BONDS

5 core bond themes for 2026: Defense now, offense later

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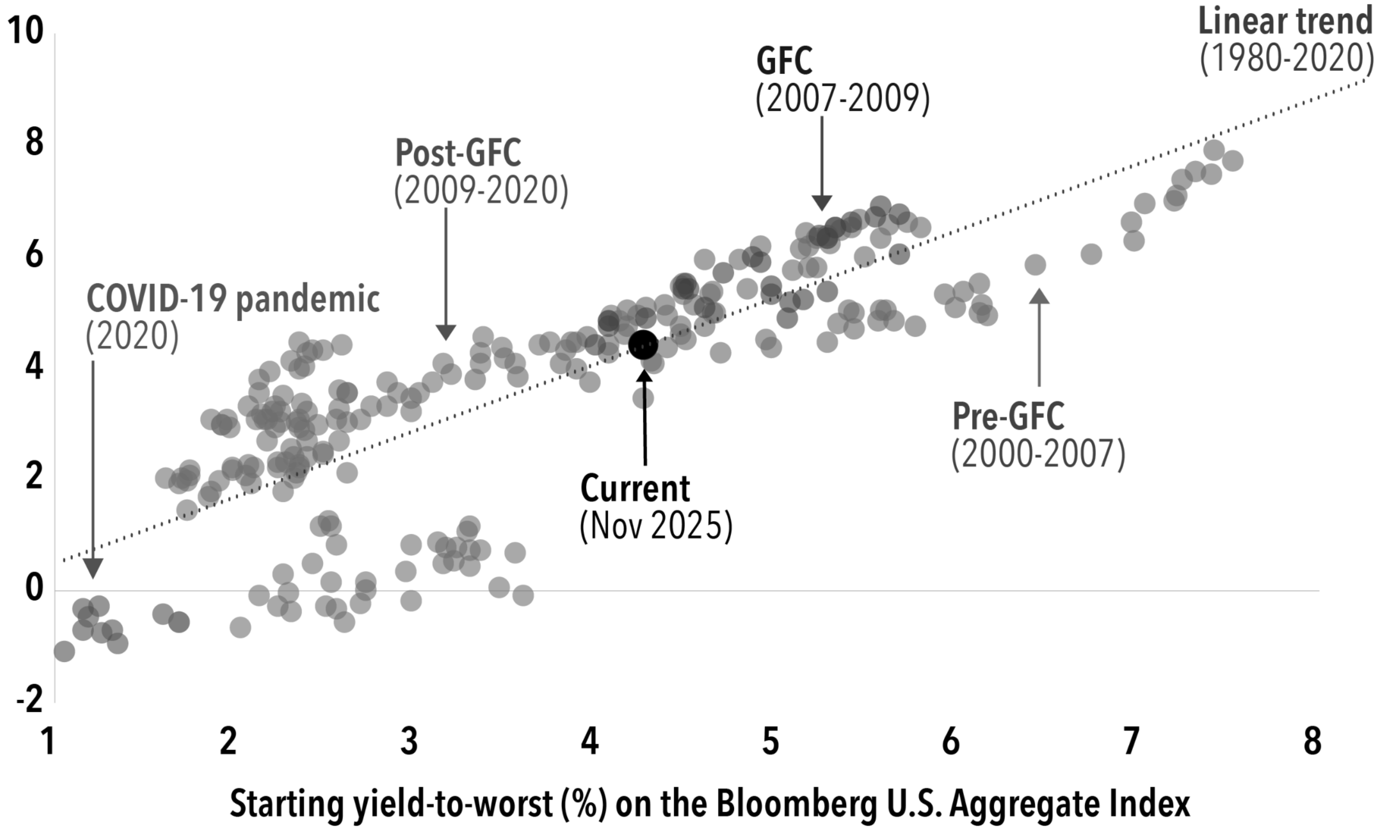
Core fixed income reaffirmed its role as a cornerstone of well-balanced portfolios in 2025, delivering meaningful diversification alongside strong total returns. Supported by a resilient yet moderating economy, easing inflationary pressures and the start of a rate-cutting cycle, core bonds (as measured by the Bloomberg U.S. Aggregate Index) posted their strongest performance since 2019. The index advanced over 7% and generally provided positive returns during episodes of stock market volatility and drawdowns.

