Compass

Each quarter, Compass plots a course through global fixed income markets by distilling top-down macro perspectives and bottom-up market intelligence into a cohesive outlook. It draws on the insights from our “Matrix Pods” - dynamic, cross-functional groups that unite subject matter experts including portfolio managers, strategists, economists and traders.

The latest Compass at a glance:

- **Resilience is key**
  The outlook for inflation and growth remain uncertain due to ongoing geopolitical tensions. Portfolios will need to be built to weather a range of outcomes, with exposure focused on areas where investors are adequately compensated for risk.
- **Dispersion is increasing**
  Beneath the global forces there is increasing dispersion between sub-asset classes and markets. EM local currency remains the most compelling opportunity.
- **Credit fundamentals intact**
  Credit fundamentals remain healthy but there may be little room for further spread compression.
- **Select and protect**
  Selection and risk management are essential to limit downside and to grasp opportunities at the granular level.

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Invest for resilience in a still uncertain world

Two factors set the background for this quarter's edition of Compass – ongoing geopolitical risk and the accelerating AI investment cycle.

The situation in the Persian Gulf is constantly shifting, and a clear resolution remains elusive. There remains a wide range of potential outcomes for growth and inflation depending, crucially, on whether maritime traffic through the Strait of Hormuz returns to normal.

The AI investment cycle, meanwhile, continues unabated, with some eye-watering bond issues from US technology groups. This creates risks for passive investors, as well as potential concentration risks as both fixed income and equity indices are increasingly dominated by a handful of companies.

This then is the weather system over global markets, but at ground level there is plenty of nuance and variation in local conditions.

The global cycle is uneven and dispersion is widening. Central banks are pivoting away from easing, but there will be significant variation in the strength and pace of central bank policies, depending on their governments' fiscal positions and exposure to energy prices.

Overall, policy remains on a gradual path rather than a dramatic one. But there will be a growing focus on central bank direction through the second half of the year.

The implication is clear: while beta remains anchored to the broader macro regime, alpha is increasingly localised.

This is precisely the kind of environment that our Matrix Pods are designed to navigate. Each pod brings together expertise in a particular dimension of fixed income. When combined, they provide both a broad global picture, but also the depth and complexity to identify risks and opportunities at a granular level (see Matrix Pod summary table Figure 1).

Credit fundamentals remain broadly healthy, but with spreads pricing in a significant amount of good news, the scope for further compression looks limited. This argues for balance rather than conviction at the extremes. Security selection, flexibility and disciplined risk management are essential as markets offer little margin for error.

Most importantly, we do not see a compelling case for being structurally long or short duration. Inflation has eased but not disappeared. Growth remains resilient, but not without signs of moderation. There is plenty of room for a range of outcomes across markets.

Fixed income investors should avoid making a single macro call and instead build resilient portfolios capable of performing across a range of scenarios. In a world where easy gains are harder to find, diversification, active management and flexibility become even more valuable.

"Investors should focus on building resilient portfolios capable of performing across a range of scenarios. In a world where easy gains are harder to find, diversification, active management and flexibility become even more valuable."

Fraser Lundie Global Head of Fixed Income

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Figure 1. **Matrix Pod summary – fixed income allocation overview**

	Parameter	Pod score: Previous	Pod score: Latest	12 month average
Liquidity	ABS	2.0	2.0	0.9
	Risk-free rates	1.3	0.3	0.6
	MM spreads	2.0	2.0	1.5
	Govt spreads	-0.3	-0.3	-0.4
Duration	US	1.0	0.0	0.2
	Europe	0.0	0.0	0.0
	UK	3.0	1.0	1.3
	Japan	0.0	0.0	-0.4
	Canada	2.0	1.0	0.5
Curve	US	1.0	1.0	0.5
	Europe	1.0	1.0	0.9
	UK	2.0	1.0	0.7
	Japan	0.0	0.0	0.1
	Canada	2.0	1.0	0.8
Credit*	Global IG	-0.5	0.0	-0.6
	Global HY	-0.3	-1.0	-0.7
Emerging Markets	EM sovereign	-1.2	-0.6	-0.3
	EM LC rates	2.8	2.8	1.9
	EMFX	1.7	1.2	1.3

Pod score scale: -5 -4 -3 -2 -1 0 1 2 3 4 5

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.

