FRANKLIN TEMPLETON

WESTERN ASSET

Fixed-Income Insights

Key Convictions 1Q26



Western Asset specializes in actively managing fixed-income strategies, employing a proven investment philosophy and process to protect capital and drive long-term investment growth for clients.

*As of 31 Dec 25

Not FDIC Insured | May Lose Value | No Bank Guarantee

Market Insights at a Glance

In 2026, global fixed-income markets should benefit from improving growth, subdued inflation and reduced uncertainty around tariffs. Inflation is broadly at target and central banks overall are nearing rate-cut cycle ends. We currently favor high-quality spread sectors for building consistent income and are positioned to take advantage of credit opportunities in AI-related issuance, M&A activity, commercial MBS and CLOs. This summary is intended to aggregate the Firm's current overall views and present an at-a-glance dashboard.*



Growth

Convictions

- US growth should stay at or above trend, supported by rate cuts, fiscal stimulus and real wage gains.
- Eurozone growth should start to gain traction from German fiscal loosening.
- China slows to ~4.5% amid property woes, while EM benefits from central bank easing.

Rationale

Growth in 2026 is being shaped by fiscal stimulus, infrastructure spending, tariffs and trade policy adjustments, labor market transitions including AI-driven productivity shifts, and geopolitical developments affecting global trade flows and investment patterns.

Inflation

- Global inflation continues trending lower, remaining contained across most developed market (DM) economies.
- US may see tariff-driven goods price increases, but services disinflation persists on lower housing and labor costs.
- Eurozone inflation is contained as labor costs ease; UK underlying inflationary pressures continue to ease, while China faces very subdued pressures.

The downward inflation trend is driven primarily by services disinflation, cooling wage growth, controlled labor costs and stabilized oil prices. However, tariff implementation may cause near-term upward pressure on goods prices as these costs work their way to consumers.

Rates

- Major central banks have eased policy on disinflation and softer labor markets; the Fed cut 75 bps and the ECB lowered rates to 2%, supporting risk assets.
- Further cuts are expected from the Fed and BoE, while the BoJ tightens as real rates remain negative.
- DM easing has enabled emerging market (EM) rate cuts, with attractive real yields favoring long duration in local markets.

Disinflation, softening labor markets and rising unemployment have prompted major central banks to cut rates, reducing recession fears and supporting risk assets. Meanwhile, the BoJ continues policy normalization given Japan's persistently negative real rates.

Monetary Policy

Convictions

- Further Fed rate cuts are dependent on labor and inflation data. Additional BoE rate cuts are expected, while the BoJ tightens as real rates remain negative.
- EM central banks have scope to cut rates further as inflation continues to decline, supporting growth and global monetary conditions.

Rationale

Continued disinflation, softer labor markets and inflation trending toward targets has prompted central banks to ease policy, reducing recession fears and enabling coordinated policy support across DM and EM economies. With easier financial conditions and fiscal stimulus the central bank easing cycle is now nearing its end.

Credit Markets

- Credit spreads are tight but supported by strong corporate and household fundamentals, justifying positioning in spread sectors for consistent income.
- Elevated M&A activity driven by deregulation presents mixed risks for investment-grade credit as companies use more debt than equity to finance deals.
- Opportunities exist in AI-driven capital needs, high-yield credit, collateralized loan obligation (CLO) tranches and commercial mortgage-backed securities (CMBS) with improving quality.

Credit markets are being shaped by strong corporate and household fundamentals, elevated M&A activity driven by deregulation, AI-driven capital needs requiring significant financing and central bank easing, which support spread sectors.

Labor Markets

- US unemployment has risen, but reflects new entrants and re-entrants rather than layoffs; labor supply remains tight due to flat migration.
- Eurozone unemployment hit a record low but is rising in Germany amid industrial threats and in France.
- Japan's labor shortages sustain higher wages, domestic inflation and strong capital spending despite slower growth.

Today's US labor market is shaped by a constrained labor supply, an evolving mix of services versus manufacturing growth, AI's differentiated impact across labor segments, and cyclical pressures from tariff uncertainty and corporate caution related to hiring.

Capturing Value in an Era of M&A and AI

"The macro environment shows improving growth and continued disinflation, while rates offer selective value with curves steepening. Our strategy centers on building consistent income through spread sectors and capturing opportunities from the massive capital requirements of the AI infrastructure build-out. Rising M&A activity presents opportunities, but we're mindful of structural changes in deal financing that warrant careful credit analysis."

— Michael Buchanan, CFA, Chief Investment Officer



*As of 31 Dec 25

Fixed-Income Overview and Outlook: Growth, Disinflation and Easing Support Risk Assets

The global fixed-income landscape in 2026 is one of improving growth, continued disinflation and central bank easing that has reduced recession fears while supporting risk assets. Major central banks including the Fed, ECB and BoE have cut rates in response to softening labor markets and declining inflation. Inflation is trending toward central bank targets globally, though the US may see short-term upward pressure from tariff-related costs offset by ongoing services disinflation.

Looking ahead, we expect US yields to remain range-bound with steeper curves, while front-end yields drift modestly lower. Our investment focus centers seeking to generate consistent and reliable income through high-quality spread sectors despite tight valuations that are supported by strong corporate and household fundamentals. Significant opportunities exist in AI-driven capital raising, where high-quality issuers will tap public markets for speed of execution, alongside selective exposure to elevated M&A activity, CLO tranches and improving commercial real estate. EM local rates remain attractive given supportive real yields and central bank coordination.

