economies to continue to move towards neutral levels, but at varying speeds. Business activity indicators point to economic resilience in major advanced economies, with the US and Japan showing signs of acceleration while the euro area holds steady. The UK remains challenged by a weakening labour market and slower growth. With its Autumn Budget, the UK government sought to reassure markets that it can improve public finances. Gilt investors seem content for now. As inflation softens, the Bank of England may have room to cut rates in December.

With the resumption of policy easing on the horizon – Japan excepted – we favour front-end US rates while preferring to take longer-dated exposure in emerging market sovereign debt, eg, Brazil, Peru, South Africa, Malaysia. We think the macro and policy backdrop still points to US yield-curve steepening. Should a more politicised and "growth-friendly" Fed emerge, short-dated bonds would likely benefit; meanwhile, a muddy inflation and fiscal outlook is set to hurt long-dated bonds. In contrast, the inflation and fiscal picture in many emerging markets is rosier, with already steeper yield curves and more runway to cut rates if growth disappoints.

Without a credit or growth shock as our base case scenario for 2026, resilient income remains a central theme. Credit spreads look set to close the year tighter despite bouts of widening and high levels of new issuance. A rush to lock in historically high all-in yields seems to have supported demand for spread assets. Importantly, solid corporate earnings, improved creditworthiness and macroeconomic outperformance in emerging markets contribute to this favourable backdrop.

For investors with large cash balances, falling short-term interest rates pose reinvestment risk. Extending maturities in core government bond markets can be a volatile bet. This year, long-dated bond yields in some core markets have risen more than same-maturity interest-rate swap rates. We think term premiums could rise further as countries such as Germany issue more sovereign bonds and fiscal fears prompt liquidity crunches at the back end of yield curves. In this context, we expect asset allocators to maintain and even increase spread product exposure, with greater diversification across geographies, sectors and ratings. At the same time, we think it's important to stay active in managing duration in portfolios as duration (especially US Treasuries) remains a reliable hedge to growth risks.

In investment grade credit, we still like floating-rate notes as a "first line of defence" to falling money-market rates since these instruments trade at a yield spread above benchmark short-term rates. In high-grade fixed-rate bonds, we maintain a moderately overweight credit allocation given that fundamentals and technicals support this asset class. Our allocation leans into higher quality tiers, with a bias towards financials and utilities versus cyclical industrials.

While retaining our high conviction to financials, we have reduced our relative exposure to the sector, based primarily on valuations, and have rotated into more senior parts of the capital structure.

In high yield, we are being very selective – even though we see a low default outlook (away from certain sectors and lower-rated issuers). In the BB-rated segment, there is little spread differential between the US and Europe, while European single Bs are trading wider and may offer select opportunities. In Asia, we maintain a preference for high yield over investment grade for the carry, while in high yield we generally favour BBs over Bs, consistent with our more defensive stance.

Fixed income market performance

Indicative market indices Data as of 28 November 2025	Total return YTD 2025 (%)	Total return Nov 2025 (%)	Yield-to- worst* (%)	Effective duration (years)
Global convertible bonds	20.94	-1.65	-2.4	1.5
Global emerging-market sovereign bonds	13.48	0.41	6.8	6.6
Asian high yield	9.81	-0.52	8.6	2.9
US investment grade	7.99	0.65	4.8	7.0
US high yield	7.76	0.46	6.7	2.9
Asian investment grade	7.60	0.35	4.8	4.8
US aggregate	7.46	0.62	4.3	6.0
Global aggregate	5.09	0.21	3.4	6.4
US Treasury bonds 1-3 years	4.86	0.45	3.5	1.7
Euro high yield	4.76	0.06	5.1	3.0
US floating-rate notes	4.71	0.38	4.6	0.0
Euro investment grade	3.22	-0.25	3.1	4.6
Global government bonds AAA-AA	3.20	-0.08	3.1	7.4
Euro government bonds 1-3 years	2.26	0.09	2.1	2.0
Euro aggregate	1.75	-0.08	2.9	6.3

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 28 November 2025. Index returns in USD-hedged except for Euro indices (in EUR). Asian and emerging-market indices represent USD denominated bonds. Yield-to-worst adjusts down the yield-to-maturity for corporate bonds which can be "called away" (redeemed optionally at predetermined times before their maturity date). Effective duration also takes into account the effect of these "call options". The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or as investment advice. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

* Represents the lowest potential yield that an investor could theoretically receive on the bond up to maturity if bought at the current price (excluding the default case of the issuer). The yield to worst is determined by making worst-case scenario assumptions, calculating the returns that would be received if worst-case scenario provisions, including prepayment, call or sinking fund, are used by the issuer (excluding the default case). It is assumed that the bonds are held until maturity and interest income is reinvested on the same conditions. The yield to worst is a portfolio characteristic; in particular, it does not reflect the actual fund income. The expenses charged to the fund are not taken into account. As a result, the yield to worst does not predict future returns of a bond fund.