*Option-adjusted spreads (OAS)

Based on internal assumptions. For illustrative purposes only and not intended as an investment recommendation. Forecasts are not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.

Source: Aviva Investors. Data as of July 2026.

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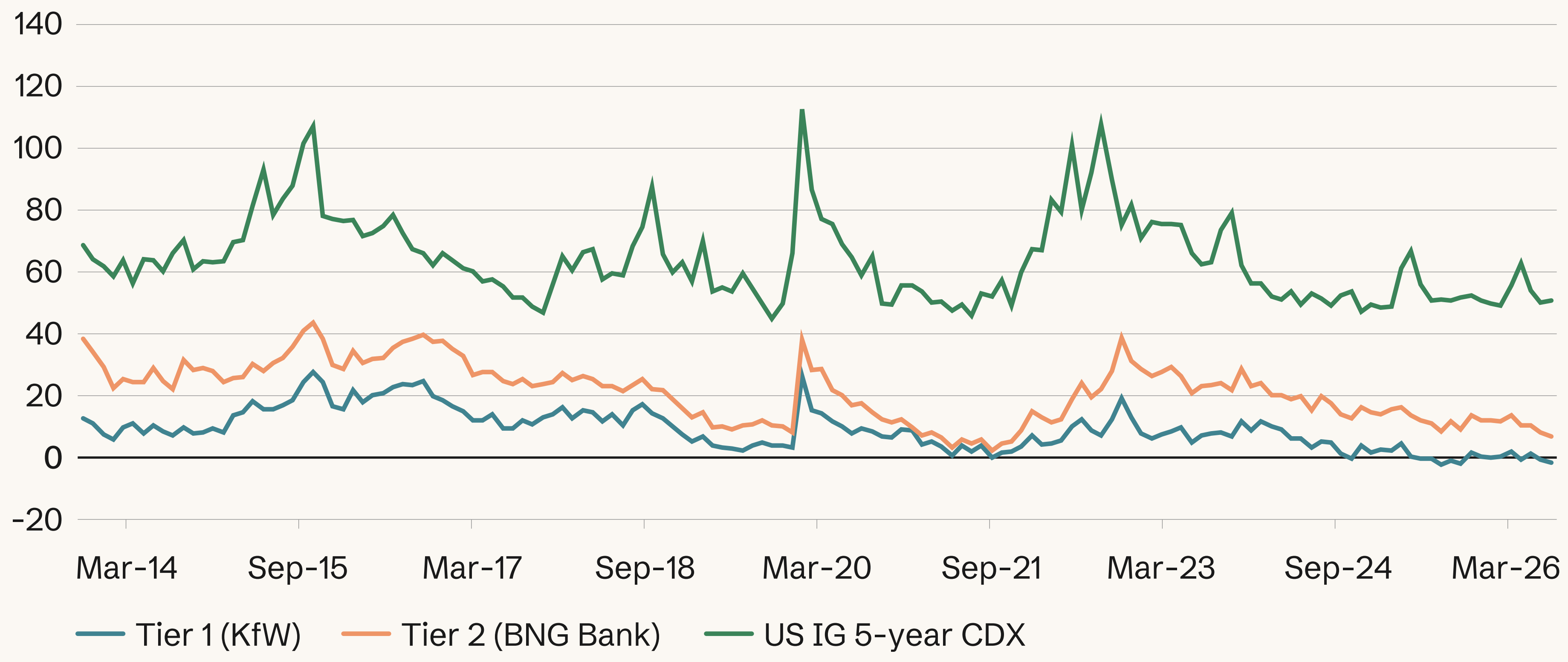
Liquidity Pod: Cautiously constructive

The pod remains cautiously constructive, favouring UK front-end rates, money markets, covered bonds and ABS, while staying neutral on European and US rates, SSAs and government bond swap spreads. The team are slightly bearish on IG credit, but we still see short-end opportunities, and expect lower covered bond net supply to support further spread compression later this year.

