DECEMBER 2025

Fixed Income Focus: Special Edition

Summary

This special edition of the Monthly Fixed Income Focus marks the end of 2025 by highlighting five pivotal themes that defined the year's bond markets, and why they won't in 2026. Far from an obituary for opportunity, it reveals the new landscape. Our 2026 playbook starts here.

The end of 2025 and a look at 2026: As we look ahead to 2026, we are Positive on UK gilts, US Agency MBS, EUR IG and GBP IG corporate bonds, as well as EM local currency bonds, which we believe offer a compelling opportunity. Additionally, we like convertible bonds and US Treasury Inflation-Protected Securities.

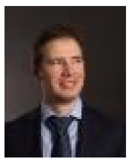
Contents

Five themes in transition:

1. **The end of 2025 and the end of high policy rates**
   Expect further cuts, EM local bonds gain
2. **The end of 2025 and the end of US repo stress**
   Funding pressures ease as liquidity normalises
3. **The end of 2025 and the end of bond scarcity in US IG corporate bonds**
   Heavy AI capex drives new US supply, prefer EUR and GBP IG corporate bonds
4. **The end of 2025 and the end of the Defined Benefit**
   Dutch pension reform reshapes capital allocation, expect a steeper curve, avoid long-dated German bonds, prefer EUR IG corporate bonds
5. **The end of 2025 and the end of the periphery's exceptionalism**
   Spreads converge, enjoy carry, not compression

Drafting completed on 18 December 2025

Edouard Desbonnets
Senior Investment Advisor, Fixed Income
BNP Paribas Wealth Management



BNP PARIBAS
WEALTH MANAGEMENT

The bank for a changing world

The end of 2025 and a look at 2026

As we look ahead to 2026, we expect central banks to continue on their paths established in 2025. We think the Federal Reserve and Bank of England will pursue rate cuts, with two cuts, to 3.25% and 3.50% respectively, while the ECB will remain on pause at 2% and the Bank of Japan will tighten further, with two rate hikes to 1.25%.

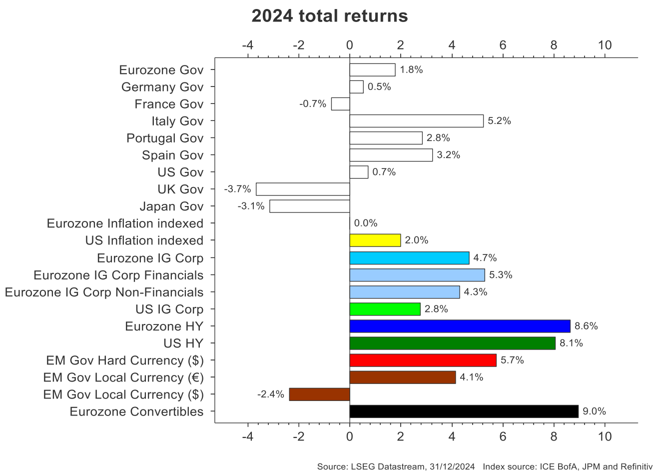
US yields will be anchored by inflation persistence and fiscal concerns, which means long-term yields will not decline in our view, despite Fed rate cuts. Our 12-month target for the 10-year yield is 4.25%, justifying a Neutral stance on nominal US government bonds; we avoid the long end of the curve. The sticky inflation backdrop supports our Positive stance on US Treasury Inflation-Protected Securities. In Europe, we expect steady economic growth, driven by fiscal expansion in Germany, subdued inflation, and record bond supply. We keep our 2.75% target for the 10-year bund and remain Neutral on eurozone sovereigns. We prefer UK gilts, as they offer value with high carry, negative net supply, and expected Bank of England cuts. We avoid Japanese government bonds.

In the global corporate space, credit spreads are either tight or very tight, but all-in yields remain elevated compared to history. The new story is that Tech giants will issue billions to finance AI and cloud infrastructure, creating technical headwinds for US investment grade (IG) corporate bonds, hence our Neutral view on that asset class. We prefer US Agency MBS since they offer similar yields relative to US IG, less duration risk and government guarantee. We also like EUR IG, given strong credit metrics and favourable risk-reward. We remain Positive on GBP IG, which benefits from a large carry cushion, expected lower bond yields, and negative net supply. In high yield (HY), we think valuations are stretched at index level. We'll enter short-dated HY on any correction.

