



Compass

In the latest edition of our forward-looking Compass series our fixed income teams explain the trends that are guiding their outlook in Q1 2026 and the most promising opportunities, emphasising, as always, the need for portfolio resilience.

Fixed Income Compass provides a forward-looking, strategic view across global fixed income. It draws on the insights from our “Matrix Pods”. These are dynamic, cross-functional groups that unite subject matter experts such as portfolio managers, strategists, economists and traders. This collaborative structure enables integrated, top-down macro and bottom-up insights, allowing Compass to deliver a clear quarterly outlook on key risk drivers and positioning.

Complementing this, SHIELD – our *Strategic, Hedging, Integrated Exposure and Loss Defence* framework – strengthens portfolio resilience by drawing on expertise across our Solutions, Core Income and Capital Opportunities teams to design more consistent and efficient hedging strategies.



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Staying ahead

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“Within this environment, three trends guide our outlook: the re-emergence of carry as a dominant return driver, the gradual normalisation of global policy cycles, and a more pro-cyclical market structure in which sentiment and financing increasingly reinforce volatility.”

¹ Fraser Lundie, “Bond Voyage: Industrialised alpha meets fixed income fragility”, Aviva Investors, January 13, 2026.

As we enter 2026, a quiet but meaningful shift in market structure is shaping how we think about resilience and opportunity across fixed income.

Liquidity remains benign, but the growing concentration of highly leveraged, short dated relative value strategies – the engines of industrialised *alpha* – is creating new forms of fragility.¹ Their dependence on abundant liquidity and low volatility means stability itself has become a shared risk factor.

As these strategies proliferate across multi-manager hedge fund platforms, they become more prone to moving in the same direction at the same time. That means even small shifts in volatility, term premia (the extra yield investors demand for holding longer-dated bonds) or funding costs can trigger correlated unwinds and magnify stress across markets. This structural evolution will be central to how we assess both risk and opportunity in the year ahead.

We favour areas where fundamentals are strong and dispersion remains underpriced, including asset-backed securities (ABS), money markets, and emerging market (EM) local currency debt.

In developed markets, clearer inflation and policy paths create selective opportunities to own duration where term premia can normalise. Credit markets, by contrast, sit near peak valuations, limiting room for further spread compression and elevating the importance of selectivity and balance sheet resilience. EMs continue to offer structural advantages in real yields, fiscal dynamics and external balances, supporting targeted exposure to economies with improving policy credibility.

Across all segments, we maintain a high focus on liquidity, resilience, and selective risk-taking. Given the growing influence of strategies that may move in a synchronised manner under stress, we aim to build portfolios that remain robust in calm regimes while also being positioned to capitalise on dislocations should underlying market dynamics shift.

In short, the outward calm of markets should not obscure the increasingly reactive structure beneath. Building resilience into portfolio design will be essential to delivering strong outcomes as 2026 unfolds (see the Matrix Pod summary table in [Figure 1](#)).

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Figure 1. Matrix Pod summary – fixed income allocation overview

