BNY | INVESTMENTS

BALANCING RISK AND CAPTURING OPPORTUNITY IN FIXED INCOME

Why we believe an active, flexible approach to fixed income may provide attractive income and improve resilience in portfolios.

FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS ONLY.

EXECUTIVE SUMMARY

- **The biggest risks are being underpriced.** Geopolitical tensions, isolationist trade policy, and fiscal divergence are visible, well-understood risks that markets continue to systematically underestimate.
- **Major asset classes are priced for perfection.** Based on credit spreads and S&P 500 valuations, both equities and bonds are priced for a positive outcome. This leaves little room for error.
- **The 60/40 portfolio is structurally flawed.** The negative correlation between equities and bonds has broken down, undermining the case for government bond duration as a hedge.
- **AI infrastructure is reshaping fixed income markets.** Hyperscalers are expected to issue up to $5 trillion in debt between 2025 and 2030, creating potential opportunity and risk.
- **Yields provide a genuine buffer.** For those worried about capital protection, we calculate that global investment grade yields could rise by up to 0.80% before total returns would become negative.
- **Shorten duration and go global.** We believe high interest rate sensitivity is a liability in a world of sticky inflation and elevated government debt. Reducing duration and diversifying globally across sectors may be the first line of defence.
- **Flexibility is a return driver, not just a risk tool.** Fixed income asset class leadership rotates year to year. An active, dynamic allocation has the potential to capitalise on these rotations in ways that a static asset class exposure cannot.
- **Keep it short, broaden exposures, stay nimble.** We believe the appropriate response to today's environment is to shorten duration, widen geographic and sector reach, and maintain the flexibility to act decisively when markets fail to price risks.

> Flexibility is a return driver, not just a risk tool."

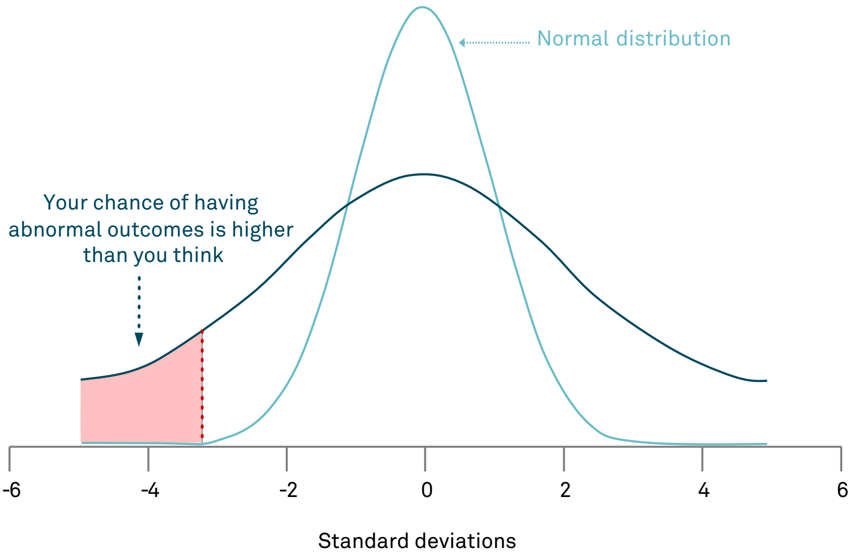
LOOKING BEYOND HEADLINE YIELDS IS CRITICAL

Yield has returned to fixed income – making the asset class a credible source of returns. However, beneath the surface, tighter credit spreads and building macroeconomic pressures mean buy-and-hold may no longer be the optimal strategy to maximise returns.

We expect moderate growth over the next 12 months with limited recession risk and stabilising labour markets supporting the case for credit markets. However, the range of plausible outcomes is widening faster than standard risk models can keep pace with (see Figure 1).

In our view, the main risk facing investors today is not unexpected shocks, but markets mispricing the expected ones. The risk of geopolitical tensions, increasingly isolationist trade policies along with fiscal and central bank divergence are, in our view, underestimated. These risks are hard to model and easy to overlook when near-term economic data still seem supportive.