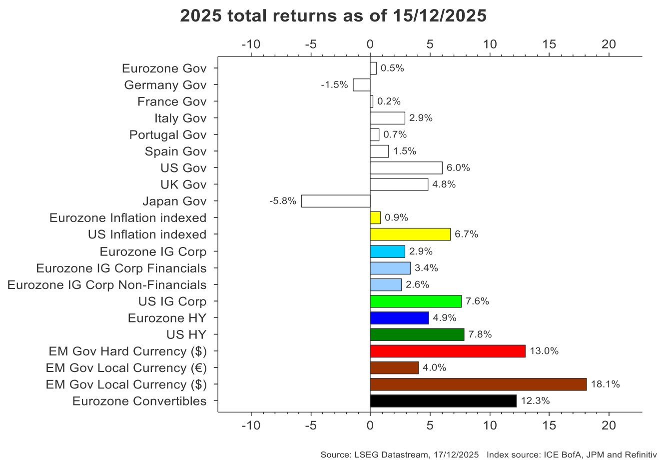
In Emerging Markets (EM), local currency bonds offer the best opportunity, with high real rates and expected appreciation of EM currencies. We are Neutral on hard currency bonds due to tight valuations.

We continue to like convertible bonds for their high equity valuations and relatively elevated coupons.

2024 SHOWED SOLID PERFORMANCE AMONG FIXED INCOME ASSET CLASSES



2025 SO FAR HAS DELIVERED DECENT RETURNS



INVESTMENT CONCLUSION

As we look ahead to 2026, we are Positive on UK gilts, US Agency MBS, EUR IG and GBP IG corporate bonds, as well as EM local currency bonds, which we believe offer a compelling opportunity. Additionally, we like convertible bonds and US Treasury Inflation-Protected Securities.

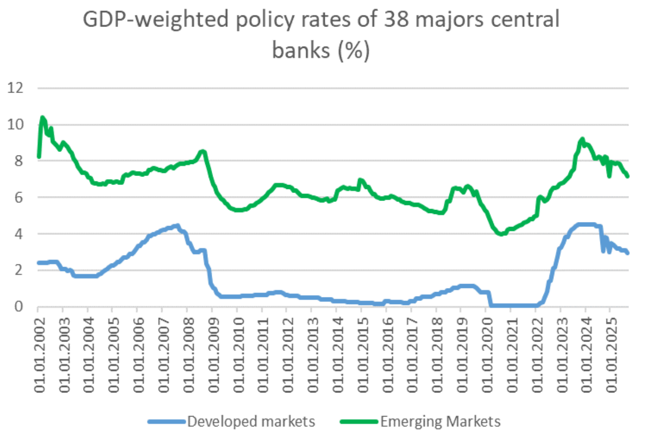
1. The end of 2025 and the end of high policy rates

Policy rates will be lower in 2026: the Federal Reserve will complete its cutting cycle by end-2026 in our view, delivering two additional rate cuts to 3.25%, extending the reductions initiated in 2024 as inflation moderated from cycle peaks. The ECB completed its easing in 2025, and shall remain on hold in 2026; we do not expect rate hikes before mid-2027. The Bank of England will continue its gradual reduction throughout 2026, we think, with two further cuts bringing rates to 3.50%. Beyond developed markets, emerging market central banks have embarked on their own easing paths, and we expect them to continue cutting rates in 2026.

The Bank of Japan remains the notable exception: the BoJ has initiated tightening at a pace materially slower than required for an economy running well above potential, with inflation persistently above target. We forecast two incremental 0.25% hikes in 2026, to 1.25%. As Japanese rates rise, Japanese investors who have massively exported capital for decades face a repatriation decision. This process will be gradual, since many investors keep bonds until maturity, and some investors (like hedged funds) will continue to invest internationally and seek FX risk, limiting significant repatriation flows to Japan. So, only investors who have hedged currency risk (banks, insurers, and pension funds) will be tempted to repatriate capital to reinvest in yen at elevated yields.

