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2026 Fixed Income Outlook: Uncertainty is High, but the Margin for Error Isn't

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With credit priced for perfection, 2026 favors nimbleness and thoughtful portfolio construction, emphasizing security-level analysis and targeted opportunities across fixed income.

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Fixed income markets are entering 2026 priced for perfection. Credit spreads remain near historic lows, leaving little margin for error if volatility returns. While fundamentals appear intact for now, the growing disconnect between tight valuations and underlying risks increasingly favors security selection over broad exposure. In this environment, flexibility, active management, and a disciplined approach to risk-adjusted returns will be essential to navigating what could be a challenging year ahead. This outlook explores:

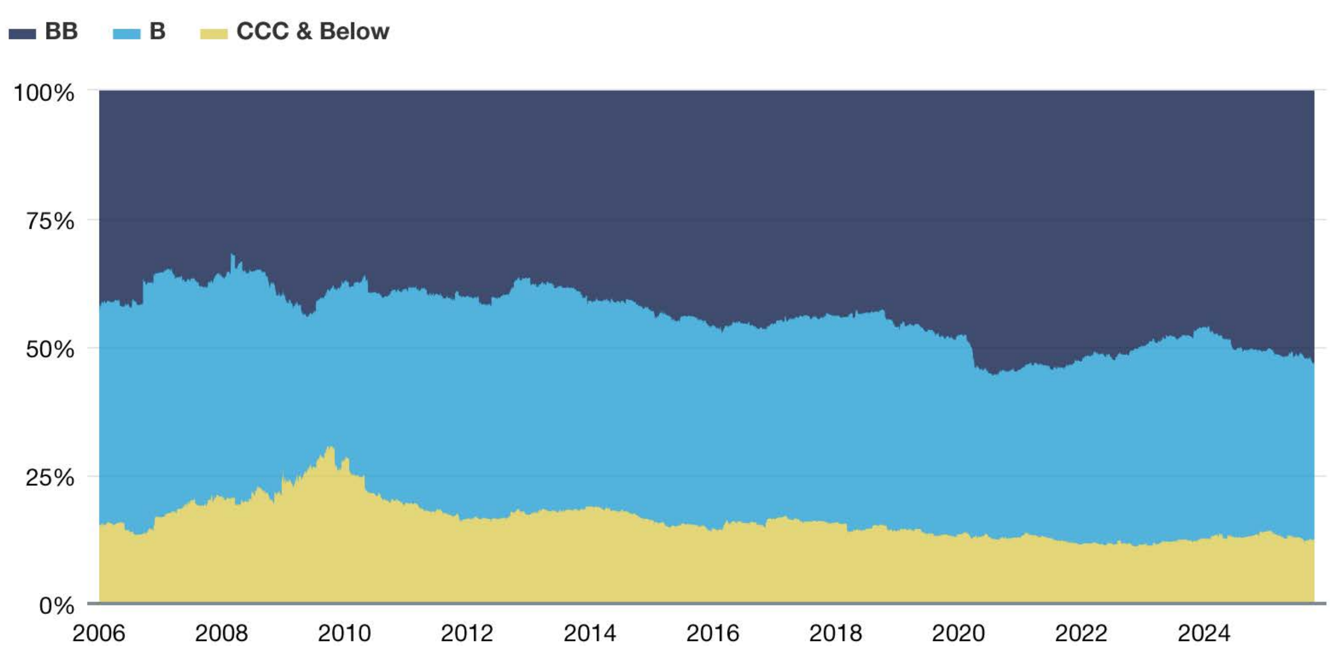
- Why tight credit spreads create asymmetric risk
- The growing importance of portfolio flexibility
- Opportunities in securitized markets
- Why municipal bonds remain attractive
- Actionable strategies for resilience

Tight Credit Offer Little Margin for Error

Despite a higher-quality mix within the high yield index, credit spreads across both BB and B ratings remain near the tightest levels of the past two decades.