As we enter 2026, core bond yields have moderated from their October 2023 peak, but remain materially above their average over the past 15 years. With the Federal Reserve (Fed) expected to continue its easing cycle amid a soft labor market and inflation slowly trending toward their 2% target, conditions appear favorable for fixed income investors. In this environment, I expect total returns could once again exceed starting yields, which at the time of writing stand at 4.3%, reinforcing the attractiveness of core bonds as both an income source and a potential driver of capital appreciation.

Core bonds could be poised for strong results

5-year forward total return (%) on the Bloomberg U.S. Aggregate Index



Sources: Capital Group, Bloomberg. Dots = monthly figures starting across each period. "Current" value is based on latest starting yield-to-worst, using the historical linear trendline to approximate implied forward 5-year return. As of November 30, 2025. Past results are not predictive of results in future periods. Dates for periods shown: Pre-GFC: 1/1/00-4/30/07; GFC: 4/30/07-4/30/09; Post-GFC: 4/30/09-2/28/20; COVID-19 pandemic: 2/28/20-10/31/20.

While my outlook for 2026 is optimistic, fixed income investors will need to contend with significant challenges and cross currents to maximize opportunities and manage risk. The global economy remains in flux as fiscal policy, geopolitics, global trade and monetary policy seek a new equilibrium. At the same time, an AI-driven investment cycle of historic proportions is unfolding. This could either lead to a year of robust growth and rising productivity or a massive bust if naysayers prove correct.

The ability to adapt to these shifts and respect valuations will be key to navigating fixed income markets in the year ahead. As such, I am positioning the core bond portfolios I manage to take advantage of the still elevated yield environment, while moving toward defense and resilience with a preference for higher quality exposures that could benefit if my positive outlook is threatened.

Here are five themes that I believe will drive core bond markets in the coming year.

1. Fiscal dominance: Tariffs take center stage

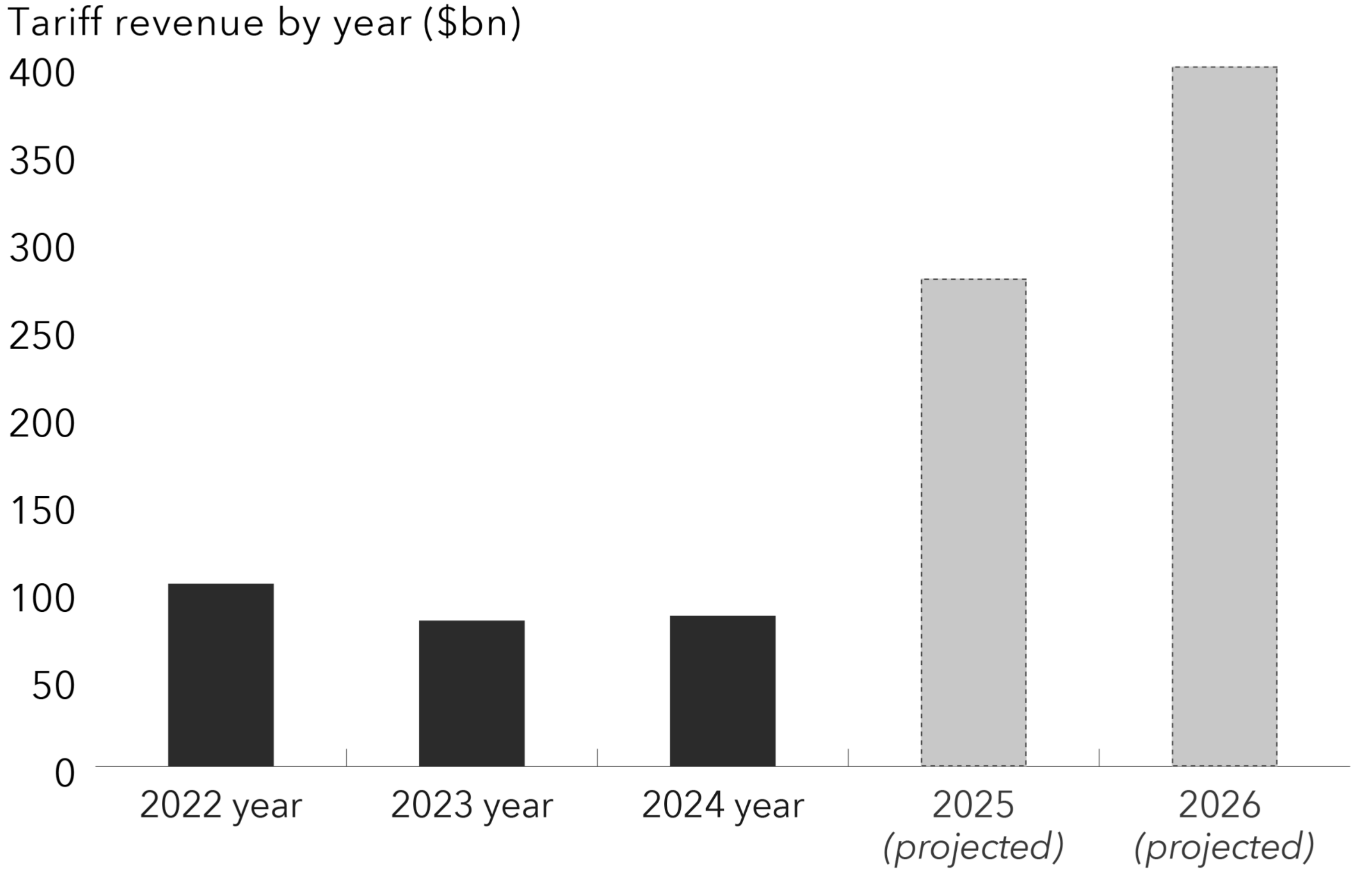
Coming into 2025, I posited that we were entering a new era for investors, where the Fed would take a back seat to the government as a primary driver of markets.