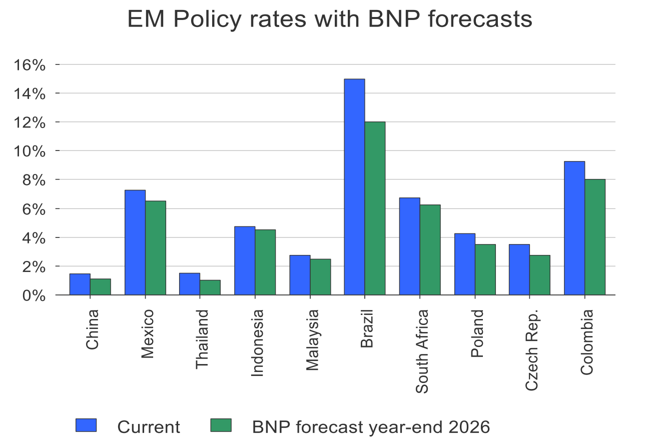
Lower rates create a support for emerging market local bonds: we forecast EM policy rates will decline, providing a monetary tailwind. Additionally, FX valuations appear attractive against the dollar, with us forecasting EM currency appreciation through 2026. Income remains compelling, at approximately 6% across the asset class. Fundamentals have improved materially, with several countries demonstrating enhanced fiscal discipline and supporting local debt sustainability. International investors remain underweight relative to historical allocations, creating potential room for significant inflows. We maintain a Positive stance on emerging market local bonds, though EUR-based investors should consider appropriate currency hedges.

POLICY RATES PEAKED IN LATE 2023 AND HAVE BEEN CUT SINCE THEN



Source: BIS, BNP Paribas WM, 17/12/2025

WE PROJECT LOWER POLICY RATES IN EMERGING MARKETS



Source: LSEG Datastream, 17/12/2025

INVESTMENT CONCLUSION

Many central banks, both in Developed Markets and Emerging Markets, will continue cutting rates in 2026, leading to lower policy rates. We think EM local bonds will benefit the most from this.

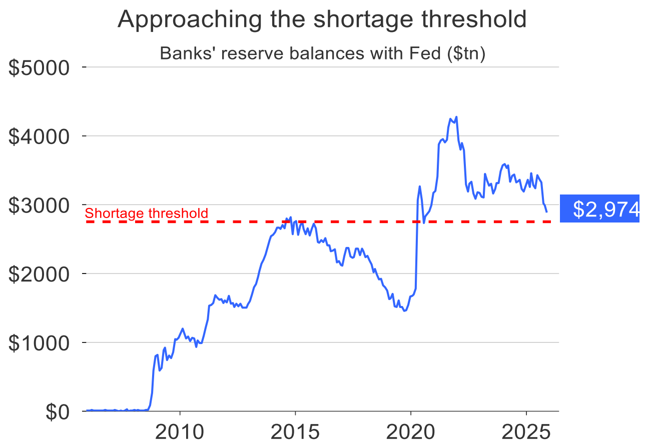
2. The end of 2025 and the end of US repo stress

Liquidity stress in US funding markets reflected structural imbalances: Through late October, several factors combined to tighten conditions in US funding markets. Heavy Treasury bill issuance absorbed cash from investors just as the Federal Reserve's Quantitative Tightening (QT) continued to reduce reserve balances. At the same time, the Treasury General Account (TGA) rose sharply as government spending was delayed by the partial shutdown, draining liquidity from banks and money market funds. The net effect was a measurable fall in system reserves. Repo rates, including SOFR, moved towards the upper end of the Fed's target range, prompting banks to draw on the Standing Repo Facility (SRF) in meaningful size for the first time since the pandemic. Although usage remained modest compared with the pandemic peak, it signalled an emerging shortage of cash in the system and suggested that the "ample reserves" framework was coming under pressure.

The Fed acted pre-emptively to avoid a repeat of 2019-style stress: With the Reverse Repo Facility almost depleted, the Fed knew that April tax payments, combined with continued heavy Treasury issuance, would drain liquidity directly from bank reserves rather than from money market buffers. In response, the Fed ended QT on 1 December and decided to reinvest the proceeds of MBS redemptions into Treasury bills. In addition, at the December FOMC meeting, the Fed announced the resumption of Reserve Management Purchases (RMP) of T-bills from 12 December, at a pace of $40 billion per month, in order to maintain ample reserves. Reserves had fallen close to the Fed's estimated scarcity threshold (see chart).