High Yield Credit Quality Has Improved, Yet Spreads Remain Near Historic Lows

High Yield Index Composite Over Time (2006 – 2025)



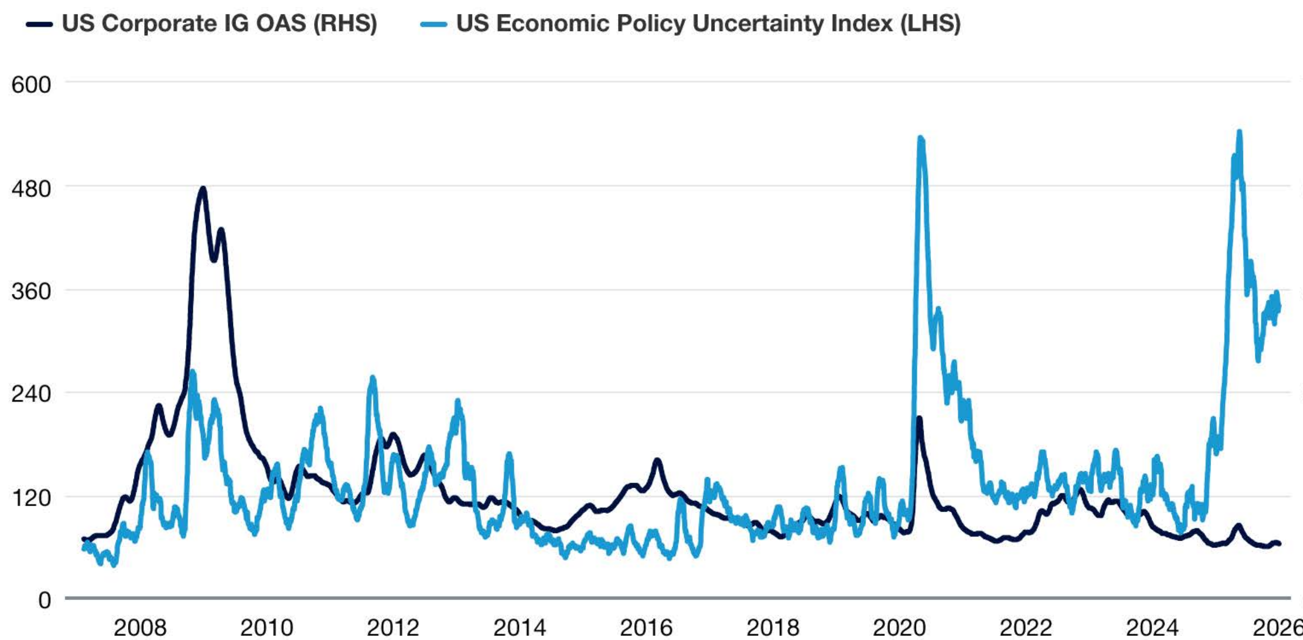
Source: Bloomberg, Bloomberg US Corporate High Yield Bond Index, as of 31 December 2025.

Past performance does not guarantee future results.

While today's US Corporate High Yield Index ratings composition is structurally higher quality than in past cycles with BB-rated corporate bonds making up a greater percentage of the overall index and CCC- & Below-rated bonds comprising a smaller percentage (see chart above), spreads holding ratings constant suggest very rich valuations. We do not believe that quality within rating buckets has evolved over time and have yet to hear this argument in the marketplace. Spreads, however, sit meaningfully below long-term averages in the top deciles of their historical range, leaving limited room for further tightening and reducing the margin of safety should conditions deteriorate. In this environment, incremental carry comes at the cost of asymmetric downside, particularly if volatility or policy uncertainty re-emerges. Said another way, a simple mean-reversion to the long-term averages versus compression to the tightest spreads in history has a very asymmetric and unfavorable risk-reward profile. This dynamic is particularly relevant for financial advisors constructing client portfolios, as traditional allocations may be exposed to more downside risk than historical models suggest.