Key: ● Previous ▲ Latest



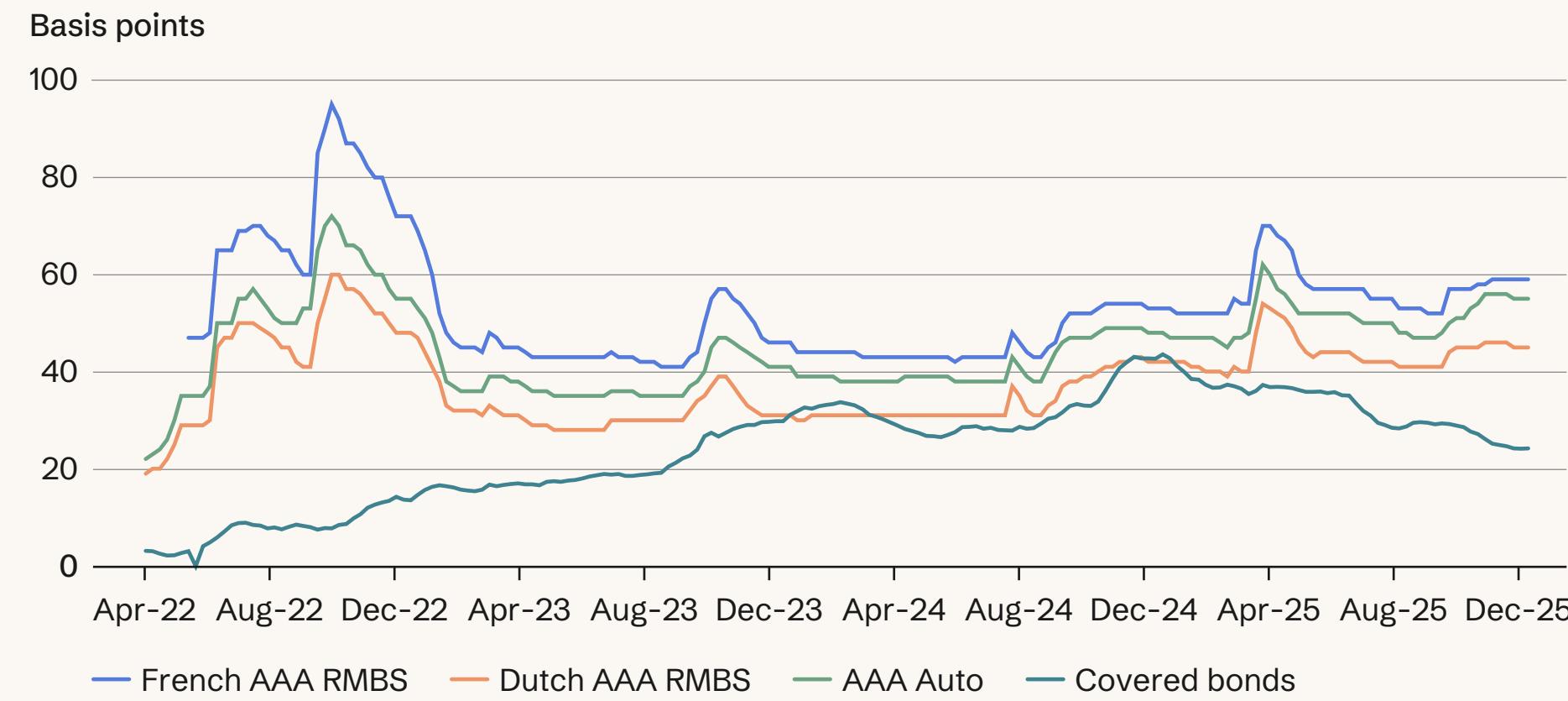
Note: Duration = A positive score indicates bond yields expected to fall, negative to rise. Curve = A positive score indicates a steeper yield curve expected, negative a flatter curve. The score-band widths proportionally weighted provide a conceptual guide to expected conviction dispersion, not a statistical model. Source: Aviva Investors. Data as of January 2026.

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Liquidity Pod: Selectively optimistic

The pod remains constructive, with stronger conviction in ABS and money markets, a modestly bullish stance on UK front-end rates, a negative bias on investment grade (IG) credit and unchanged views on US/euro rates and covered bonds – both remaining neutral.

Figure 2. European ABS becoming more attractive versus covered bonds



Past performance is not a reliable indicator of future returns.

Note: All indices are in euro. RMBS = Residential mortgage-backed securities; auto: auto asset-backed securities. JP Morgan data for RMBS and autos, Barclays data for covered bonds. Source: Aviva Investors, JP Morgan, Barclays. Data as of December 25, 2025.

Macro and rates

Modestly bullish on UK front-end rates, supported by weaker than expected macroeconomic data and a lower terminal rate outlook. We retain a neutral position on US and euro front-end rates amid mixed labour and inflation signals.

Money markets

Conviction in money market spreads has increased, supported by persistent demand and increasingly attractive relative value in commercial paper and certificates of deposit.