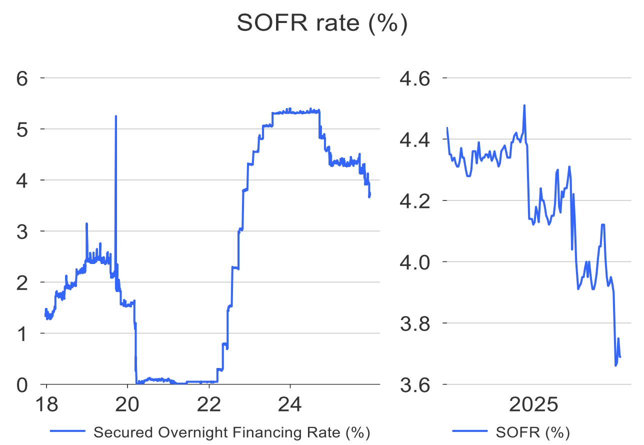
RMP is not Quantitative Easing (QE), even if both add liquidity: While QE is designed to stimulate the economy and lift inflation by purchasing long-dated assets, RMP aims instead to ensure market stability and ease short-term funding pressures by managing the level of reserves. The distinction is important for the policy stance, but the market impact on funding conditions has been clear. Following these measures, SOFR fell, indicating that the immediate liquidity stress had been brought under control.

THE FED'S QUANTITATIVE TIGHTENING REDUCED RESERVE BALANCES



Source: LSEG Datastream, 10/12/2025

SHORT-TERM FUNDING PRESSURES EASED AS THE SOFR RATE DROPS



Source: LSEG Datastream, 17/12/2025

INVESTMENT CONCLUSION

The Fed's December 2025 liquidity injection establishes the 2026 technical backdrop. We expect continued support from T-bill purchases stabilising reserves and funding markets.

3. The end of 2025 and the end of bond scarcity in US IG corporate bonds

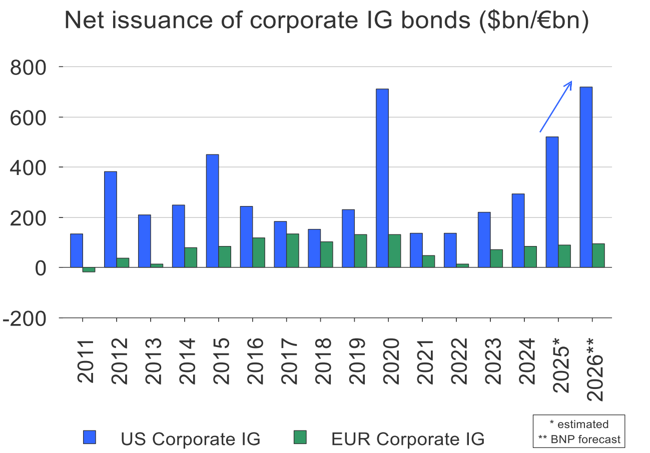
2026 vs 2025: Bond markets enter 2026 differently. In 2025, investors benefited from bond scarcity and strong technical support, while 2026 will see substantial bond supply in the US and corporate balance sheet normalisation. The tone shifts from scarcity-driven to carry-driven.

A key headwind emerges from the tech sector: major US tech and AI leaders will borrow heavily to fund AI and cloud infrastructure. We estimate issuance of $250 billion in 2026, ten times their five-year average. This long-dated supply will end the bond scarcity phase in US investment grade (IG), removing a technical tailwind. We forecast US net corporate IG issuance to rise 44% from 2025 to 2026 (see chart), driven by AI Hyperscalers' growing capex needs (Amazon, Microsoft, Alphabet, Meta, Oracle). In contrast, EUR corporate IG net supply will increase by only 6% in 2026, while GBP IG will see negative net supply in our view.

Corporate bonds start 2026 from a strong position: tight spreads, especially in the US (see chart), leave little room for compression, so carry will be the primary return driver. Corporate fundamentals remain solid, with healthy earnings. As issuance builds and management teams regain confidence, balance sheets will re-lever through investment and Merger & Acquisition. Credit metrics will remain sound, but the direction is no longer improving.

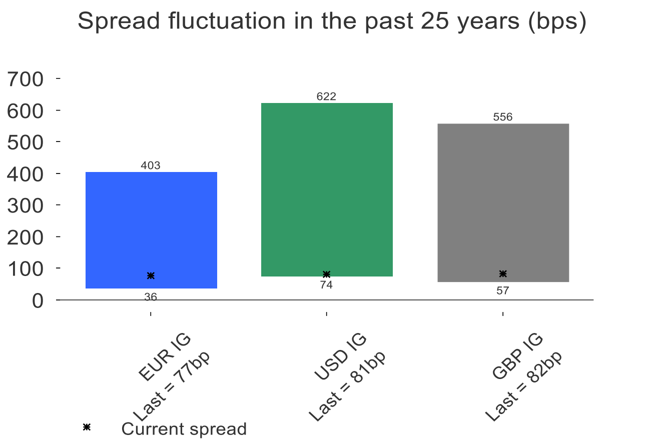
Investment implications: Given rich valuations, fading scarcity, and rising leverage, a more cautious stance is warranted, and we hold a Neutral view on USD IG credit. In contrast, we remain Positive on EUR IG, which benefits from a stable supply environment, better valuations, and German fiscal stimulus. We also remain Positive on GBP IG, which benefits from a large carry cushion, lower bond yields, and negative net supply. Our stance also reflects our conviction in regional diversification as a hedge against USD risks.