Figure 2. Tier 1 SSA spreads tighten versus US Treasuries

5-year generic spread, basis points



Past performance is not a reliable indicator of future returns.

Note: Five-year USD denominated KfW/BNG Bank bond yields versus generic five-year Treasury.

Source: Aviva Investors, Bloomberg, monthly data, as of June 30, 2026.

Macro and rates

We remain constructive on UK front-end rates and view the markets' pricing of a further rate hike by the end of 2026 as overly hawkish as we expect a meaningful decline in inflation through the second half of the year. In Europe, our stance remains neutral, with market pricing of one further rate hike appearing broadly appropriate. We are also neutral in the US, given considerable uncertainty around the Fed's policy outlook, particularly after Fed Chair Warsh's recent comments and the absence of clear forward guidance.

Money markets

We remain constructive on money markets. Sterling spreads have tightened modestly despite ongoing liquidity withdrawals. The anticipated rebuilding of cash balances over the quieter summer period should provide a supportive backdrop for spreads.

Government bonds

We continue to be broadly neutral on government bond swap spreads over the next six months. Performance is likely to be driven by a balance of political developments and technical factors. We have moved our stance on SSAs from positive to neutral, as strong recent performance in semi-core and peripheral European government bonds has reduced the sector's relative value appeal (Figure 2).[1]

Credit and ABS

We remain positive on covered bonds, supported by expected negative net supply in the second half of the year and scope for further spread compression. We are slightly bearish on IG credit, where valuations limit further tightening, but still see selective value at the short end. Our stronger positive ABS view is unchanged. We prefer the very short end, where bank treasury demand supports compelling value versus the three- to five-year segment.

What this means for positioning and implementation

We still see value in short-dated UK rates and are using market weakness to add duration. While we remain cautious on credit spreads overall, we are focusing more on sector selection and increasing allocations to asset-backed securities for diversification and relative value.

[1] SSAs: Sub-sovereign, Supranational, and Agency bonds are high-quality, government-related debt securities issued by institutions like the World Bank, European Investment Bank, or government agencies to fund public projects.

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Duration and Curve Pod: Selective on long duration

The team maintains curve steepening exposure while favouring selected long duration positions. Term premia have moderated in most markets given the fall in inflation risk premia, with Japan the exception, as fiscal uncertainty continues to weigh on longer dated yields (Figure 3).

Regional views

US
US rates have continued to underperform in June, mainly due to a more hawkish FOMC and a communication shift to less forward guidance and a greater focus on inflation. A key difference versus the May sell-off was the much greater flattening of the yield curve. Despite the recent flattening, the group retains a modest steepening bias.