Government bonds

Modestly bullish on gilt spreads on expectations of easier policy, while remaining mindful of political risks. Neutral on US bonds. Slight short bias on German bonds due to fiscal expansion. We see value in short-dated French and Belgian SSAs, supported by strong demand, and prefer semi-core over peripheral European government bonds (see [Figure 2](#)).²

Credit and ABS

We have maintained a positive view on ABS as the spread differential against covered bonds has increased, and expect spreads to remain stable with senior tranches well protected. We see potential opportunities in autos and collateralised loan obligations. We stay neutral on covered bonds given recent tightening and Q1 supply, while IG credit retains a negative bias amid historically tight spreads and limited upside.

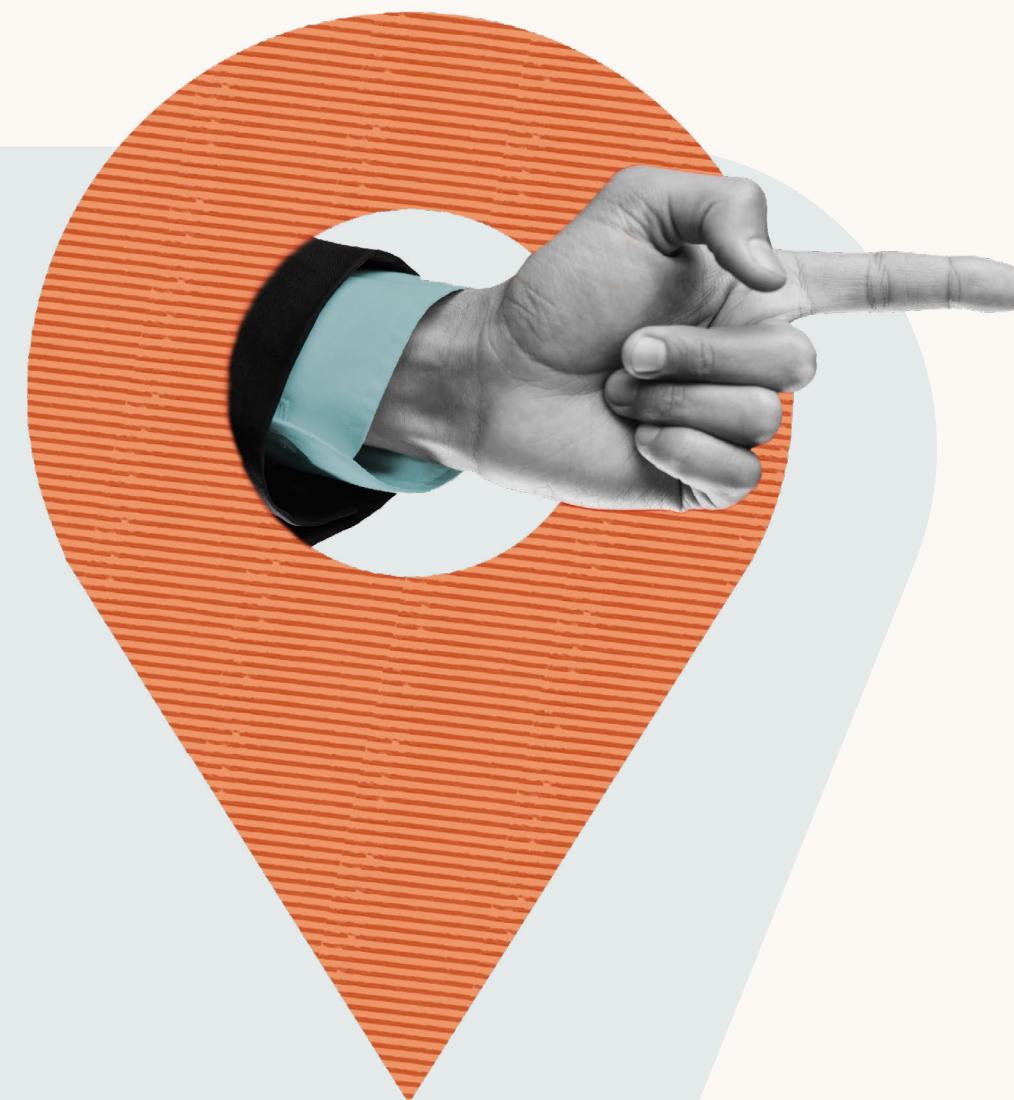
What this means for positioning and implementation

Overall, positioning reflects a disciplined approach to capturing carry and liquidity while navigating gradual policy shifts and market volatility.