WE EXPECT US NET CORPORATE IG ISSUANCE TO SOAR IN 2026



Source: LSEG Datastream, Bloomberg, BNP Paribas, 17/12/2025

CREDIT SPREADS ARE CLOSE TO HISTORICAL TIGHTS, ESPECIALLY IN THE US



Source: LSEG Datastream, 17/12/2025

Investment Conclusion

2025 benefited from bond scarcity, but 2026 will mark the end of this tailwind in the US, as hyperscalers are expected to issue billions to fund AI and cloud infrastructure. In contrast, EUR IG net supply is expected to remain manageable, and GBP IG will even enjoy negative net supply. This supports our preference for EUR and GBP IG over USD IG corporate bonds.

4. The end of 2025 and the end of the Defined Benefit

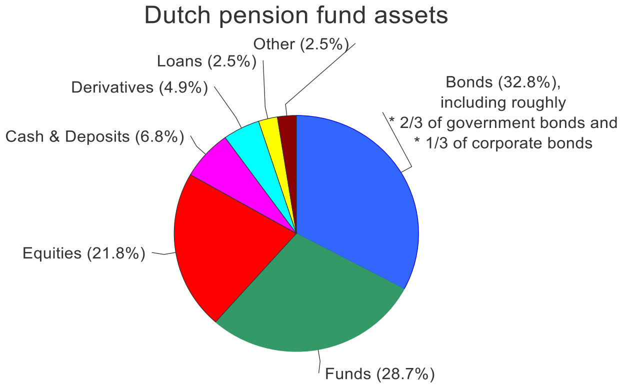
The Dutch pension reform is a transition from a Defined Benefit to a Defined Contribution pension system, which means that Dutch pension funds will no longer purchase bonds to match their known liabilities, a practice that had created stable, predictable buying patterns. Instead, Defined Contribution funds will allocate their assets based on asset allocation models rather than liability matching, resulting in more flexible positioning. Many funds are expected to switch to the new system from 1 January 2026, with approximately EUR 540bn in assets under management (AuM) anticipated to transition on that day. All schemes must be switched by 1 January 2027, with around EUR 900bn in AuM expected to transition on that day, or face fiscal consequences.

The Dutch pension system is large (€1.6 trillion) and holds a substantial quantity of long-dated government bonds, primarily in core and semi-core European government bonds, particularly German and French debt, as well as Dutch government bonds (see chart).

In practice, the reform eliminates a source of demand that has been supporting long-end valuations in the eurozone. This rebalancing coincides with an unprecedented surge in German net supply, which we estimate at €140 billion in 2026, four times the 25-year average. Unlike cyclical supply shocks, this structural and permanent shift will represent a persistent technical headwind.

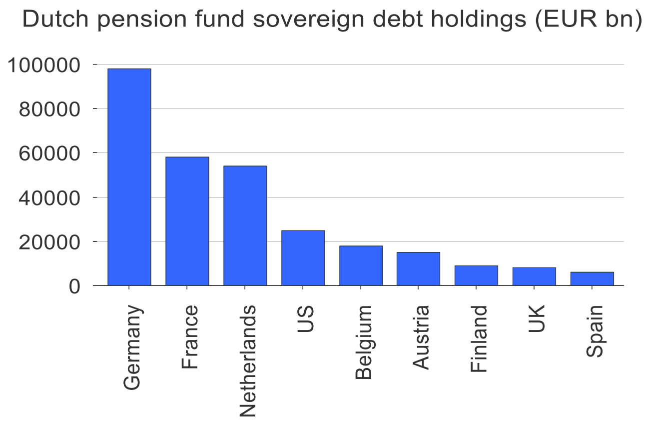
Capital reallocation: We expect reductions in bond holdings during the January 2026 transition, particularly at the longer end of the curve. With Dutch pension funds buying fewer longer-dated government bonds whilst German supply remains substantial, we anticipate a steeper curve (see chart) and further repricing of term premium. We therefore avoid long-dated German bonds. Several asset classes will benefit from the reallocation, with euro credit being a possible beneficiary.