Figure 1: Beyond the base case: Why the tails now matter more



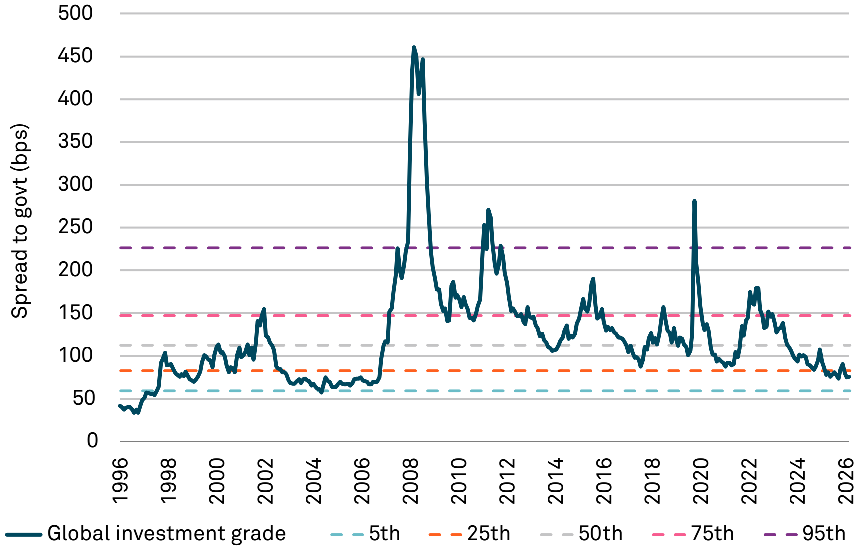
For illustrative purposes only.

We believe there are four fundamental shifts redefining the way fixed income markets behave.

1. Beta is expensive in major markets

With credit spreads tightening to historic ranges (see Figure 2), certain bond markets look expensive. At the same time, the S&P 500 is trading at 20-year price to earnings (P/E) highs. Both major risk asset classes are priced for a positive economic outcome, posing challenges to returns from broad market exposure alone.

Figure 2: Investment grade (IG) credit spreads (BP) and percentiles



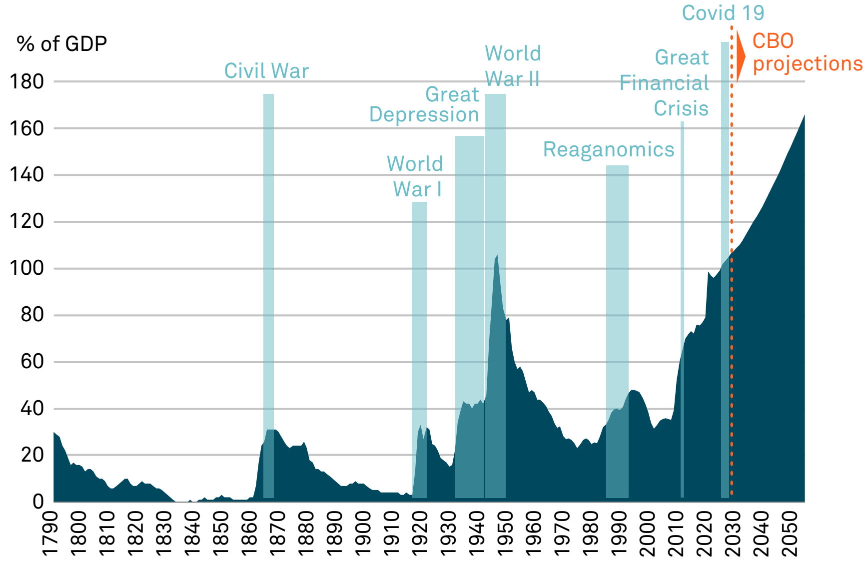
Insight and Bloomberg as at 30 June 2026. Data is based on Bloomberg Global Aggregate Corporate index (G0BC). For illustrative purposes only.

2. Long-maturity bonds may remain under pressure

Governments in developed markets are facing significant debt issues. The US deficit is around 5.8% of GDP[1]. Japan, the most indebted major economy, has seen the sharpest rise in government bond yields globally[2], as markets focus on the sustainability of its long-dated debt. In the UK, Gilt yields remain sensitive to any deterioration in the fiscal and political outlook. Meanwhile, central bank policy divergence is changing the relative attractiveness of sovereign bonds across markets.

> "Central bank policy divergence is changing the relative attractiveness of sovereign bonds across markets."