Duration and Curve Pod: Regional divergence

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The pod has gradually reduced its steepening bias across regions but maintains selective positions in Japan and Europe, looking for higher intermediate yields. We reaffirm our long UK front-end rates stance and expect higher 10-year yields in Japan and Germany despite positive moves in Q4 2025.



Regional views

US

We maintain a constructive outlook on US growth, but labour market uncertainty keeps us neutral on duration and curve positioning. That said, we see risks skewed toward a steeper curve, driven by potential increases in term premia.

Europe

We retain a short duration and curve steepening bias, anticipating higher medium and long-dated yields, given a constructive economic and improved inflation outlook. We expect higher long yields as issuance weighs on German bonds, while Dutch pension reform is expected to reduce structural demand for long-end rates.

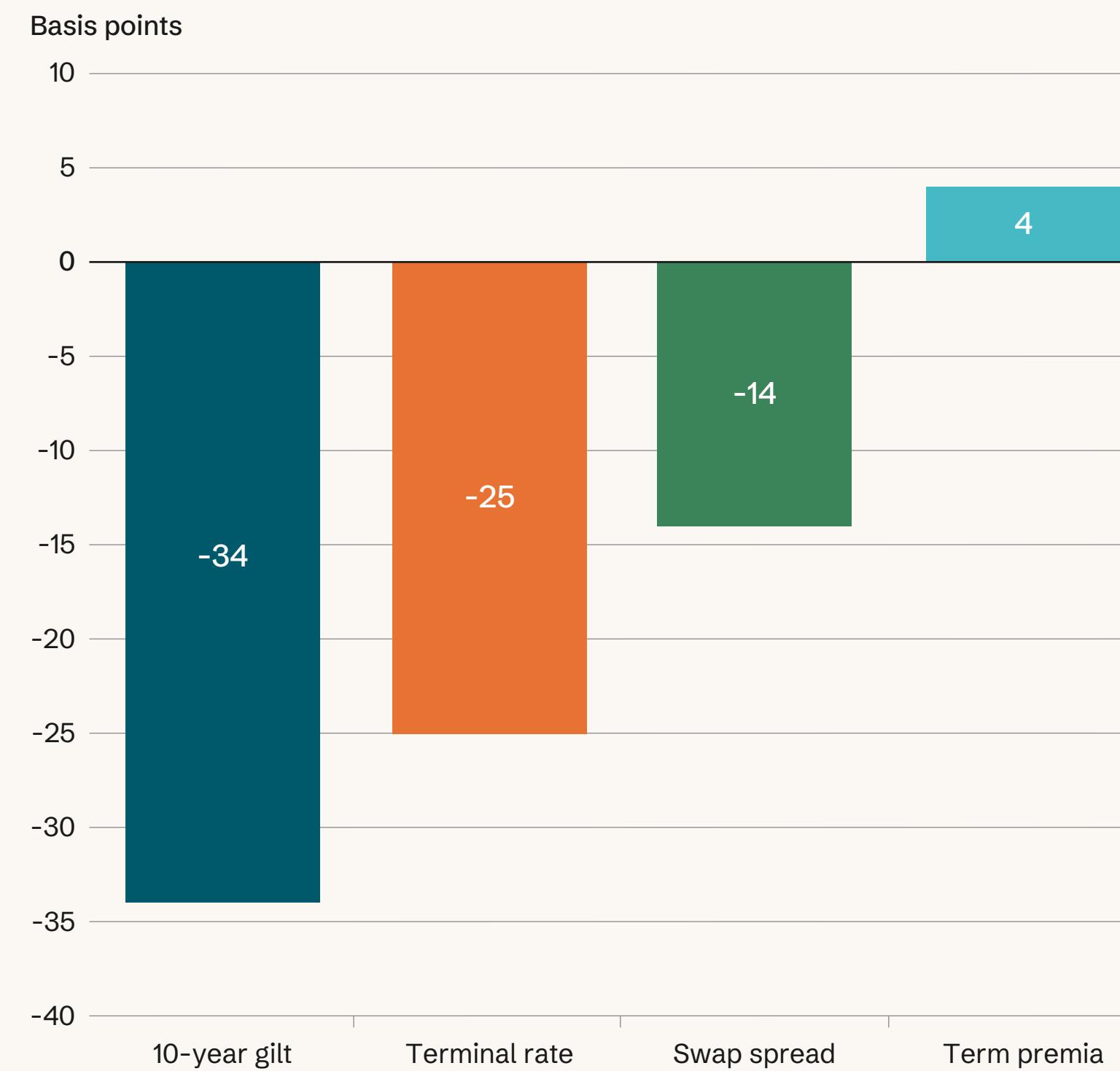
UK

We remain positive on UK rates and expect lower front-end rates with risks skewed toward additional rate cuts in 2026. During Q4 we switched from a steepening bias to neutral as a reduction of fiscal concerns and a more supportive supply backdrop should see longer dated gilts perform well.

10-year gilts had a strong Q4, driven by a further increase in policy easing expectations, but also a more balanced budget and a shift in issuance from the UK treasury, which has seen gilts outperform swap rates (see [Figure 3](#)).

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Figure 3. Q4 2025 gilt rally decomposed



Past performance is not a reliable indicator of future returns.

Source: Aviva Investors, Bloomberg. Data as of December 31, 2025.



Regional views

Japan

Following the repricing of Japanese rates in Q4, we see Japanese front-end rates as fairly valued and have shifted to neutral. Fiscal expansion plans aimed at supporting growth introduce upside risk to intermediate yields, leading us to favour curve steepening between the 2-and-10-year maturities.