DUTCH PENSION EXPOSURE: HIGH WEIGHT IN FIXED INCOME



Source: LSEG Datastream, Dutch National Central Bank, Q3 2025

DUTCH PENSION FUNDS ARE LARGELY INVESTED IN BUNDs, OATs AND DSLs



Source: LSEG Datastream, Eiopa, BNP Paribas, as at Q2 2025

INVESTMENT CONCLUSION

2025 saw Dutch pension funds providing demand for longer-term government bonds, but 2026 will reverse this dynamic. The combination of reallocating away from longer-dated bonds and record German supply creates a headwind for core duration. We expect a steeper curve, avoid long-dated German bonds, and see euro credit as a beneficiary of pension reallocation flows.

5. The end of 2025 and the end of the periphery's exceptionalism

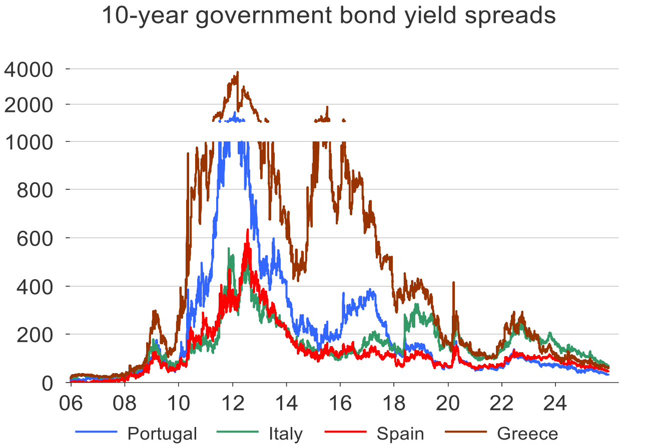
Periphery convergence: Periphery spreads have compressed materially over the past several years (see chart). This reflects years of deficit reduction and stronger public finances by these countries, supported by multiple rating upgrades. The ECB's anti-fragmentation backstop, the TPI (Transmission Protection Instrument), further underpins this convergence by providing reassurance against any potential fragmentation risk. Additionally, common EU-level borrowing through the Recovery and Resilience Facility has reduced individual periphery countries' need to issue, easing supply pressures and supporting technical conditions.

Periphery fundamentals: We forecast Italy and Spain to grow 1.0% and 2.4%, respectively, in 2026, with inflation moderating to 1.5% and 2.3%. Notably, Spain's growth outlook outpaces both Germany (1.4%) and the eurozone average (1.5%), whilst Italy edges ahead of France (1.1%). These countries have made tangible progress on public finances and debt sustainability. Italy's debt-to-GDP ratio stands at 137%, whilst Spain has made more notable progress, with its ratio at 93%, and Portugal at 77%. These levels are stabilising, with gradual improvement expected as fiscal consolidation efforts take effect.

Limited spread tightening ahead: After the sharp rally already experienced in spreads, we expect only limited further tightening, with Italian 10-year spreads versus Bunds narrowing by around 10bp to 65bp by the end of 2026, whilst we see Spain and Portugal stabilising near 45bp and 35bp, respectively.

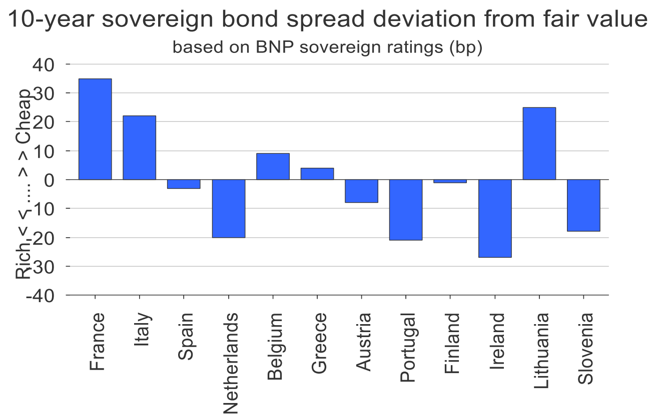
Periphery valuation: Periphery bonds offer attractive carry, but the potential for further spread compression is limited. Only Italy appears somewhat undervalued relative to its credit rating, which we have forecasted. In contrast, Spain seems fairly valued, while Portugal appears slightly overvalued. Considering the current valuations and solid carry, we remain Neutral on the periphery.