Figure 3: US federal debt held by the public



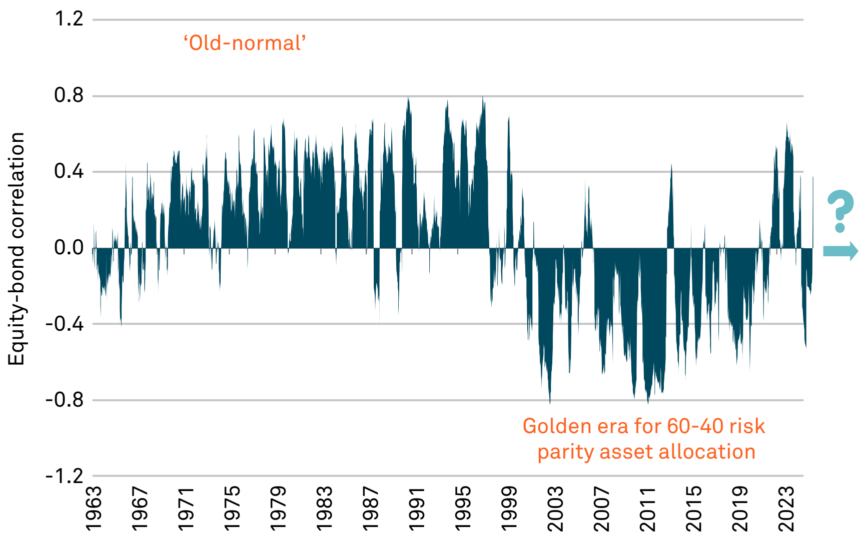
Source: Congressional Budget Office and Insight as at 31 December 2025.
For illustrative purposes only.

1. Source: Congressional Budget Office. The Budget and Economic Outlook: 2026 to 2036. February 2026.
2. Source: Bloomberg.com. Japan Yields Rise to Record Highs on Global Inflation Fears. 15 May 2026.

3. Static allocations may have become a liability

The investment regime has changed but many asset allocation frameworks have not. The negative correlation between equities and bonds that defined the 60/40 portfolio for two decades has broken down (see Figure 4). Recent history demonstrated that inflation shocks can cause equities and bonds to fall together. In this environment, we question whether government bond duration can provide portfolio protection – and whether governance structures built around quarterly investment committees can respond quickly enough.

Figure 4: Asset allocation is becoming more nuanced
Six-month correlation of US equities and 10-year Treasury yields



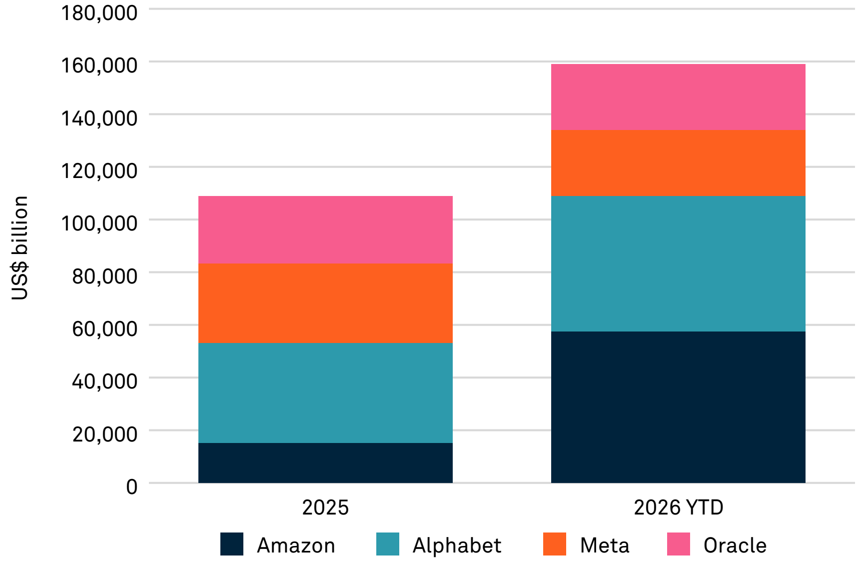
Source: Insight and Bloomberg as of 1 May 2026. For illustrative purposes only.

> Recent history demonstrated that inflation shocks can cause equities and bonds to fall together."

4. AI infrastructure build out is reshaping credit markets

Artificial intelligence (AI) hyperscalers are increasingly turning to bond markets to help fund vast amounts of infrastructure spending (see Figure 5). This spending could reach about $5 trillion between 2025 and 2030[3]. Meta and SpaceX[4] both issued $25bn in investment grade bonds and Morgan Stanley expects global AI-related debt issuance to reach nearly $570bn in 2026[5].

Figure 5: Bond issuance by big AI tech companies



Technology "hyperscalers" are now 3.7% of US IG market and 1.2% of European corporate market

Source: Bloomberg and Barclays as at 30 June 2026.