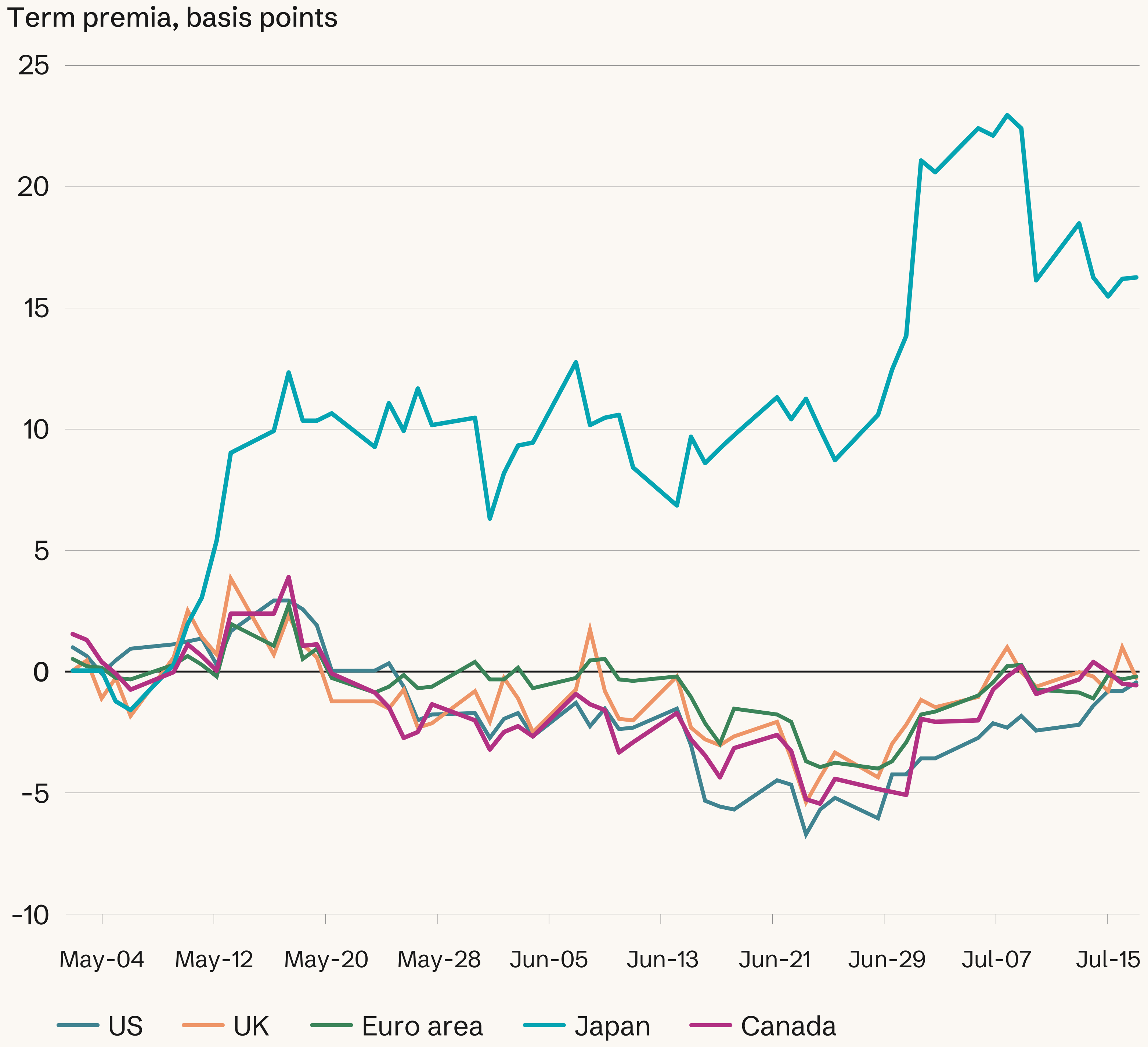
Our bearish case for US rates is centred on the removal of the easing priced for 2025, implying two to three additional hikes rather than a more aggressive tightening cycle. With resilient growth likely, spillovers to risk assets should remain limited.

Europe
We remain neutral on front-end rates. Markets are pricing one more rate hike, in line with economist consensus and our strategy team's expectations. Our conviction remains higher on the curve, as limited front-end sell-off risk supports a continuing steepening bias, driven by rising term premia on German fiscal expansion and changing demand for longer-dated bonds.

UK
We maintain a long duration stance, having moderated our view in recent months as yields moved away from their highs. Markets are almost pricing in a policy tightening for this year. However, we view the Bank of England as likely to remain on hold before resuming policy easing in 2027 – inflation remains elevated, but weaker activity could pressure yields lower. The team also favours curve steepening, supported by fiscal concerns, supply pressures and sticky term premia.

Regional views

Figure 3. Term premia ease but not in Japan



Past performance is not a reliable indicator of future returns.

Note: 5s10s swap term premia.

Source: Aviva Investors, Bloomberg, data from May 4 to July 17, 2026.

Japan

We remain neutral on duration and curve. Front-end pricing is rangebound, while fiscal uncertainty and a Bank of Japan that is still behind the curve continue to weigh on the market. Near-term catalysts for a reversal remain unclear. Given ongoing volatility, Japan remains a key focus for the pod and an important theme for the second half.