PERIPHERY SPREADS HAVE COMPRESSED MATERIALLY



Source: LSEG Datastream, 17/12/2025

ITALY OFFERS RESIDUAL VALUE, SPAIN IS FAIR, AND PORTUGAL IS RICH



Source: LSEG Datastream, BNP Paribas, 17/12/2025

Investment Conclusion

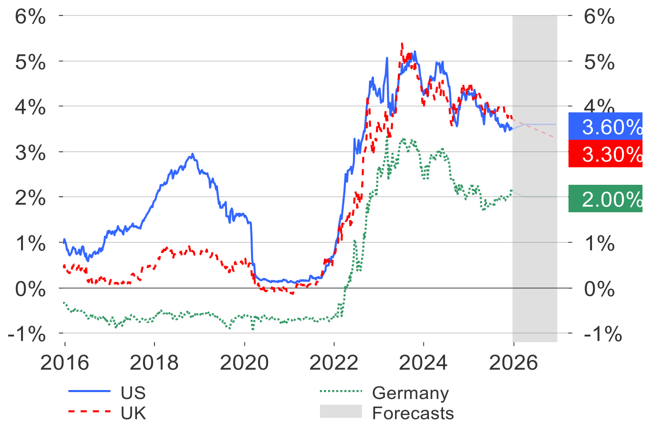
The periphery is no longer what it used to be. Tangible progress has been made on public finances and debt sustainability, and spreads to Bunds have significantly compressed. Tighter spreads, stronger fundamentals, and reduced issuance needs have eroded the exceptional risk premia that once characterised these markets. We therefore hold a Neutral stance on periphery bonds, forecasting limited spread tightening.

Bond yields forecasts

	Maturity (years)	17/12/2025	3-month target	12-month target
USA	Policy rate	3.75	3.75	3.25
	2	3.48	3.60	3.60
	5	3.70	3.75	3.75
	10	4.15	4.10	4.25
	30	4.82	4.75	4.90
Germany	Policy rate	2.00	2.00	2.00
	2	2.14	2.00	2.00
	5	2.47	2.25	2.25
	10	2.87	2.75	2.75
	30	3.49	3.50	3.60
UK	Policy rate	4.00	3.50	3.50
	2	3.72	3.60	3.30
	5	3.92	3.80	3.75
	10	4.48	4.40	4.30
	30	5.23	5.20	5.10
Japan	Policy rate	0.50	0.75	1.25
	2	1.07	1.15	1.30
	5	1.44	1.40	1.60
	10	1.98	1.90	2.10
	30	3.35	3.35	3.50

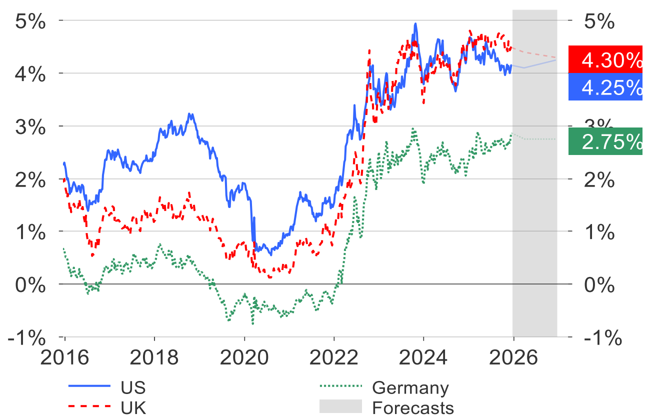
Source: Refinitiv Datastream, BNP Paribas WM

2-YEAR RATES



Source: LSEG Datastream, 18/12/2025

10-YEAR RATES



Source: LSEG Datastream, 18/12/2025

Our Investment Recommendations

Asset class	Zone	Our opinion	
Government bonds	Germany	=	Neutral on German sovereign bonds. Prefer 2-5 years maturities.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United Kingdom	+	Positive on UK government bonds.
	United States	=	Neutral on US sovereign bonds, prefer 2-5 years maturities. Positive on TIPS.
Corporate bonds Investment Grade (IG)	Eurozone United Kingdom United States	+	• Positive on EUR and GBP IG corporate bonds, and Neutral on USD IG corporate bonds. • We prefer maturities up to 7 years in the eurozone and up to 5 years in the US. • Positive on convertible bonds in the eurozone.
Corporate bonds High Yield (HY)	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angels* and *rising stars.*
Emerging bonds	In hard currency	=	Neutral on EM hard currency bonds (sovereign and corporate).
	In local currency	+	Positive on EM local currency government bonds.