This risk is compounded by the notable disconnect between credit spreads and elevated economic policy uncertainty (see chart below). Historically, periods where spreads fail to reflect rising uncertainty have proven difficult to sustain, with eventual adjustments occurring abruptly rather than gradually. This pattern has repeated across multiple cycles, typically catching passive investors unprepared. As a result, the risk–reward profile in high yield appears skewed: modest upside from further spread tightening versus meaningful downside should spreads revert even partway toward long-term norms.

Fixed Income Spreads Are Disconnected from the Economic Policy Uncertainty Index



Source: Economic Policy Uncertainty, Macrobond, Apollo Chief Economist, as of May 29, 2025.

Key takeaway: With modest upside and significant downside risk, selectivity is essential. Investors should avoid chasing incremental yield at the expense of risk discipline. Consider rebalancing high yield allocations toward higher-quality issuers with strong balance sheets and sustainable cash flows.

Portfolio Flexibility Is More Important Than Ever

Many investors continue to view the Bloomberg US Aggregate Bond Index (Agg) as a bellwether for domestic fixed income, yet its construction reflects a narrow and increasingly incomplete opportunity set. The index excludes below investment grade credit, omits large parts of the securitized market, and is structurally biased towards interest rate risk. The index has also exhibited a duration generally above six in recent years, years characterized by interest rate volatility, in consequence exposing index investors to higher than desirable volatility within portfolios. These characteristics can limit its effectiveness as a guide for portfolio outcomes in more dynamic market environments.

These limitations have become especially apparent in recent years. In the post-COVID period, the Agg has lagged a range of individual fixed income asset classes, particularly in environments where rising rates or shifting credit dynamics drove returns (see table below). This divergence highlights the challenge of relying on a benchmark that is constrained by design rather than positioned to adapt. For financial professionals, this highlights the importance of looking beyond traditional benchmark-oriented approaches when constructing fixed income allocations.

The structural limitations of the Agg also fail to capture opportunities in areas like floating-rate securities, non-US debt, and specialized securitized products—areas that can provide both diversification and potential alpha in challenging environments.

Given tight credit spreads, geopolitical uncertainty, and concerns about the Fed's independence, we anticipate an environment with increased potential for volatility. In volatile markets, flexibility becomes a source of resilience, particularly for portfolios that might reduce risk exposure as the risk/reward profile becomes more asymmetrically skewed. Therefore, we believe that flexibility in fixed income has become increasingly important for navigating markets going forward. This environment plays to the strengths of managers with expertise across multiple fixed income sectors, including taxable municipal, securitized, and global markets.

The Agg Has Lagged Other Fixed Income Sectors

Fixed Income Returns (2015-2025)

SHOW ALL | International Bonds | US High Yield | Global High Yield | EM Debt | US Aggregate | Corporates | US Govt | Short Duration | Long Duration | Securitized | Cash | TIPS | Bank Loans | Taxable Muni

2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
1.47	17.13	10.71	1.82	19.59	16.12	5.96	1.52	14.04	9.19	12.06
1.29	14.27	10.51	1.60	14.54	10.99	5.28	-0.77	13.45	8.95	11.11
1.03	10.16	10.43	0.99	14.32	10.52	5.20	-3.69	13.32	8.19	8.85
0.86	9.88	8.17	0.88	13.11	10.11	0.99	-11.19	9.09	6.58	8.62
0.65	6.67	8.15	0.62	12.56	9.89	0.94	-11.67	8.84	5.32	8.49
0.55	6.11	7.50	0.44	11.08	7.94	0.04	-11.85	8.52	4.36	7.89
0.03	4.68	6.42	0.01	8.72	7.51	-0.47	-12.32	7.13	2.13	7.77
-0.68	4.61	4.12	-1.26	8.64	7.11	-1.04	-12.71	5.72	1.84	7.45
-0.69	2.65	3.54	-2.08	8.43	7.03	-1.04	-13.01	5.53	1.57	7.30
-1.44	1.78	3.01	-2.15	6.83	6.52	-1.54	-15.26	5.14	1.46	6.62
-2.72	1.49	2.51	-2.46	6.44	4.18	-1.65	-15.76	5.08	1.25	6.31
-3.30	1.28	2.30	-2.51	5.09	3.33	-2.28	-18.11	4.61	0.62	5.90
-4.47	1.05	0.84	-4.06	4.03	3.12	-2.52	-18.70	4.09	-4.15	5.35
-6.02	0.26	0.82	-4.68	2.21	0.54	-7.05	-27.09	3.90	-4.22	4.29

