

Late cycle calls for resilient income and duration

KEY TAKEAWAYS

- The Fed cuts again – falling rates help duration reassert its role as a risk-off hedge when volatility rises.
- There are idiosyncratic cracks in the credit market but systemic risk remains low as large US banks report strong third-quarter earnings.
- To achieve resilient income, we focus on active duration management, high-quality carry and security selection.

The US Federal Reserve cut rates for the second time this year, bringing the federal funds rate down by another 25 basis points to a range of 3.75-4%. The central bank hopes to shield the job market from downside risks – despite inflation running above target. While Chair Jerome Powell's hawkish comments cloud the timing of the next cut, there remains room for the terminal rate to come down in the next six months as growth remains below potential. The European Central Bank reaffirmed its neutral stance and kept its rate at

2%; it predicts inflation will stay near its 2% target. In contrast, the Bank of England is contending with inflation of about 4%, but the door is open for a cut before year end as the UK's consumer price index held steady for the third month in a row.

We still favour exposure to yield-curve steepening in the US and prefer short-to-intermediate maturities given that fiscal imbalances put pressure on longer dated bonds leading to volatility. In Europe, Germany's planned 2026 deficit of 4.75% of GDP implies the largest fiscal stimulus since the 1970s while many other member states plan to moderate spending. Such divergencies provide relative value opportunities in the global bond space. For example, we expect a relatively tighter fiscal stance and favourable bond valuations to help the ultra-long debt of Spain outperform that of the US – a cross-market trade we maintain in place.

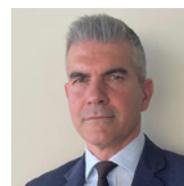
In the credit market, volatility resurfaced triggered by the recent bankruptcies of subprime auto lender Tricolor and auto parts manufacturer First Brands. Comments by JP Morgan CEO Jamie Dimon about

"cockroaches"¹ spurred renewed questions about asset quality among smaller and regional banks, underwriting standards in private markets, and where the next cracks could be. Regional banks got hit hard – the KBW Nasdaq Regional Bank Index sold off more than 11% from its September highs into mid-October before partially recovering by month end. Credit spreads, particularly high yield, widened initially but recouped most of the widening in the following week.

To us, these are typical noises in a late cycle. Sectors that have higher financial leverage and heavy interest burdens start to crack when borrowing costs are rising, including commercial real estate and automobiles. Unsurprisingly, within



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¹ Dimon told analysts on his company's third-quarter earnings call, "I probably shouldn't say this, but when you see one cockroach, there are probably more... everyone should be forewarned on this one."

those interest-rate sensitive sectors, some of the most aggressive, most stretched and (potentially) fraudulent borrowers fail.

In our view, the systemic risk is small at this point, thanks to manageable exposure to total loans and capital, as well as broadly solid fundamentals across the banking system. Such strength is evidenced in the latest US bank third-quarter earnings releases with strong profitability, healthy balance sheets and stable credit quality.

That said, overall public credit remains in good shape despite tight valuations. Fundamentals are

moderating from high levels and dispersion is rising among sectors, but leverage is lower than in prior cycles, interest coverage is healthier, and the high-yield index quality has improved as weaker issuers are taken out (partially by private markets). This is an environment that calls for vigilance while it is too early to give up on carry.

This should also remind investors of the concentration risk in US assets. That said, we believe a truly globalised, diversified and high-quality portfolio with active duration management is best positioned to provide income with resilience in today’s macro backdrop. We see a good case to selectively add

high-quality securitised assets and convertible bonds as diversifiers to other fixed income sectors. As corporate credit spreads compress, securitised debt becomes an attractive diversifier due to its short duration, backing by tangible assets, good ratings-adjusted spreads and floating-rate structure. In the mid- to long-term, Asian and emerging markets stand out as compelling destinations for diversification thanks to improving central bank credibility and diverging credit cycles.

Fixed income market performance

Indicative market indices Data as of 31 October 2025	Total return YTD 2025 (%)	Total return October 2025 (%)	Yield-to- worst* (%)	Effective duration (years)
Global convertible bonds	22.96	3.39	-3.2	1.4
Global emerging-market sovereign bonds	13.02	2.13	6.8	6.7
Asian high yield	10.38	1.22	8.3	2.7
US investment grade	7.29	0.38	4.8	7.0
US high yield	7.27	0.20	6.8	3.0
Asian investment grade	7.23	0.66	4.7	4.9
US aggregate	6.80	0.62	4.3	6.0
Global aggregate	4.87	0.79	3.4	6.4
Euro high yield	4.69	0.09	5.0	2.9
US Treasury bonds 1-3 years	4.38	0.36	3.6	1.7
US floating-rate notes	4.32	0.41	4.8	0.0
Euro investment grade	3.48	0.69	3.0	4.6
Global government bonds AAA-AA	3.28	1.04	3.0	7.5
Euro government bonds 1-3 years	2.16	0.30	2.1	2.0
Euro aggregate	1.83	0.81	2.8	6.3

Source: Bloomberg, ICE BofA and JP Morgan indices; Allianz Global Investors, data as at 31 October 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.

 WHAT TO WATCH

1 Banks

Recent market concerns about the US subprime consumer did not stop large-cap banks and “money centres” beating earnings estimates, offering reassurance on credit trends and net interest income. Regional banks have lagged and reported mixed updates. We don’t see systemic risks but expect a higher level of due diligence on banks’ subprime loan exposures in future.

2 US-China trade

The US and China agreed a one-year trade truce on the sidelines of an economic summit in South Korea. The agreement involves pausing higher US tariffs on Chinese imports in return for China delaying rare earth export controls. The move has been seen as a de-escalation but not an end to the trade war, with some calling the truce “fragile”.

3 Oil

Crude rallied after the US announced sanctions on Russia’s two largest oil producers. Major buyers of Russian oil, such as China and India, may have to source more oil from OPEC suppliers; however, the backdrop of a global surplus is likely to limit price gains for now. Any sudden supply shock and sustained price spike could hurt the global economic outlook.

 CHART OF THE MONTH

Banks’ exposures to non-bank financial institutions



Source: Allianz Global Investors, Barclays, data as at 30 September 2025. The information 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

Recent events in the US have raised concerns about underwriting standards in private credit. First came the two bankruptcies of subprime auto lender Tricolor and auto parts manufacturer First Brands. Then US regional banks Zions and Western Alliance revealed their exposure to alleged fraud involving loans to a commercial real estate fund. Despite the high profile of these events, the exposure of the broader banking

sector to the two bankruptcies and the real estate case looks manageable and idiosyncratic. We do not see systemic risks or direct read-through from these events into the broader financial or corporate sector. Bank lending to non-bank financial institutions (NBFIs) has been a fast-growing segment in the US banking system and now represents over 10% of total loans. Across the largest US banks, loans to NBFIs averaged

64% of common equity tier 1 capital, 9% of total loans and 5% of total assets. Much of these exposures are collateralised and span a wide range, including auto lenders, commercial real estate mortgage originators and servicers, equipment lessors, insurance companies and private market funds. Transparency remains suboptimal but has been improving. In future, expect to see a higher level of due diligence on subprime credit.

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