Market Data

	10-year rate (%)	Spread to bund (bp)	Spread change 1 month (bp)
United States	4.15	---	
Germany	2.87	---	
France	3.58	71	-1
Italy	3.54	67	-3
Spain	3.30	44	-3
Portugal	3.17	30	-3
Greece	3.47	60	-4

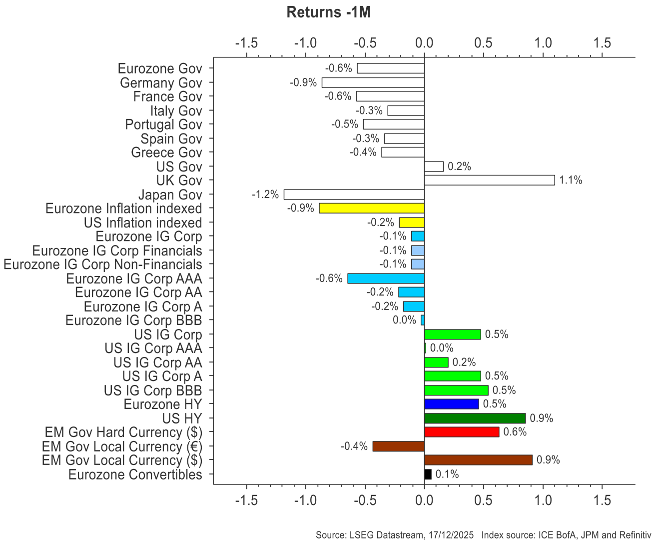
17/12/2025
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.53	28	-2
Corporate bonds IG EUR	3.22	76	0
Corporate bonds IG USD	4.83	81	3
Corporate bonds HY EUR	5.10	279	0
Corporate bonds HY USD	6.76	312	8
Emerging government bonds in hard currency	6.62	234	-5
Emerging government bonds in local currency	5.93	223	-3

17/12/2025
Source: Refinitiv Datastream, Bloomberg

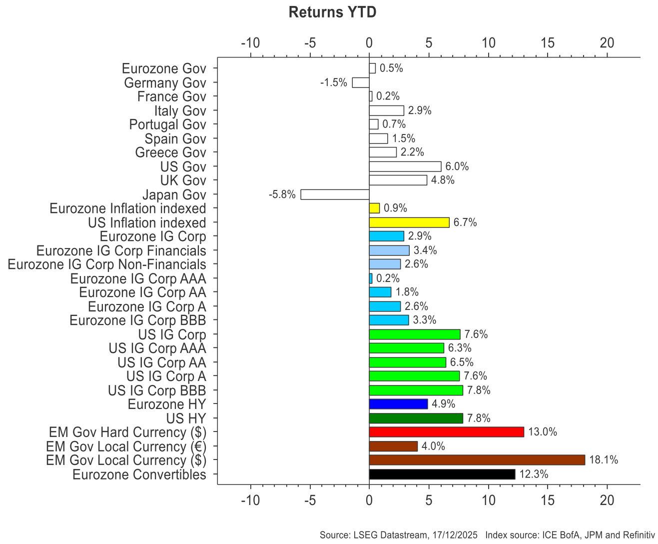
Returns

OVER ONE MONTH



EM = Emerging Markets

SINCE 01/01/2025



THE INVESTMENT STRATEGY TEAM

FRANCE

Edmund SHING
Global Chief Investment Officer

Jean-Roland DESSARD
Chief Investment Advisor

Isabelle ENOS
Investment Advisor

ITALY

Luca IANDIMARINO
Chief Investment Advisor

BELGIUM

Philippe GIJSELS
Chief Investment Advisor

Alain GERARD
Senior Investment Advisor, Equities

Patrick CASSELMAN
Senior Commodities Strategist

GERMANY

Stephan KEMPER
Chief Investment Strategist
Stefan MALY

LUXEMBOURG

Guy ERTZ
Chief Investment Advisor – Deputy Global CIO

Edouard DESBONNETS
Senior Investment Advisor, Fixed Income

ASIA

Prashant BHAYANI
Chief Investment Officer, Asia

Grace TAM
Chief Investment Advisor, Asia

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