Canada

The pod's long front-end duration view briefly turned neutral in June but has moved back to long. Canada remains attractive on a relative basis, with an extended pause still our base case, though some see the possibility of a rate cut. The group continues to favour curve steepening as part of a broader global view, alongside a relatively dovish front-end stance.

What this means for positioning and implementation

Portfolios remain overweight in the front ends of the UK and Canadian yield curves, where market pricing still suggest more policy tightening than our central view implies. We maintain a core steepening bias, reflecting our expectation that term premia will rise over the medium term. Japan is the exception, where we are neutral on curve positioning after recent moves and a more balanced outlook.

Credit Pod: Cautious valuations, selective opportunities through active sector rotation

Our credit positioning remains cautious given tight spreads, however, there are pockets of value emerging in certain areas of the market. Certain sectors are facing increased volatility and dispersion versus the rest of the market, which is providing opportunities to rotate risk without taking excessive market beta. While there is no clear catalyst for an imminent spread widening, given a strong fundamental and technical backdrop, valuations are not attractive enough, especially in longer maturities. The group's bias is overweight front-end carry offset by more defensive positioning further out the curve.

Macro and fundamentals

The macroeconomic backdrop has become more supportive, though tight spreads leave little room for error. Growth expectations are firmer, labour markets remain stable and inflation should ease if current energy prices hold. However, the oil shock needs careful monitoring (Figure 4). Policy rates look fairly priced except for the UK, where further cuts are expected early next year.

Corporate fundamentals remain resilient, with only isolated downgrades and limited signs of broader stress. The financial sector remains stable, though risks persist in private credit and non-bank lenders. Q2 reporting is unlikely to uncover new risks, leaving the sector broadly supported.

Valuation and technicals

Technicals are still strong, but spreads are historically tight, supply remains a risk in parts of high yield, and long-duration credit looks vulnerable. This is especially so within TMT sectors where supply has expanded, especially in IG from 'hyperscalers'. The pod's near-term bias is to stay modestly overweight carry where technicals justify it, especially at the front end, but with a clear preference for quality, sector discipline, and limited triple-C exposure.

Private debt: Sustained relative value in a shifting market

The outlook for private debt has been stable and consistent over the last quarter reflecting the enduring relative value offered by the asset class. Still supported by a higher-for-longer interest rates environment and elevated illiquidity premia. Across investment grade assets, illiquidity premia of around 100 basis points (bps), based on our proprietary data set, remain above long-term averages, while spreads have tightened less sharply than in public credit.

In sub-investment grade assets, our proprietary dataset shows average illiquidity premia closer to 300bps, reflecting both higher compensation for risk and structurally lower competition from banks and insurers.

Source: Aviva Investors, July 2026.