Source: Bloomberg, as of 31 December 2025.
Past performance does not guarantee future results.

Key takeaway: Portfolios should adapt rather than anchor to static benchmarks. Consider strategies that incorporate securitized credit, mid-grade corporates, and floating-rate instruments to reduce duration risk and enhance income potential through active sector rotation.

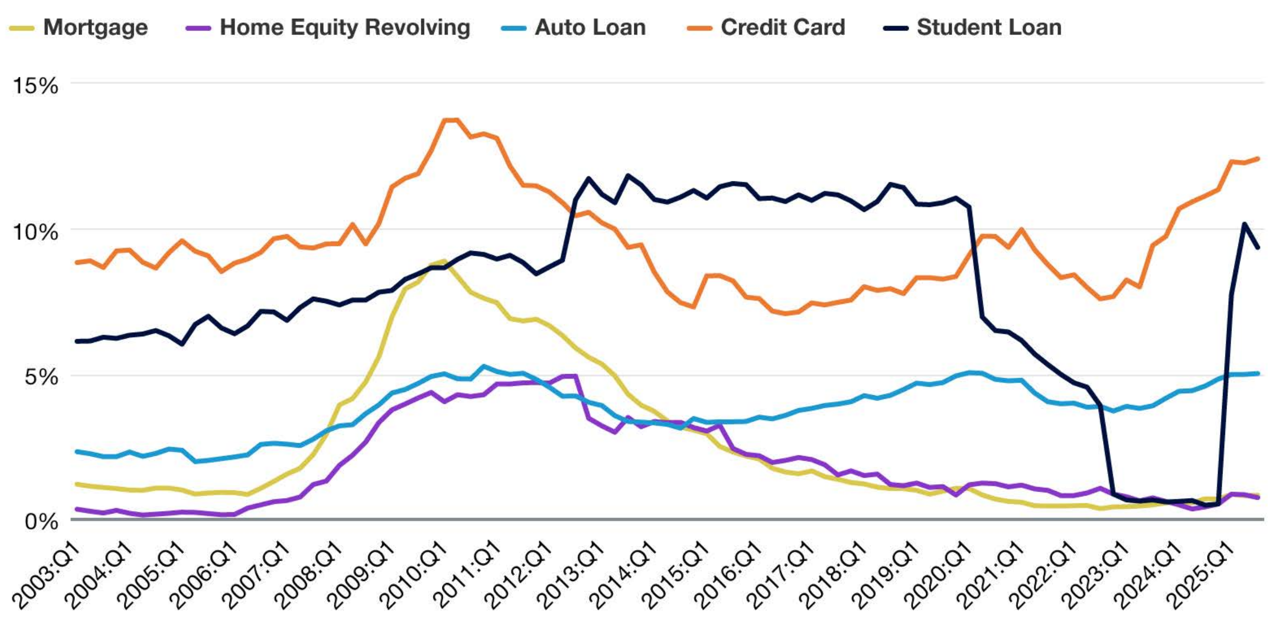
Opportunities in Securitized Markets Require Active Management

While investment grade and high yield corporate credit spreads sit in the tightest historical deciles, select segments of the securitized fixed income market offer more attractive relative value. Though not cheap from a historical spread perspective either, pockets of mortgage-backed (MBS & CMO), commercial mortgage-backed (CMBS), and asset-backed (ABS) securities can provide a good opportunity to add value to fixed income portfolios at more attractive spread levels with the additional diversification benefit of low correlation to other fixed income investments. Importantly, securitized credit provides more direct exposure to the underlying health of the U.S. consumer, housing market, and commercial real estate, increasingly reflecting a growing bifurcation within the consumer. Higher-income households, which disproportionately own homes and benefit from locked-in low mortgage rates, continue to exhibit relatively stable credit performance. In contrast, lower-income and more leveraged consumers are showing rising stress, most visibly in unsecured credit such as credit cards and student loans (see chart below). This bifurcation is likely to continue through 2026, creating both opportunities and pitfalls that are difficult to navigate through broad index exposure.