CHART OF THE MONTH

"Safe haven" bonds are in negative territory on a six-year basis (in %)

Indicative market indices Data as of 28 November 2025	Cumulative total return 2020–YTD 2025	Total return YTD 2025	Total return 2024	Total return 2023	Total return 2022	Total return 2021	Total return 2020
Euro aggregate	-6.28	1.75	2.63	7.19	-17.18	-2.85	4.05
Global government bonds AAA-AA	-1.80	3.20	1.95	7.13	-15.41	-3.08	6.27
Euro investment grade	2.03	3.22	4.67	8.01	-13.95	-1.02	2.65
Euro government bonds 1-3 years	3.19	2.26	3.16	3.48	-4.82	-0.70	0.02
Asian high yield	5.02	9.81	15.18	4.76	-15.09	-11.05	4.94
US aggregate	5.72	7.46	1.25	5.53	-13.01	-1.54	7.51
Global aggregate	7.61	5.09	3.40	7.15	-11.22	-1.39	5.58
US investment grade	9.63	7.99	2.13	8.52	-15.76	-1.04	9.89
US Treasury bonds 1-3 years	12.18	4.86	3.98	4.23	-3.80	-0.61	3.24
Global emerging-market sovereign bonds	14.14	13.48	6.54	11.09	-17.78	-1.80	5.26
Asian investment grade	15.81	7.60	4.22	7.42	-10.01	-0.01	6.86
Euro high yield	19.81	4.76	8.63	12.00	-11.48	3.35	2.76
US floating-rate notes	22.84	4.71	6.42	6.73	1.34	0.52	1.38
US high yield	31.38	7.76	8.22	13.44	-11.22	5.36	6.17
Global convertible bonds	75.35	20.94	9.37	12.05	-14.56	4.15	32.97

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 28 November 2025. Index returns in USD-hedged except for Euro indices (in EUR). Asian and emerging-market indices represent USD denominated bonds. The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or as investment advice. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

The last six years reveal an opportunity cost associated with an underweight exposure to credit. Spread sectors have outperformed core rates by a wide margin, mainly due to the power of carry. Over time, these bonds accrue higher coupon payments that have the potential to more than offset any losses associated with interest-rate changes and defaults. In contrast, the longer average duration profile of the highest-rated government bonds, coupled with lower coupons, mean they have barely recouped losses suffered in 2021-2022 (on a US dollar-hedged, index-level basis). This serves as a harsh reminder of the performance drag that can come from "safe haven" government debt. Even without a material deterioration in creditworthiness, these assets have suffered from a sharp rise in interest rates and concerns about long-run fiscal sustainability. Euro high-grade bonds have been hit the worst and are still in negative territory on a standalone basis (see Euro Aggregate index). In September, borrowing costs of several French companies even fell below those of French government debt of similar maturity. While we are some way from corporate debt substituting high-grade sovereign debt as a safe haven, the resilience of global and diversified credit has certainly put into sharper perspective the potential pitfalls of holding (fiscally-challenged) long-dated government debt.

WHAT TO WATCH

1. Fed meeting

After a pause in November, the US central bank meets again on 9-10 December to decide on rates. The October meeting revealed divisions among voting members, with some worried about a softening jobs market and others wary of inflation. October-November jobs data, as well as key inflation figures, won't be released until after the Fed meets.

2. Ukraine conflict

Energy prices, as well as eastern European currencies, have been volatile amid renewed talks to reach a Russia-Ukraine peace deal. The latest diplomatic push involves a US plan that both Ukraine and EU leaders have criticised as too favourable to Russia. A lasting deal at this juncture is unlikely; commodity and currency markets remain highly sensitive to the news flow.

3. AI bonds

Unlike in the dot-com era, today's AI infrastructure spend is largely financed by strong cash flows and public sector-backed initiatives rather than corporate leverage. That said, so-called AI hyperscalers have overtaken banks this year as the largest (in volume) high-grade bond issuers in the US. AI capex is bound to face greater investor scrutiny amid record tech valuations and bond issuance.