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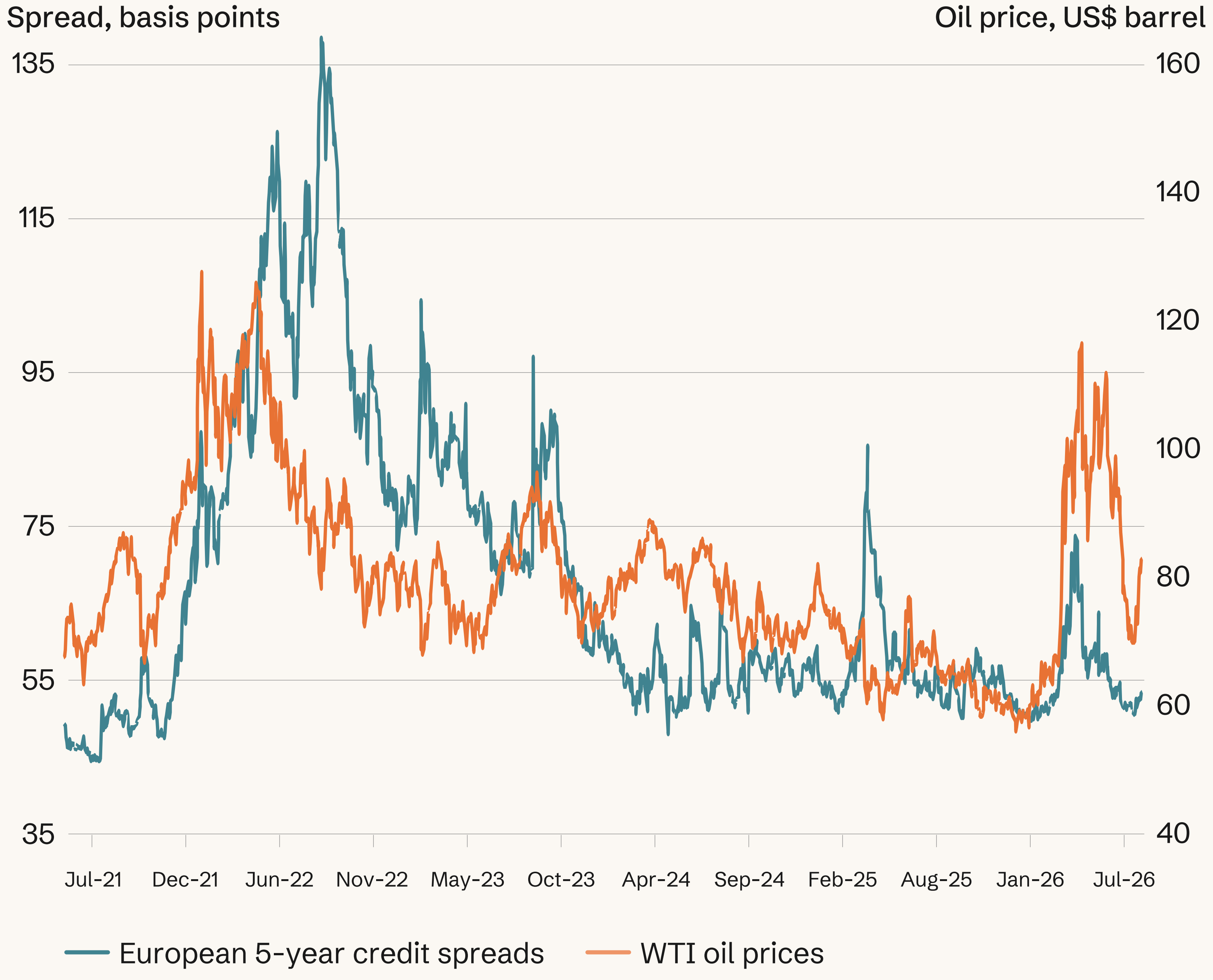
Figure 4. Credit spreads likely to remain volatile as oil price fluctuates



Past performance is not a reliable indicator of future returns.

Note: Five-year Markit iTraxx Europe Credit Default Swap (CDS) index and Bloomberg generic front month WTI crude oil continuous contract.

Source: Aviva Investors, Bloomberg, as of July 17, 2026.

Asset class views

Global IG

Strong ETF and mutual fund inflows, robust annuity reinvestment and foreign buyers absorbing around 50 per cent of US issuance suggest IG remains well supported by technicals. Given spreads at historically tight levels, the pod's neutral stance remains unchanged. We will continue with a positive carry bias, but position for modest decompression with protection against potential losses.

Global HY

Technicals are viewed as more negative in high yield, as spreads appear tight and lack clear top-down directional drivers. Supply remains the key factor, with ETF outflows and a significant maturity wall posing risks. However, the technical picture is more supportive for European high yield, with the maturity wall not a concern until 2028 and continued strong demand from collateralised loan obligation (CLO) buyers. Dispersion and selection are increasingly important for performance. Valuations remain tight and risk-reward is less attractive. Yields offer limited protection against potential volatility, and the spread-to-yield ratio points to limited upside and higher downside risk.

What this means for positioning and implementation

Positioning will focus on quality, sector selection and dispersion. The pod has a preference for stronger BB/B credits, IG sectors with supportive fundamentals and technicals such as tech and insurance and will use wider dispersion in high yield to drive name and sector selection while keeping exposure to the riskiest credits limited. Positions in corporate hybrids, particularly in the one to three-year part of the curve, are thought to offer attractive risk-adjusted returns compared to generic IG or high yield.