Geopolitics at the Core: Venezuela's Transition and EM Resilience

EM countries are starting 2026 with a mix of promise and complexity. Recent geopolitical developments, particularly in Venezuela, have added uncertainty to the global landscape, but the underlying case for EM strength remains compelling. As noted in our recent EM outlook, economic growth across the EM world has continued to outpace that of DM economies, supported by disinflation trends, elevated real interest rates and disciplined monetary policy. We believe these factors, combined with improved fiscal positions and robust reserves, create a foundation for resilience.

From a technical perspective, EM assets benefit from low crossover participation and strong IMF-backed programs in frontier markets. While hard-currency returns are likely to lean more on carry than further spread compression, selective opportunities persist—especially among investment-grade sovereigns where fundamentals support incremental tightening.

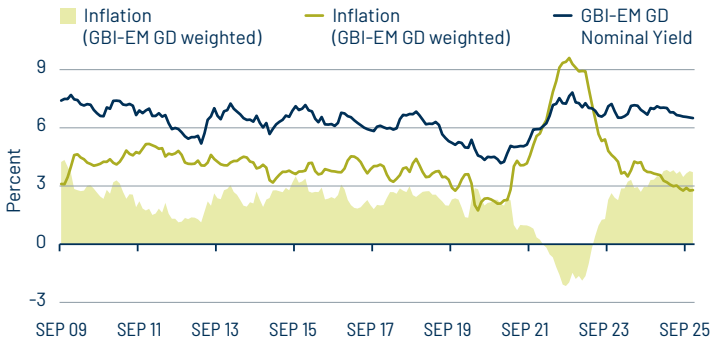
Latin America illustrates the nuanced risk/reward dynamic. Venezuela's bond rally reflects optimism around political transition and debt restructuring, though any resolution is likely to require a multi-year process. Elsewhere, Colombia faces heightened political noise ahead of elections, while Mexico and Brazil maintain relatively stable trajectories. Brazil in particular continues to warrant tactical overweight positioning despite election-related uncertainty.

Beyond the region, reform-driven economies such as Nigeria and Egypt showcase the upside of structural improvements, while rising stars like Costa Rica and Ivory Coast offer long-term potential. EM corporates remain attractive for incremental spread and carry, particularly in sectors like mining & metals, utilities and energy.

In currencies, EM FX valuations stand out as deeply discounted on a real effective basis, contrasting with an expensive US dollar. Higher real rates, undervaluation and even modest portfolio diversification flows could drive meaningful outperformance without requiring a dollar reversal.

Overall, EM fundamentals are stronger than in prior cycles, supported by supply-chain diversification and favorable terms of trade. Against this backdrop, we maintain a constructive stance on EM local markets, emphasizing selective opportunities while actively managing geopolitical and idiosyncratic risks.

EM Real Yields



Source: Macrobond. As of 30 Nov 25.

The Bottom Line

Even with ongoing policy easing, inflation is declining faster than interest rates. This leaves EM real yields elevated and preserving the carry advantage, offering compelling real income opportunities despite rate cuts.

Western Asset Investment Themes

Asset Class	Our View
Corporate Credit	We are gradually reducing exposure to corporate credit due to tight valuations, but strong fundamentals persist. Anticipated supply from AI-driven infrastructure and elevated M&A activity may create attractive opportunities to add high-quality credit.
Investment-Grade Credit	A wave of new issuance is expected as companies raise capital for AI-related infrastructure, with high-quality issuers likely to offer attractive rates in 2026.
High-Yield Credit	Fundamentals remain strong, with new issuance primarily used for refinancing rather than aggressive expansion. M&A activity is generally positive, as acquired companies tend to be upgraded in quality.
Private Credit	Leverage is higher than in public credit, but remains manageable and below prior peaks.
Structured Products	CLOs and select tranches offer attractive relative value, and we believe agency MBS can be used as effective portfolio hedges. Commercial real estate may be the most compelling opportunity at this time, with prices rebounding and spreads remaining wide relative to corporate credit.
Emerging Markets	High real yields and supportive local-rate environments encourage long positions in EM debt, with active issue selection favored in high-beta and frontier markets.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Fixed-income securities involve interest rate, credit, inflation and reinvestment risks and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Low-rated, high-yield bonds are subject to greater price volatility, illiquidity and possibility of default.

Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks.

Investments in **companies engaged in mergers, reorganizations or liquidations** also involve special risks as pending deals may not be completed on time or on favorable terms.

Active management does not ensure gains or protect against market declines.

Companies in the **infrastructure industry** may be subject to a variety of factors, including high interest costs, high degrees of leverage, effects of economic slowdowns, increased competition, and impact resulting from government and regulatory policies and practices.

An investment in **private market investments** is suitable only for investors who can bear the risks associated with them (such as private credit and private equity) with potential limited liquidity. Shares will not be listed on a public exchange, and no secondary market is expected to develop.

Real estate investment risk includes, but is not limited to, fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by local, state, national or international economic conditions. Such conditions may be impacted by the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, and environmental laws.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Investments in companies in a specific country or region may experience greater volatility than those that are more broadly diversified geographically. The government's participation in the economy is still high and, therefore, investments in **China** will be subject to larger regulatory risk levels compared to many other countries. There are special risks associated with investments in **China, Hong Kong and Taiwan**, including less liquidity, expropriation, confiscatory taxation, international trade tensions, nationalization, and exchange control regulations and rapid inflation, all of which can negatively impact the fund. **Investments in Taiwan** could be adversely affected by its political and economic relationship with **China**.

Commodities and currencies contain heightened risks that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

US Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the US government. The US government guarantees the principal and interest payments on US Treasuries when the securities are held to maturity. Unlike US Treasuries, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the US government. Even when the US government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

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