Canada

We shifted from a steepening bias to a neutral curve stance in Canada, maintaining an overall neutral view on rates. Our base case is that the Bank of Canada stays on hold, though mixed data and downside risks persist, even as markets price potential hikes in line with the global shift in policy expectations.



What this means for positioning and implementation

Preference for UK long rates positioning and selective curve steepeners in Europe and Japan, mindful that while the themes from the second half of 2025 continue, valuations have become more balanced.

Credit Pod: Peak valuations

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Credit markets are trading at near peak valuations, leaving them vulnerable to a market correction. We expect only modest spread widening, supported by a still-favourable macro backdrop, stable fundamentals, and robust demand. Rising supply, however, may exert incremental pressure on credit spreads.

Macro and fundamentals

Global growth remains supportive and credit fundamentals strong, with weakness mainly in oil and gas due to sustained price declines, and in chemicals, due to Chinese oversupply. Default rates are low, but easier funding conditions are encouraging greater risk-taking, with mergers and acquisitions activity and growth capex accelerating, particularly in technology and healthcare. This could marginally pressure spreads.

Valuation and technicals

Spreads remain near historical tights, leaving limited room for further compression and creating asymmetric risk-reward dynamics. Technicals are supported by robust demand for credit products, particularly in the US, where yields remain attractive. However, projected supply increases in IG and high yield (HY) markets in 2026 could exert incremental widening pressure.