Emerging Markets Pod: Resilient fundamentals continue to anchor EMD

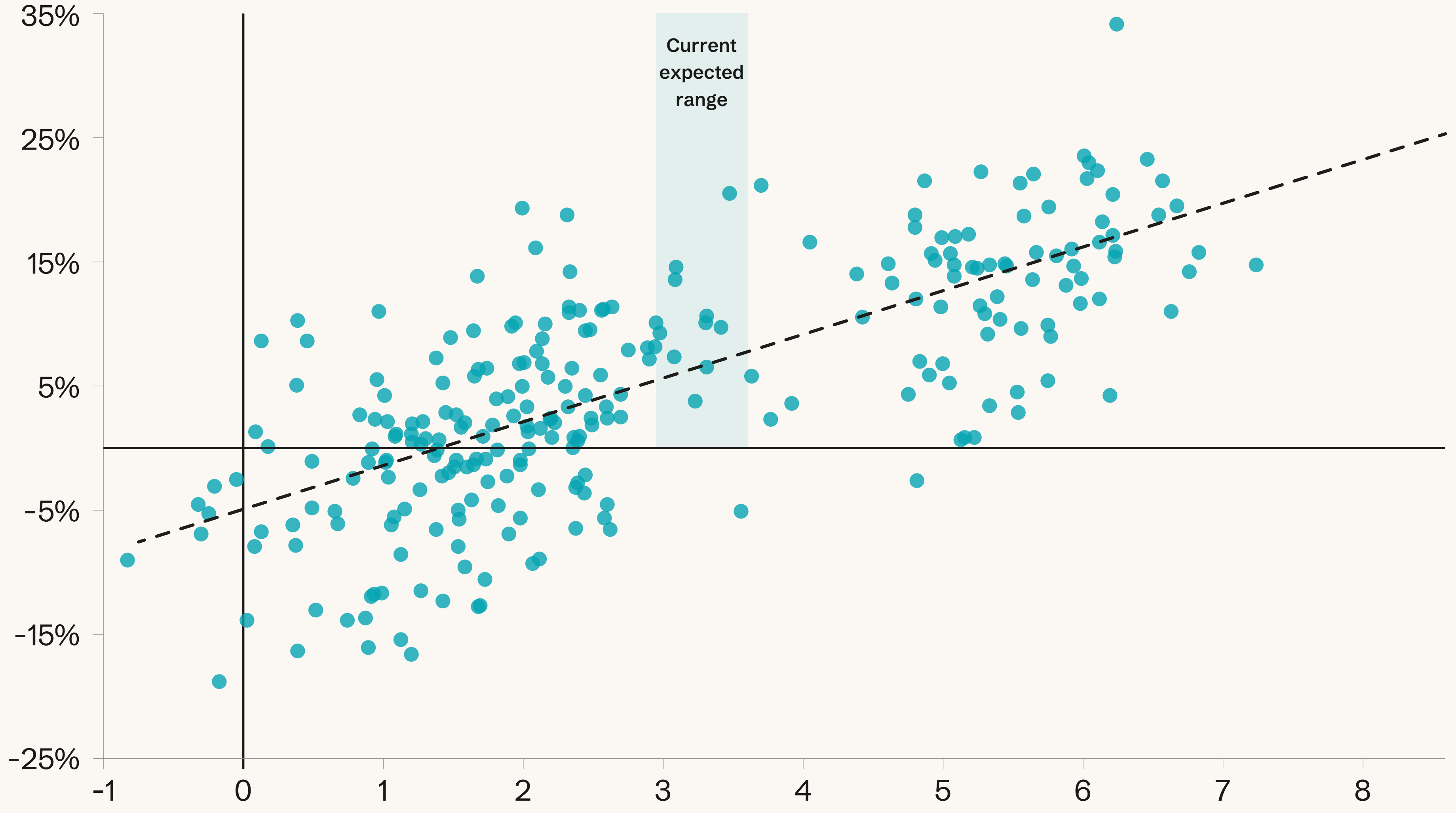
Emerging market debt enters the second half of 2026 on firm footing, supported by resilient fundamentals, easing inflation and stronger policy credibility. While opportunities remain in hard currency sovereign and corporate debt, local markets offer the most compelling return potential. Attractive real yields, orthodox central bank policies and stronger external balances support rates and currencies, creating multiple sources of return.