This has largely come to pass. Government policies — on everything from trade and immigration to taxes and regulation — have been key drivers of the economy, while the Federal Reserve has remained "data-dependent," adjusting their stance based on the impact to growth and inflation.

Tariffs have been a signature policy for the current administration, driving profound and far-reaching changes in economic and trade dynamics. They have reduced trade deficits while stimulating domestic production and investment. As the economy adjusts to this new framework, consumption is likely to slow, and business investment should strengthen in the year ahead. This shift may pressure investments tied to U.S. consumer spending, such as the consumer discretionary sector. Conversely, strategies aligned with onshoring and capital investment stand to benefit from a favorable economic tailwind.

Another benefit of tariffs has been their contribution to U.S. government revenue. While the U.S. fiscal deficit remains large, the combination of significant tariff income and lower interest rates could improve the government's financing gap. This could then anchor long-term yields and reduce a significant risk for bond investors.

Tariff revenue is growing significantly



Sources: Capital Group, U.S. Treasury, Tax Foundation. Revenue for 2025 represents realized revenue through October 2025, with projections for November-December. Data as of 10/31/2025.

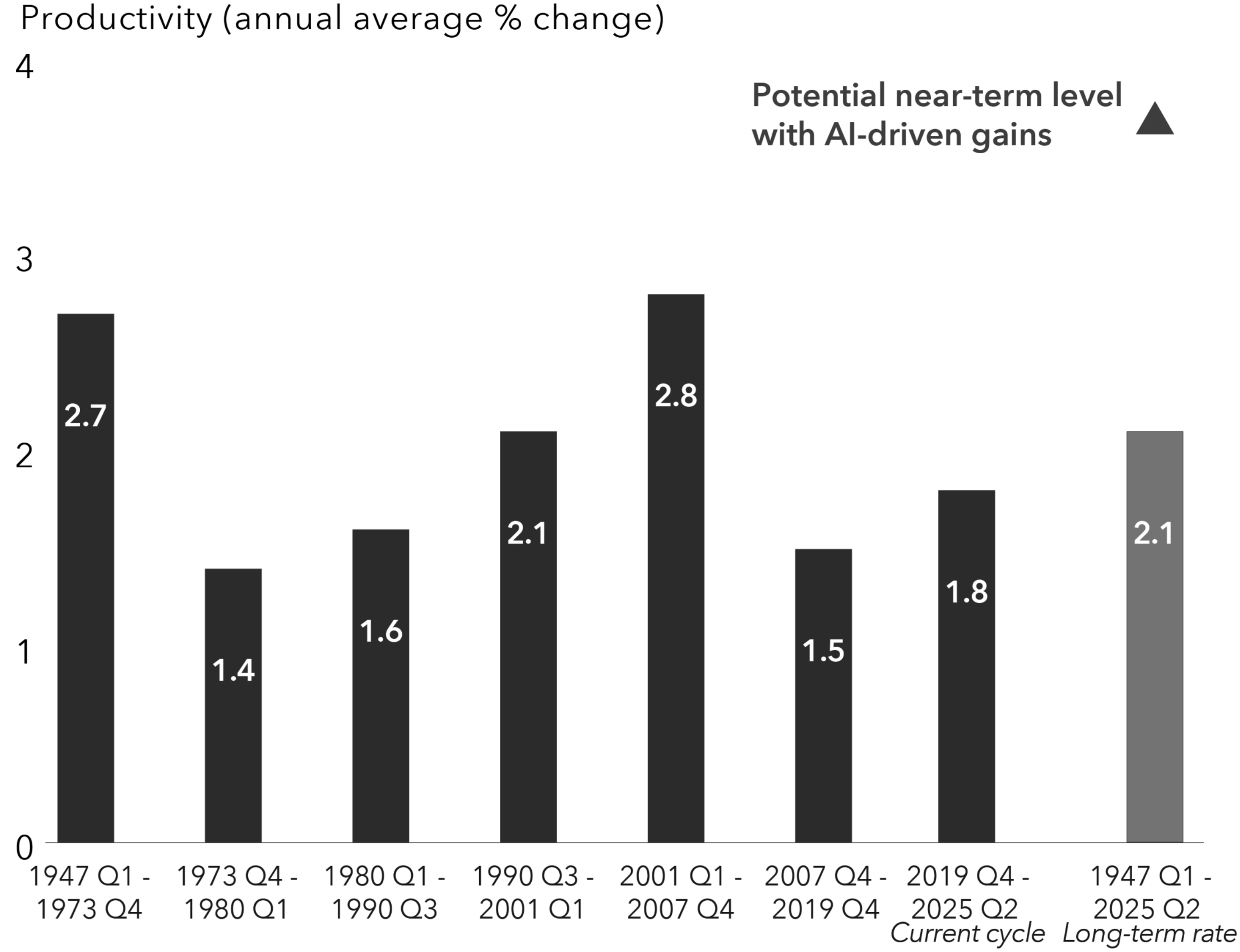
2. AI and productivity gains underpin growth optimism

My base case anticipates a reacceleration of U.S. economic growth in 2026 following a brief slowdown early in the year. Under favorable conditions, GDP growth could average approximately 3%, materially exceeding most forecasts and the Congressional Budget Office's estimated potential growth rate of 1.7%.

Although tariffs are inherently stagflationary (lower growth and higher inflation), this impact could be offset by productivity gains driven by AI (boosting growth and lowering inflation), investments in energy infrastructure (boosting growth) and easier monetary policy (boosting growth). Under such conditions, the combination of these effects could lead to an acceleration of GDP growth even as job growth remains flat or negative.

Given the deep pockets and strong cash flows of leading technology firms in the AI space, I believe this technology investment super-cycle will persist, potentially lifting U.S. productivity growth to 3–4% annually over the next five to 10 years. Such a boost to productivity would have profound implications for both economic growth and inflation, ultimately benefiting fixed income investors. For perspective, historical productivity has averaged 1–2%, with peaks of 2–3% following World War II and during the technology-driven boom of the late 1990s and early 2000s.

AI could boost productivity to unprecedented levels



Sources: Capital Group, U.S. Bureau of Labor Statistics. Data as of September 4, 2025. Potential near-term level is for illustrative purposes only.