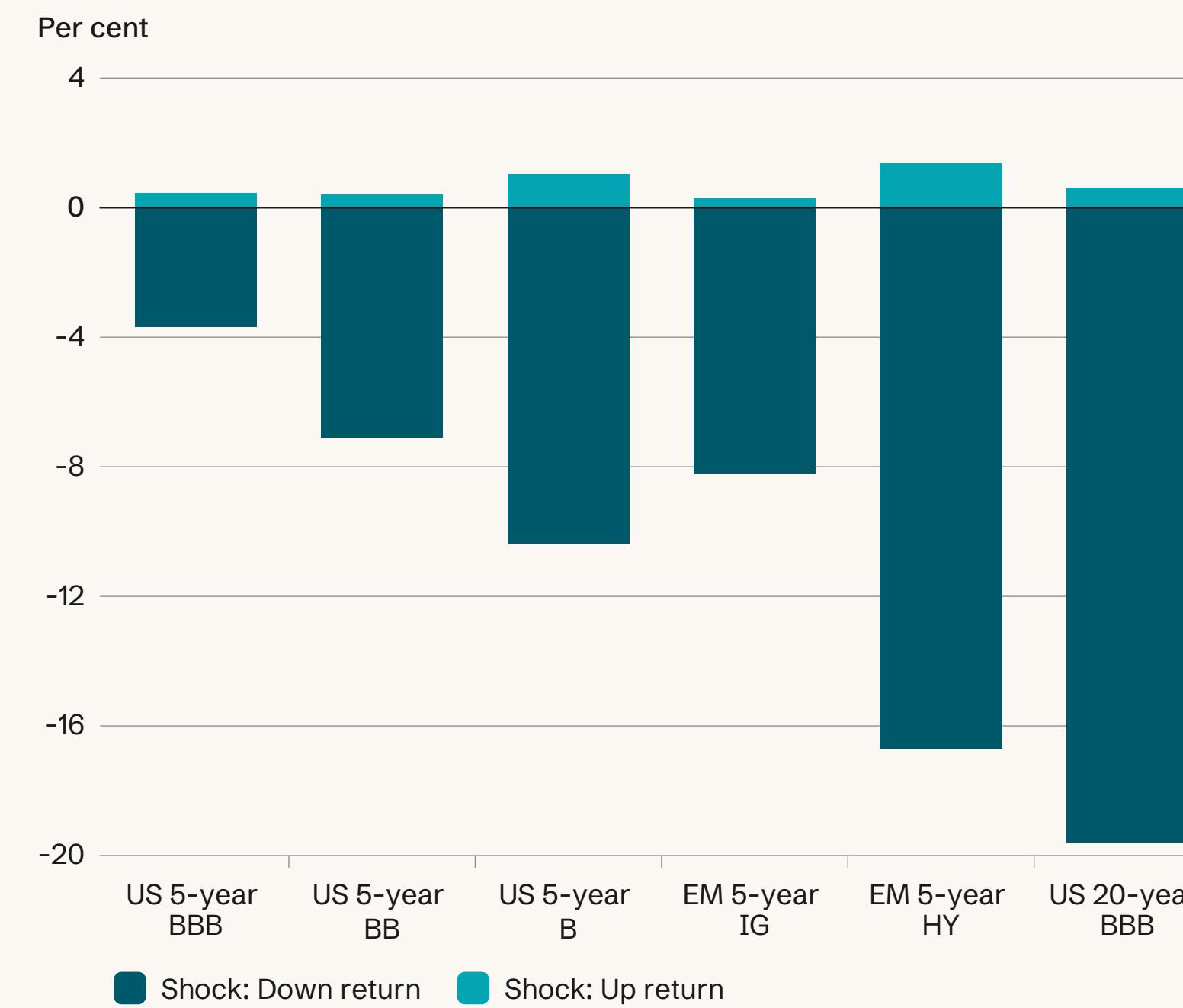
Private debt: The illiquidity premium remains a key source of relative value

Private debt remains attractive, supported by higher-for-longer rates and strong all-in yields. While public credit spreads tightened sharply following “Liberation Day,” private debt adjusted more gradually, keeping the illiquidity premium above its long-term average.

In Q3 2025, illiquidity premia rose to 92 basis points, from 74, underscoring the structural appeal of investment grade private credit.³ Despite rising competition, disciplined underwriting and sector selection remain key.

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Figure 4. A measure of resilience in fixed income markets



Note: ICE BofA corporate indices.

Source: Aviva Investors, Bloomberg, as of December 31, 2025.



Asset class views

Global IG

Valuations are stretched, particularly at the long end of the curve, where risk-reward is poor. Excess return expectations are near zero as carry is offset by anticipated spread widening. The scenario analysis in [Figure 4](#) illustrates the immediate return impact for the asset classes shown, should credit spreads shift one standard deviation wider, or tighter, versus historical mean. These are pure 'shock returns', excluding any forward yield. The key takeaway is that long duration IG (BBB 20-year) has very little upside and very significant downside compared to most other areas in fixed income, such as EM HY. In EM HY secular positive trends are not represented in the data, which we think will improve the outcome versus the historically-driven expectations.

