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Keep Calm and Carry On Diversifying

FEATURING

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In brief

- **Scarcity is becoming a defining feature of the global backdrop, supporting higher real yields and reinforcing the case for selectivity**
- **The easy era for duration has passed, making relative value opportunities across regions and yield curves increasingly important**
- **Liquidity, diversification, and defensive carry remain powerful tools for navigating uncertainty around central banks, geopolitics, and the AI investment cycle**

Global fixed income markets are entering a more complex phase. Central banks are following increasingly divergent paths, geopolitical risks persist, and the AI investment cycle continues to reshape both economies and capital markets. At the same time, higher yields have created attractive income opportunities for investors willing to stay disciplined and selective. In our view, the challenge is balancing opportunities created by elevated yields and growing market dispersion against a backdrop of policy uncertainty and evolving structural risks.

Japan has become the epicenter of global bond markets

Japan has become a key driver of global fixed income markets as the country continues its transition away from decades of disinflation and weak growth. Inflation is running above the Bank of Japan's target, while wage growth, capital inflows, and stronger economic activity support further policy normalization. We believe the direction of travel for Japanese rates is higher, although the pace is uncertain. The yen will likely continue to be driven by shifting expectations around the timing and speed of policy adjustments, official intervention, and capital flows. Rather than a one-way currency view, we expect greater volatility as markets assess how quickly the Bank of Japan closes the gap with other major central banks.

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Scarcity is reshaping the investment landscape

The theme of scarcity provides a useful framework for understanding today's global market environment. Commodity scarcity continues to influence inflation expectations as energy markets, industrial metals, and agricultural inputs are affected by geopolitical disruptions and supply constraints. At the same time, the AI infrastructure buildout is creating shortages of power, water, labor, and suitable locations for datacenters, adding further inflationary pressure. Perhaps most importantly, investors are now facing scarcity of capital. Governments, corporations, and AI infrastructure projects are competing for financing at a time when many traditional providers of capital have their own funding needs. In our view, this helps explain why investors are demanding higher real yields and why rates may remain elevated absent a significant risk-off event.

AI and private credit are creating new fault lines

The AI investment cycle presents one of the most important opportunities and risks in fixed income. On one hand, AI-related spending supports growth, corporate earnings, and credit fundamentals. On the other, the scale of financing required is creating substantial debt issuance, increasing concentration in parts of the market and contributing to growing dispersion between issuers and sectors. We believe security selection and relative value analysis are becoming increasingly important as a result. Private credit is another area warranting close attention, as rising yields and increasingly differentiated performance across lower-quality issuers suggest fragilities may be emerging beneath otherwise resilient index-level spreads. Forced liquidations by large institutional investors or refinancing challenges in coming years could expose additional weaknesses that are not yet fully reflected in broader markets.

Positioning for a more selective fixed income environment

The outlook for duration has become more challenging, and we believe investors should place greater emphasis on relative value opportunities rather than broad directional duration views. In the United States, curve positioning remains more attractive than outright duration exposure given the uncertainty surrounding Federal Reserve policy. In Europe, markets appear to be pricing in a more aggressive policy path than growth fundamentals warrant, creating opportunities elsewhere on the curve. We continue to find value in UK duration, particularly in the belly of the curve, while local emerging market bonds offer diversification, attractive real yields, and potential policy easing opportunities.

Across credit markets, we favor investment grade as a core holding while maintaining shorter spread duration. We also continue to see opportunities in selected emerging market corporates and sovereigns, along with higher-quality segments of US high yield.

On currencies, the US dollar could be supported tactically by interest-rate differentials, stronger growth, and safe-haven demand, although the longer-term structural outlook appears less compelling.

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Conclusion

We believe global fixed income continues to offer attractive opportunities, even as uncertainty stays elevated. Higher yields allow investors to construct portfolios with compelling income characteristics without taking excessive risk, while growing dispersion is creating a richer opportunity set for active managers.

In this environment, maintaining liquidity, diversification, and defensive carry remains a prudent approach. Doing so allows investors to benefit from attractive income today while retaining the flexibility to capitalize on future dislocations as the outlook for central banks, geopolitics, and the AI story evolves. We believe that patience, selectivity, and a globally diversified approach will be the most effective tools for navigating the next phase of fixed income markets.

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