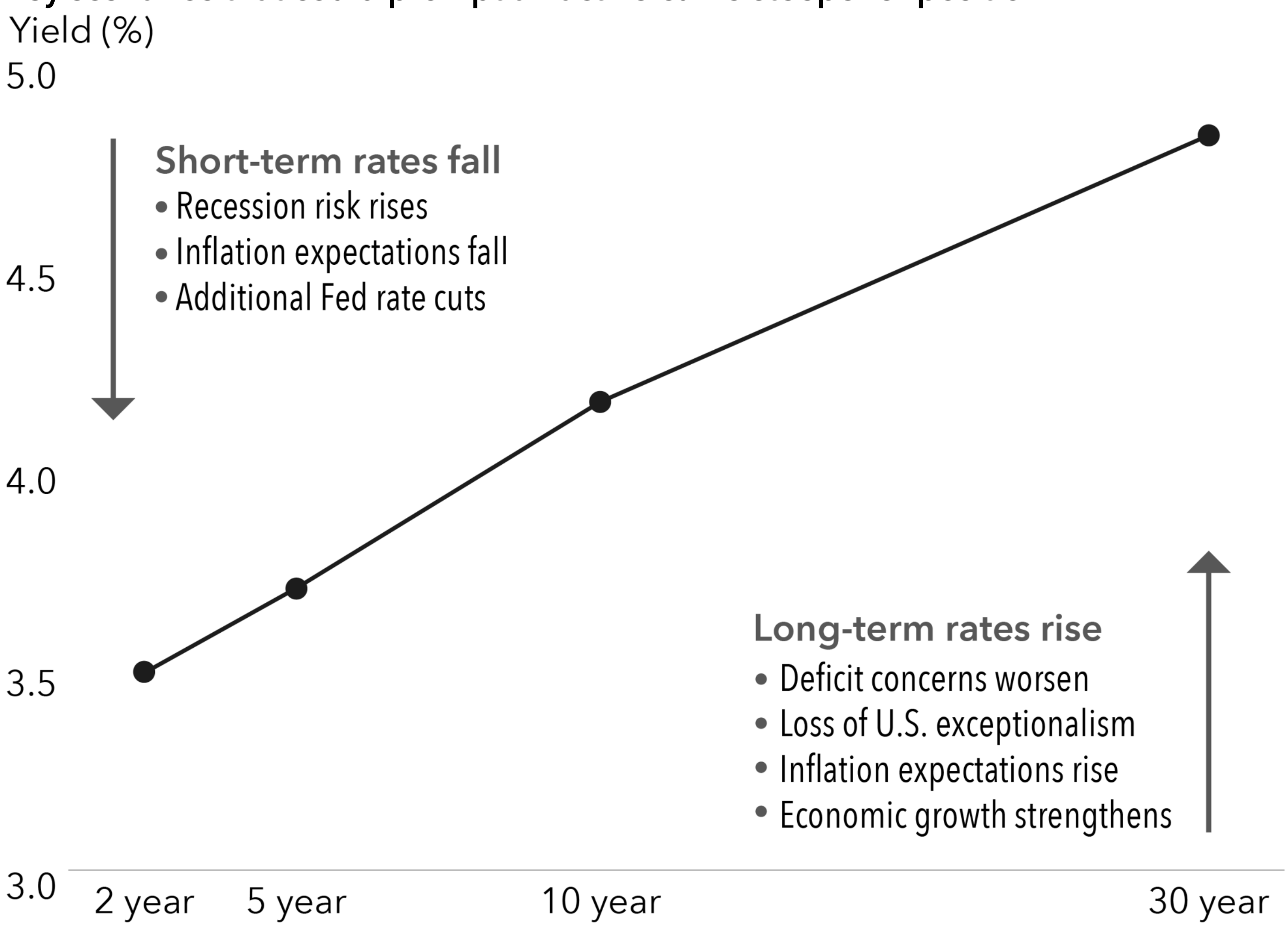
3. Contained inflation and a supportive Fed increase opportunities in interest rates

If inflation moderates as tariffs stabilize and AI-driven productivity rises, the Federal Reserve is likely to continue cutting rates amid cooling labor markets. In this environment where inflation remains above 2%, growth is above potential and the Fed is cutting short-term rates, I believe the yield curve will continue to steepen.