Global HY

The pod upgraded its view on HY fundamentals to neutral, supported by a stable economic outlook and the fading of tariff-related concerns that weighed on sentiment in 2025. EM corporate HY is marginally favoured over developed market HY, given stronger fundamentals and supply dynamics.



What this means for positioning and implementation

Preference to maintain limited portfolio beta given tight spreads and asymmetric risk-reward. Focus on resilience and credit selection as key return drivers. New issue concessions may offer tactical value, while monitoring themes such as artificial intelligence (AI)-related issuance, technicals, and liquidity dynamics could help to enhance returns.

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Emerging Markets Pod: Overweight local

The pod maintains its clear preference for local currency over hard currency, supported by strong fundamentals and favourable risk-reward. While credit remains a cautious call, a slower pace of spread widening is leading to more balanced valuations, supported by attractive carry and subdued volatility.

Macro and fundamentals

Global conditions remain supportive for EM, with inflation continuing to normalise and fiscal positions broadly resilient. The pod upgraded EM rates scores slightly, reflecting room for further policy easing in 2026. Credit fundamentals remain robust, though the wave of upgrades seen in 2025 is unlikely to repeat. Default risk is low but rising corporate risk-taking and capex warrant monitoring.

Valuation and technicals

EM credit spreads are at their tightest since the global financial crisis, limiting outright value, particularly in IG where curves are flat and risk-reward is poor. HY valuations are more balanced, supported by carry and subdued volatility, though meaningful value is confined to idiosyncratic opportunities. Technicals remain supportive for local markets.

Figure 5. Brazilian real's FX carry-to-volatility ratio moving back toward all-time highs



Past performance is not a reliable indicator of future returns.

Note: The FX carry-to-volatility ratio is calculated as the annualised interest rate differential (carry) divided by the annualised volatility of the currency pair, in this case Brazilian real versus US dollar. A higher ratio implies better risk-adjusted returns – good carry with lower volatility risk. Source: Aviva Investors, Bloomberg. Data as of January 14, 2026.

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Asset class views

EM local currency debt

The outlook for the asset class is still constructive, underpinned by strong balance sheets, high real yields, and a weaker USD. Structural under-ownership and positive flows reinforce the case for overweight positioning.

EM FX

USD remains under medium-term pressure from deteriorating US fundamentals, supporting shorts versus EM FX. EM FX should benefit from low volatility, positive global growth, and favourable terms of trade. We favour high-carry currencies with strong bottom-up stories such as the Turkish lira and Egyptian pound alongside currencies such as the Brazilian real, South African rand, and Mexican peso (see [Figure 5](#)).

EM sovereign credit

Fundamentals remain solid, but valuations are stretched with EM sovereign credit spreads at their tightest since the global financial crisis. HY offers selective value in idiosyncratic names such as Ukraine, Argentina and Senegal. IG faces curve flattening and potential long-end issuance early in 2026, adding supply risk.

What this means for positioning and implementation

The pod maintains an overweight bias in EM local markets and cautious stance on hard currency sovereign credit, with selective HY exposure in idiosyncratic opportunities. Focus is on liquidity and resilience, while monitoring thematic drivers such as technicals, issuance patterns, and global rate dynamics. Any significant market pullback should be viewed as an opportunity to add exposure.

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The main risks to watch and how we're hedging them

While the base case in the rates market remains a range-bound environment with potential for lower volatility, the main risk for portfolios is a move toward lower yields and bull flattening, particularly if growth shocks emerge. We favour strategies such as receiver spreads that can offer insurance against a growth-driven repricing in rates lower.

In credit, although the pod expects a moderate move wider in credit spreads over time, geopolitical tail risks remain. In addition to running larger cash balances and neutral beta positioning, we are looking at ways to add cheap tail protection on the main credit indices when realised volatility drops.

Given EM risks are increasingly linked to potential shocks in developed market credit, we aim to protect portfolios through a balanced approach: using low-cost credit hedges and selective FX strategies to guard against dollar strength. This provides efficient downside protection without significantly eroding carry.





Key risks

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Investment risk and currency risk

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

Credit risk

Bond values are affected by changes in interest rates and the bond issuer's creditworthiness. Bonds that offer the potential for a higher income typically have a greater risk of default.

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