This offers the potential for a yield pick-up, but heavy issuance may keep pressure on credit spreads in the tech sector over the medium term. One way to avoid this may be through high yield markets. This area of fixed income is less exposed to the AI theme and may offer useful diversification against AI-related disruption.

3. Source: Insight, Bloomberg, Cognitive Credit and Morgan Stanley, as at 30 November 2025.
4. Source: FT. SpaceX pitches investors juicy yields in $25bn bond deal. 23 June 2026.
5. Source: Reuters. Global AI debt issuance to top $500 billion in 2026, Morgan Stanley says. 10 June 2026.
References to specific securities are for illustrative purposes only, and are not intended as recommendations to purchase or sell securities.

YIELDS CAN PROVIDE A DEFENSIVE BUFFER

For those investors worried about capital preservation, current yield levels may provide a meaningful cushion in a scenario where yields rise, reducing the risk of absolute losses. As Table 1 shows, our modelling suggests global investment grade yields could rise 0.80% over the next year before the total return falls to zero. This so-called 'breakeven yield increase' is 1.20% for sterling investment grade corporate bonds, 2.30% for global high yield corporate bonds and 3.10% for sterling high yield corporate bonds.

Table 1: Yield buffer by asset class

	Duration (years)	Yield to maturity (%)	Simulated return if yields fall 1.0%	Simulated return if yields rise 1.0%	Breakeven yield increase
Global IG corporate[1]	5.8 years	4.70%	10.50%	-1.10%	0.80%
Sterling IG corporate	4.8 years	5.50%	10.30%	0.70%	1.20%
Global HY corporate[1]	3.1 years	7.10%	10.20%	4.00%	2.30%
Sterling HY corporate	2.8 years	8.60%	11.40%	5.80%	3.10%

Source Bloomberg and Insight as at 30 June 2026 – assuming all else equal. Model results have certain inherent limitations. Unlike an actual performance record, model results do not represent actual trading/returns and may not reflect the impact that material economic/market factors might have. Clients' actual results may be materially different than the model results presented. [1] Global yield has been hedged into GBP using short-term interest rate differentials. ICE Bank of America indices (Global IG corporate = ICE BofA Global Corporate Index (G0BC), Sterling IG corporate = ICE BofA Sterling Corporate Index (UR00), Global HY corporate = ICE BofA Global High Yield Index (HW00), Sterling HY corporate = ICE BofA Sterling High Yield Index (HL00)).

POSITIONING FOR RESILIENCE

We believe fixed income investors should position for these global macroeconomic and market dynamics in two ways:

1. Reduce structural headwinds

In today's environment, carrying high interest rate sensitivity could hurt returns if interest rates rise further. Shortening duration is one way to potentially reduce this risk.

In addition, a global approach to rate positioning allows a portfolio to own duration where it looks most attractively priced, rather than holding it uniformly through index exposure. We believe the following sub asset classes can drive differentiated return streams:

- **Global credit:** credit and security selection in global investment grade across currencies, credit quality and maturities offers the potential to improve risk-adjusted yield, broaden idea generation and potentially reduce drawdowns.
- **Multi-sector credit:** Spanning both global investment grade credit and high yield, an active manager can seek to deliver high-yield style income return at an investment-grade average rating, with potentially lower interest rate duration than a conventional fixed income portfolio.
- **Short-dated credit:** In the current flat yield curve environment, short-dated credit aims to capture yield premium while minimising volatility.
- **Absolute return bond:** These strategies seek to eliminate market beta by having no index credit exposure and no interest rate exposure. They aim to generate positive returns in all market conditions over a set timeframe from active security selection.
- **Strategic bonds:** Strategies with the flexibility to invest in the full global fixed income universe. They actively adjust the portfolio as market conditions change, aiming for a combination of income and attractive risk-adjusted returns throughout the market cycle.

2. Act quickly when dislocations appear

As Figure 6 shows, asset class leadership in fixed income rotates each year. For example, in 2022, only asset-backed securities delivered a positive return; in 2013, global high yield was the best performing before being the worst in 2014. The ability to dynamically flex asset allocation can capitalise on these asset class movements, potentially improving resilience and return potential compared with an inflexible exposure to a single segment of the fixed income universe.