This divergence underscores why broad, passive exposure to securitized markets can be misleading. In consumer-related ABS, rising delinquencies warrant selectivity across collateral types, borrower profiles, and deal structures. Similarly, in CMBS, elevated vacancy rates in certain central business districts contrast sharply with more resilient property types and regions. In this environment, active management that is focused on security-level analysis and subsector differentiation is critical to capturing opportunity while avoiding areas where credit fundamentals are deteriorating. This environment strongly favors managers with specialized expertise in loan-level analysis and structural considerations who can identify relative value opportunities while avoiding deteriorating credits.

Delinquency Rates Have Risen Sharply Among Unsecured Credit

Percent of Loan Balances: 90-Plus Days Delinquent



Source: New York Fed Consumer Credit Panel, Equifax, as of September 30, 2025.

Key takeaway: Investors should focus on collateral quality, borrower profiles, and deal structures. Avoid broad exposure and instead target resilient subsectors such as prime auto ABS, select residential MBS with strong borrower characteristics, or CMBS backed by high-quality properties in growth markets with diversified tenant bases.

Municipal Bond Yields Remain Attractive on a Tax-Adjusted Basis

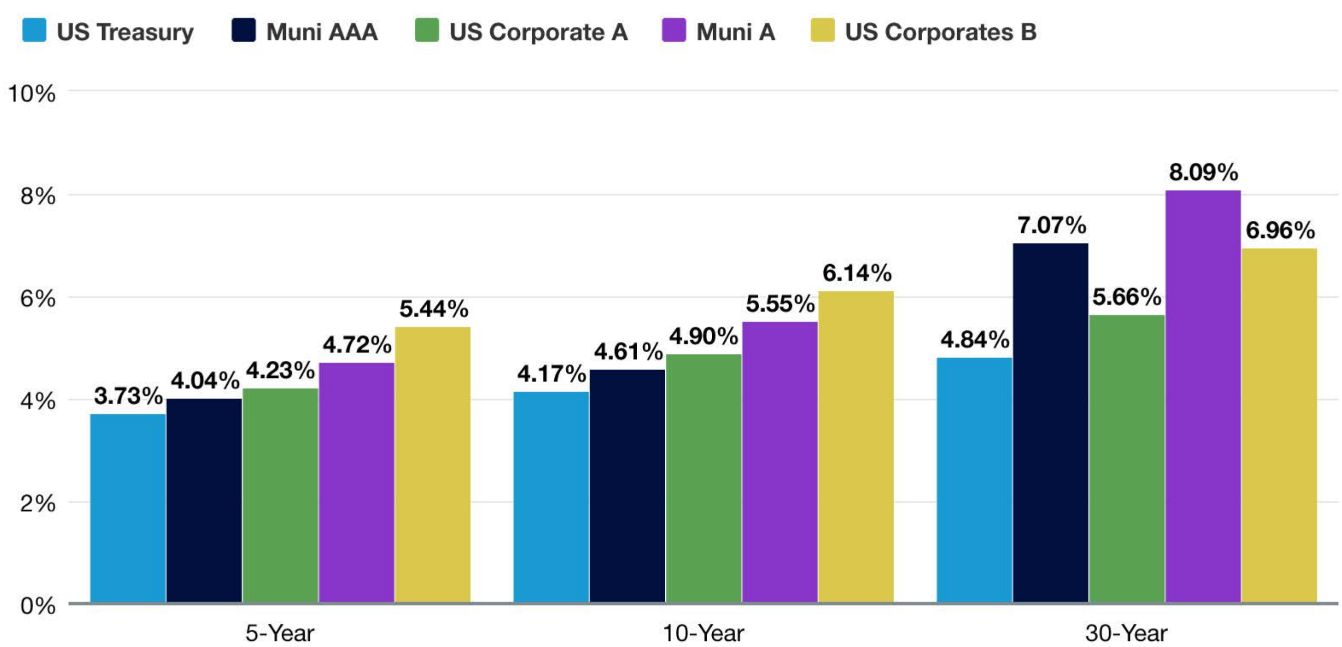
With valuations broadly stretched relative to history for many asset classes, municipal bonds at the start of 2026 are the exception that proves the rule and continue to look fundamentally cheap. Municipal bond issuance in 2025 broke last year's issuance record of $494 billion with $610 billion issued. The AAA muni-to-Treasury ratio remains through breakeven for higher-tax-bracket investors. Municipal bonds generally represent relative cheapness on an after-tax-return basis versus federally taxable investments, which is an attractive proposition for investors. During the year, the AAA-municipal bond yield curve steepened with the long-end rising while front-end yields declined in step with Fed rates cuts. Investors interested in locking in attractive yields should look to longer-dated municipal bonds. Even as consumer loan delinquencies rise, municipalities continue to provide essential services, where revenues tend to lag behind those of households and corporations. This countercyclical quality makes municipal bonds particularly valuable in late-cycle environments or during periods of economic uncertainty. The outlook for municipal credit remains stable for most sectors, and state revenues have generally remained resilient. With a quality bias inherent in municipal bonds, municipal credit remains attractively valued. For high-net-worth clients in particular, the after-tax benefits of municipal allocations are compelling in the current yield environment, offering both tax efficiency and potential principal protection.