Positioning for a steeper yield curve by favoring short- and intermediate-term bonds over longer term issuances can benefit portfolios under multiple scenarios. First, in a risk-off environment, short-term yields typically fall more rapidly than longer term yields as markets anticipate deeper Federal Reserve cuts. Second, in a risk-on environment where growth remains healthy while the Fed remains concerned about labor market weakness, short-term rates could remain depressed while long-term rates rise, leading to a steeper curve. This steepener position could also benefit if deficit concerns reignite.

Meanwhile, risks to the level of interest rates appear to be more balanced. I plan to be opportunistic around a neutral duration stance and adjust exposure as opportunities arise.

Key scenarios that could prompt an active curve steepener position



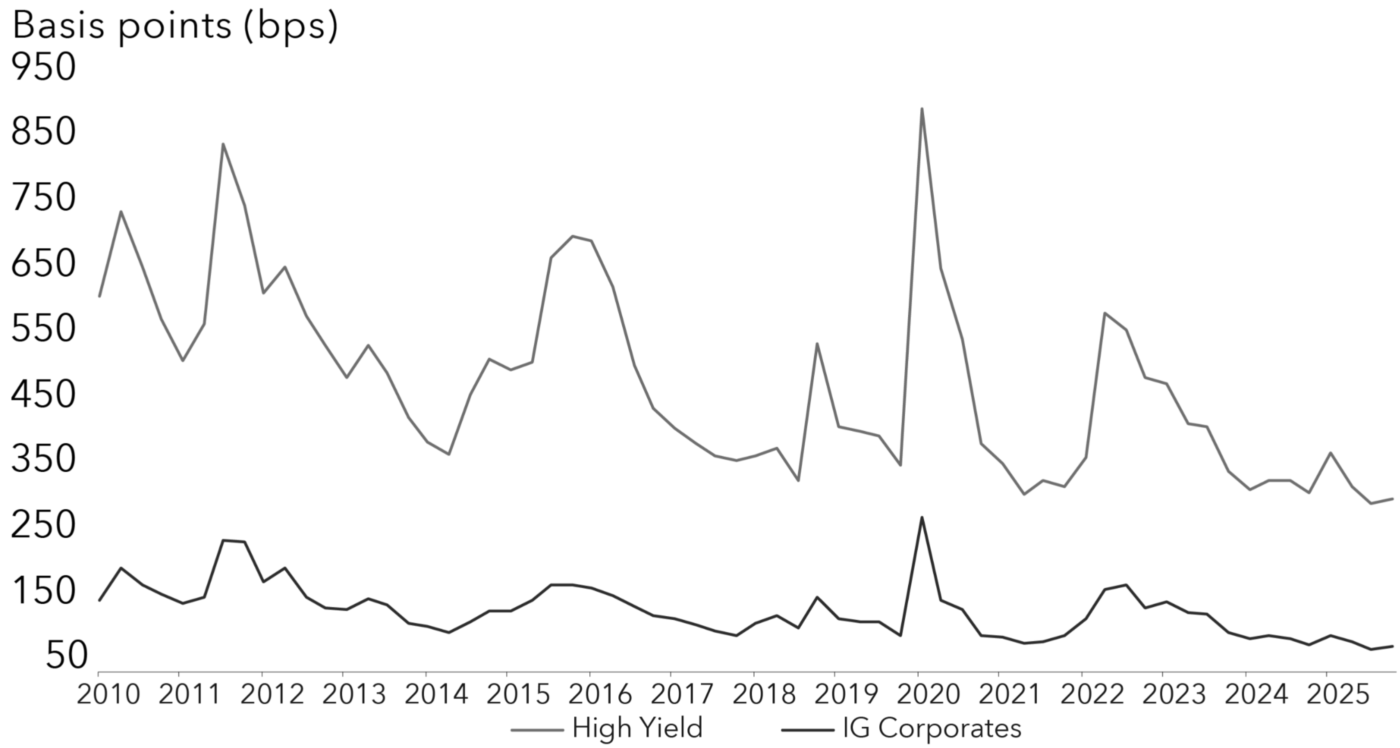
Source: Capital Group. Data as of December 16, 2025.

The key risk to this view is if inflation surprises to the upside or if the labor market reaccelerates before the Fed completes its current cutting cycle. In that scenario, the Fed might become more hawkish, which could lead to both higher interest rates and a flatter yield curve.