Figure 6: Return experience varies by fixed income asset class

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026 YTD
10.25	13.69	10.81	12	59.4	14.82	7.35	19.6	7.33	7.43	1.18	14.27	10.43	2.38	15.04	7.8	3.75	0.15	10.45	9.3	13.45	2.77
6.84	9.86	7.26	-7.04	38.61	13.5	7.22	17.44	1.3	5.7	1.18	10.15	10.26	-0.66	13.09	7.13	0.92	-10.73	8.83	7.98	10.02	2.43
3.59	7.29	6.16	-12.03	29.82	12.24	4.59	16.95	-0.11	2.94	-0.18	9.65	8.93	-1.65	12.56	6.9	0.91	-12.08	8.68	7.63	9.53	1.84
-3.14	6.65	3.45	-15.36	16.85	6.42	3.24	10.81	-1.73	1.67	-2.61	3.67	7.96	-3.17	10.74	6.13	-0.95	-12.26	4.45	5.73	6.82	2.39
-6.53	5.94	3.16	-26.88	1.9	5.62	3.12	1.3	-4.5	0.67	-2.72	2.72	6.83	-4.06	6.02	5.26	-1.51	-14.22	4.18	3.52	6.8	1.58
NA	NA	NA	NA	NA	NA	NA	NA	-5.25	0.01	-3.55	1.57	3.84	-4.26	2.4	2.29	-2.3	-16.45	2.12	-3.58	5.43	-0.71

EM Corporate | Global IG Corporate | EM Sovereign | Global Government | Global HY | Global ABS

Source: Returns shown represent benchmark indices calculated in USD and may be influenced by currency movements. Indices differ in risk profile, duration, credit quality and regional exposure and are not directly comparable. Methodology available on request. Source: Insight as of 30 June 2026. Benchmarks per asset class: 'EM corporate' – JP Morgan Corporate EMBI Broad Diversified index; 'Global IG corporate' – Bloomberg Global Aggregate Credit Index; 'EM sovereign' – JP Morgan EMBI Broad Diversified index; 'Global government' – JP Morgan World Government Bond index; 'Global high yield' – Bloomberg Global High Yield index; 'Global ABS' – Bloomberg US ABS Floating Rate index. Above returns have been calculated in USD.

WHERE MANAGER SELECTION MATTERS MOST

The restoration of meaningful yield levels has changed the role of fixed income in portfolios. Starting yields now provide the potential for meaningful compound returns generated from income, a source of returns that was difficult to achieve in the era of quantitative easing. We also believe that there is significant scope to generate excess returns in fixed income markets, as they are structurally less transparent and efficient than equities, which can create opportunities that skilled active managers can exploit.

But in the current environment, investors should be aware that the range of possible portfolio outcomes is wider than in the 20 years prior. In this 'fat-tail' regime, the chance of abnormal outcomes is higher. And even when the risks are known, for the most part, they are underpriced by the market.

We believe the appropriate response is to consider approaches that can mitigate the risks we face, such as shortening duration, broadening geographic and sector exposure, and keeping enough flexibility to act when the markets fail to reflect known risks.

CONTRIBUTORS

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Important information

Index definitions

The **S&P 500** is an index designed to track the performance of the largest 500 US companies.

The **Bloomberg Global Aggregate Corporate Index** is a flagship measure of global investment grade, fixed-rate corporate debt.

The **ICE BofA Global Corporate Index** tracks the performance of investment-grade, publicly issued corporate debt across major domestic and Eurobond markets.

The **ICE BofA Sterling Corporate Index** tracks the performance of GBP-denominated, investment-grade corporate debt publicly issued in the Eurobond or UK domestic markets.

The **ICE BofA Global High Yield Index** tracks the performance of below-investment-grade, publicly issued corporate debt across major domestic and Eurobond markets.

The **ICE BofA Sterling High Yield Index** tracks the performance of GBP-denominated, below-investment-grade corporate debt publicly issued in the Eurobond or UK domestic markets.

The **JP Morgan Corporate EMBI Broad Diversified Index** is a global, US dollar-denominated benchmark tracking debt instruments issued by corporations in emerging market countries.

The **Bloomberg Global Aggregate Credit Index** is a broad-based measure of global investment-grade, fixed-rate corporate and government-related debt.

The **JP Morgan World Government Bond Index** tracks local-currency, fixed-rate government bonds issued by developed and select global economies.

The **Bloomberg Global High Yield Index** is a broad-based measure of the global high yield market.

The **Bloomberg US ABS Floating Rate Index** tracks investment-grade, US dollar-denominated, floating-rate asset-backed securities tied to consumer and utility credit.

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