Risk Looks Appropriately Priced on the Short End, While Opportunities May Exist on the Long End

As illustrated in the chart below, looking across yields as we start the year, as expected they stack rank from low to high by underlying credit risk across 5- and 10-year maturities. However, looking further out on the curve to longer-duration municipal bonds (30 years), municipal yields appear particularly attractive from a relative value perspective, with AAA and single-A rated municipal bonds out-yielding single-B rated corporates on a tax-adjusted basis. This anomaly in long-dated municipals represents one of the most attractive relative value opportunities across fixed income markets as we enter 2026.

Longer Duration Municipal Bond Yields Appear Attractive

Yields Across the Fixed Income Duration Spectrum



Source: Bloomberg, as of 31 December 2025.

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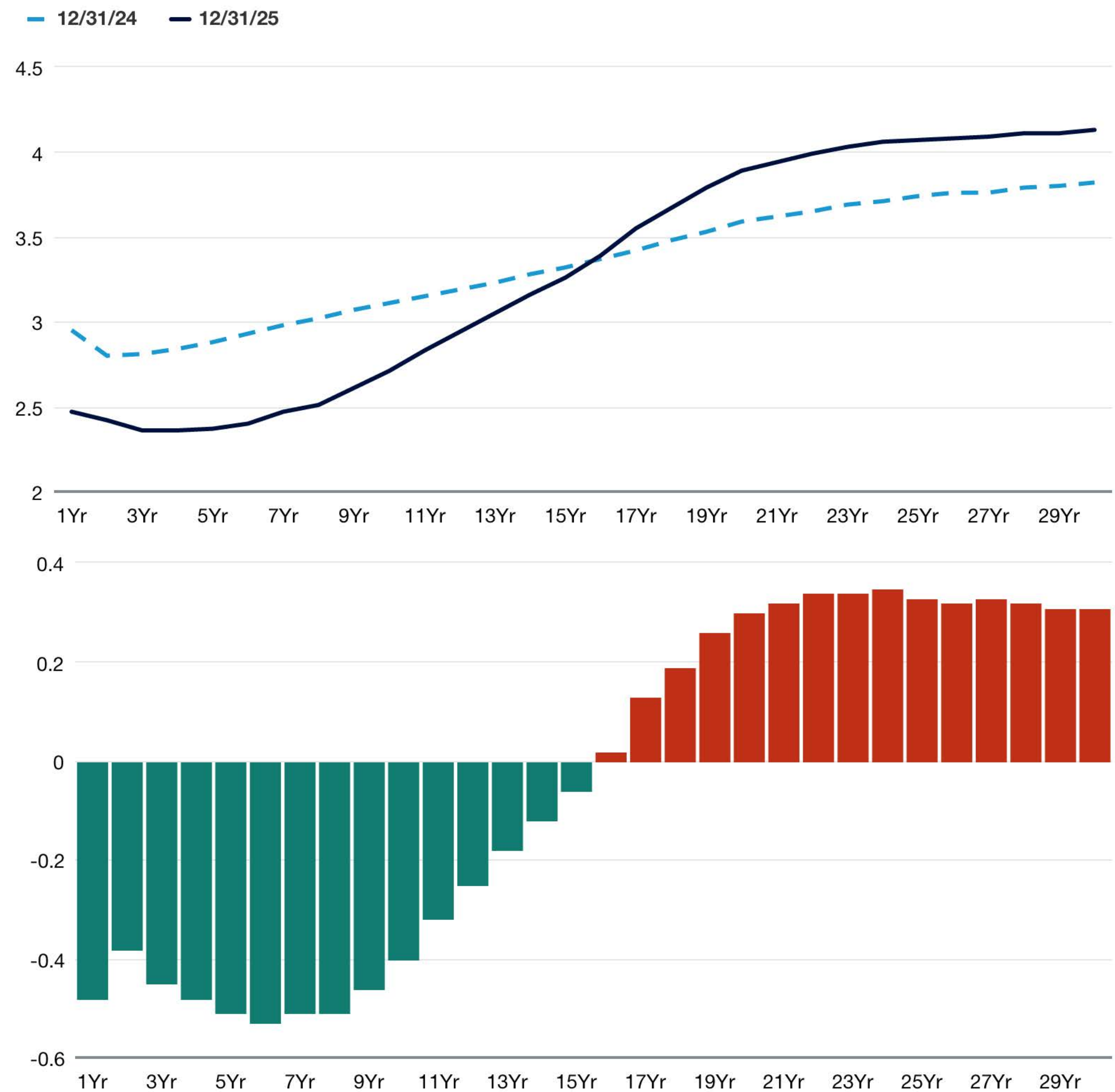
Municipal Duration Looks Attractive Heading Into 2026

While both the taxable and tax-free yield curves steepened in 2025, the AAA municipal bond yield curve saw diverging fortunes across maturities as illustrated in the chart below. Maturities under 15 years saw a tailwind from declining rates while longer maturities experienced a headwind with rates rising. We believe this offers an attractive entry point for adding incremental duration across portfolios.

The AAA Municipal Yield Curve Steepened in 2025, Creating Attractive Entry Points in Intermediate Long Duration

Muni AAA Yield Curve



Source: Bloomberg, as of 31 December 2025.

Key takeaway: Consider adding long-duration municipal exposure to lock in attractive yields. For investors seeking tax efficiency, municipals offer a compelling alternative to taxable bonds while providing exposure to generally high-quality issuers with essential service revenues.

Final Thoughts

While investors remain attentive to macro and policy developments, the primary focus of fixed income investors should not be to forecast interest rates or spreads but to evaluate how individual securities and structures are positioned to perform across a range of economic outcomes. In 2026, this means balancing income potential against asymmetric risks, being selective about credit exposure, and maintaining the flexibility to adapt as market conditions evolve. The most valuable role active fixed income management can play is helping portfolios remain resilient by seeking income where compensation for risk is compelling, managing downside where asymmetries exist, and navigating uncertainty with discipline rather than prediction.

Important Information