4. Valuations matter – Get paid for defense now, offense later

While it's tempting to own riskier assets because fundamentals and the economic environment look positive, I am deterred by valuations, especially in corporate credit markets. Fixed income differs fundamentally from equities because the upside potential is capped. As valuations become richer, expected returns decline. On a standalone basis, corporate credit yields are high and suggest attractive forward returns. However, in a core bond portfolio context, the sector's appeal relative to other sectors is diminished as investment-grade (BBB/Baa and above) credit spreads are near historic tight levels, indicating investors are receiving minimal compensation for taking on additional risk over Treasuries. This dynamic reinforces the importance of disciplined risk management and robust credit selection.

Credit spreads approach historically tight levels



Source: Bloomberg. IG Corporates = Bloomberg U.S. Corporate Investment Grade Index. High yield = Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index. Data as of December 15, 2025.

Within spread sectors, higher quality assets like agency mortgage-backed securities (MBS) and asset-backed securities (ABS) look more attractive than lower quality, longer duration corporates. But even these sectors have become less attractive after a very strong rally in 2025.

MBS, especially high-coupon issuances, have been a key area of focus in core portfolios because they offered extra nominal income and spread (in some cases comparable to or higher than investment-grade corporate credit), but with little to no credit risk and greater liquidity. However, with expectations for the Fed to cut rates in the coming year, I have moderated exposure to the highest coupon issuances (which are more vulnerable to prepayment risk) and moved down in coupon to bonds that are more protected from this risk.

Within ABS, I see select opportunities in bonds from conservative issuers that sit higher in the capital structure. These issuances offer strong investment income potential and can be held to maturity. Senior tranches, in particular, can act as yield-enhanced cash surrogates due to their quick amortizing nature, which provides additional liquidity to portfolios.

In commercial mortgage-backed securities (CMBS), many office exposures remain challenged, but the fundamentals underpinning multifamily housing, warehouses and other segments have remained intact, with strong cashflows in many sectors.

By focusing on high-quality issuances and diversifying positions to reduce exposure to any single macro factor, core portfolios should be able to withstand market turbulence and maintain income. If a market correction occurs, losses should remain limited relative to risk-heavy strategies and should preserve room to add risk by deploying capital opportunistically into attractive bonds at more compelling valuations.

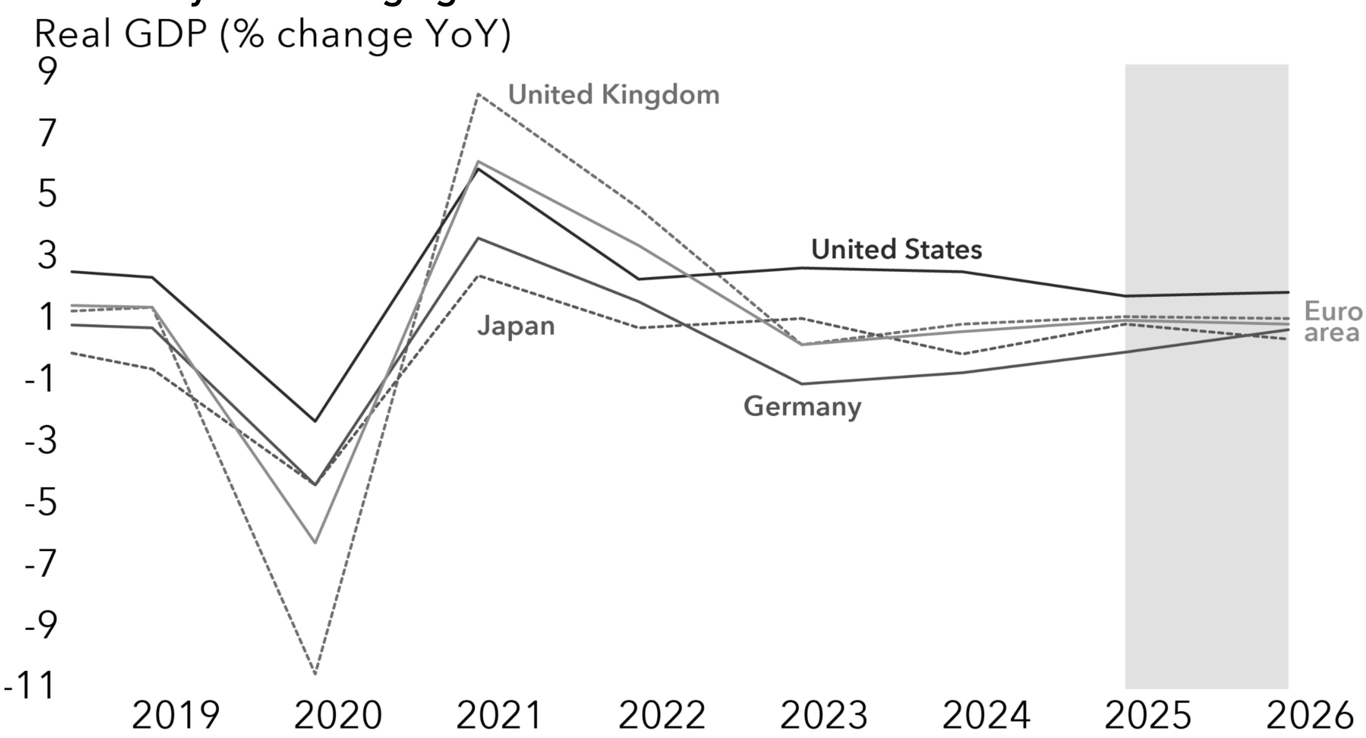
5. Global opportunities arise as U.S. builds trade barriers