Macro and fundamentals
The EM fundamental backdrop remains increasingly compelling, underpinned by stronger policy frameworks, greater macroeconomic discipline and healthier sovereign balance sheets. Lower external vulnerabilities, improved reserve adequacy and more proactive policymaking have enhanced resilience across much of the asset class. While dispersion between countries is widening, emerging markets today are operating from a position of strength, providing a more durable foundation for long-term investors than in previous cycles.

Valuation and technicals
EM debt valuations remain attractive, although increasingly selective. Local markets offer compelling real yields and targeted FX opportunities, while sovereign debt continues to provide attractive income backed by stable credit fundamentals. Technical conditions remain supportive, underpinned by strong demand, disciplined issuance and increasing appreciation of the asset class's improved fundamentals.

Many EM economies combine well-funded external balances with some of the highest real yields in the world, a rare and powerful mix (Figure 5).

Figure 5. Healthy balance of payments and high real yields generate positive FX returns for GBI-EM



Past performance is not a reliable indicator of future returns.

Note: One-year ahead FX return expectations (y-axis) versus basic balance (FDI plus current account, as percentage of GDP) plus real yields (x-axis).

Source: Aviva Investors, International Monetary Fund (IMF), Bloomberg, as of July 9, 2026.

Asset class views

Rates
We see the strongest opportunities in EM local debt. High real yields provide a meaningful cushion across macro outcomes, while credible policy frameworks, improving external balances and anchored inflation expectations support fundamentals. With uncertainty well recognised by markets, income and duration returns offer attractive asymmetry for long-term investors, keeping local markets a high-conviction area within EM debt.

EM FX
We remain constructive on EM FX, supported by attractive real yields, credible policy frameworks and strong external positions. Improved reserves, healthy balance of payments dynamics and sustained foreign investment flows have strengthened resilience, while valuations remain appealing in several markets. As country-level fundamentals increasingly drive outcomes, active currency selection is key to capturing carry and appreciation potential across EMFX.

EM sovereign credit
We remain more balanced on EM hard currency debt. External vulnerabilities have eased, policy frameworks have strengthened and sovereigns are better able to navigate volatility. While aggregate spread valuations are less compelling, current yields still provide an attractive cushion. In this environment, active country selection remains key, as dispersion creates opportunities to identify issuers with stronger risk-adjusted return potential.

What this means for positioning and implementation
We maintain core long positions in EM local markets, supported by strong fundamentals, favourable macro conditions and attractive valuations. In credit, wider spreads may create selective opportunities, but broad-based dip-buying remains limited. Our focus is on idiosyncratic, flow-driven dislocations where technical factors offer compelling entry points.

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

In rates, markets are underestimating the likelihood of a deep interest rate cutting cycle, despite concerns about tech valuations. As a result, deep out-of-the money receiver swaptions look underpriced and should provide protection in the event of a wobble in risk assets. Using such expressions as a structural hedge in portfolios provides attractive risk versus reward.

In credit markets, spreads remain close to the tight end of the range despite various emerging risks. These include the end of the ceasefire in the Persian Gulf, a hawkish shift from central banks amid potentially resurgent inflation, and rampant hyperscaler debt supply. The market remains sanguine and arguably complacent about these risks, with protection still relatively cheap. We recommend owning outright CDS index protection as well as some short-dated, out-of-the money options to provide cheap convexity over what can be a seasonally volatile end to the third quarter.

The main risk for emerging markets is a stronger US dollar, potentially driven by a US Fed tightening cycle, which could pressure EM assets and raise volatility. To help manage this risk, our hedging strategies include positions designed to capture local interest rate opportunities while reducing exposure to broader EM credit stress.

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Key risks

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.

Important information

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For further information:
avivainvestors.com/en-gb/capabilities/ fixed-income/

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