Although the administration's signature tariffs face numerous legal challenges, the trajectory toward protectionism appears firmly established. Regardless of the outcomes of pending legal cases, a secular shift appears to be underway with no quick return to pre-2018 free trade dynamics.

If the U.S. relinquishes its role as a primary source of global demand, other countries will need to establish new trade patterns and partnerships, creating more economic activity and opportunities outside the U.S. As global demand becomes less U.S.-centric, the number of investable relative-value opportunities in non-U.S. rates and select credits could expand significantly.

In response to U.S. tariffs, many countries are leaning more heavily on fiscal stimulus and lower interest rates to provide domestic support. This should mean less downside risk than previously feared and more pockets of opportunity for investors.

Growth may be converging across economies



Source: International Monetary Fund (IMF). Shaded area represents IMF forecasts. Data as of December 15, 2025.

As such, I believe exposure to Japan, Europe and select emerging markets looks more compelling as we enter 2026. Emerging market debt is not typically a large part of core bond funds, but there are some idiosyncratic opportunities where the risk/reward is attractive, such as select hard currency bonds in countries like Mexico.

The bottom line

While 2026 is likely to include periods of volatility, my outlook for core fixed income is positive. Supported by above-trend growth, moderating inflation and a dovish Federal Reserve, core bonds could deliver returns exceeding the Bloomberg U.S. Aggregate Index's current yield of 4.3%. Should risk markets falter, core bond returns could rise even further, as high-quality bonds have once again demonstrated their role as an effective diversifier during recent equity market declines.

My overarching investment philosophy is defense now, offense later. When risk is not well compensated, as currently appears to be the case, I tilt defensive. And when volatility eventually rises, I shift to offense and buy riskier assets at cheaper prices. Therefore, our core fixed income team will continue seeking to build resilience in portfolios while valuations remain full.

Despite positive economic expectations, we have reduced credit exposure in core portfolios and shifted into higher quality bonds. I am being tactical on interest rates, waiting for better entry points to add or reduce duration risk while maintaining an overweight to shorter maturities that may benefit from a steeper yield curve. I am also looking globally for pockets of value, reflecting my view of a less U.S.-centric opportunity set. This positioning should allow the portfolios I manage to better withstand bouts of volatility while maintaining room to add should valuations become more attractive. This cyclical approach is a hallmark of my investment strategy, and I expect that these themes will be key to successfully navigating fixed income markets in 2026.

Read important disclosures

Pramod Atluri *is a fixed income portfolio manager with 22 years of investment industry experience (as of 12/31/2025). He holds an MBA from Harvard and a bachelor's degree in biological chemistry from the University of Chicago. He is a CFA charterholder.*

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