Morgan Stanley
INVESTMENT MANAGEMENT

Broad Markets Fixed Income Multi-Sector Playbook

A World of Increasing Dispersion

OUTLOOK | BROAD MARKETS FIXED INCOME | Mid-Year 2026

The defining feature of today's investment environment is no longer simply higher interest rates, but increasing dispersion across countries, industries and issuers. While global growth has remained resilient despite elevated rates, inflation uncertainty and geopolitical tensions, the underlying drivers of growth are becoming less synchronized. Fiscal capacity differs dramatically across countries, AI adoption is creating clear winners and losers and trade policy is reshaping supply chains and capital flows. The result is a world where economic and market outcomes are becoming increasingly differentiated, creating both opportunities and risks for active investors.

Monetary policy increasingly reflects this dispersion. The era of coordinated central bank actions appears behind us, as policymakers respond to different inflation pressures, growth trajectories, labor-market conditions and fiscal realities. Some economies continue to confront persistent inflation and resilient demand, while others face slowing growth and greater pressure to ease. Central bank divergence is becoming a structural feature of markets rather than a cyclical anomaly.

The same forces are even more evident within credit markets. Corporate fundamentals remain broadly healthy, but the gap between winners and losers continues to widen. AI-related investment in technology, utilities, power infrastructure and data centers is driving substantial capital needs and debt issuance, while technological disruption is challenging established business models across numerous industries. With broad credit spreads already near historically tight levels, dispersion matters more than ever. We believe the opportunity is less about capturing further spread compression and more about identifying future winners while avoiding future losers.

Higher starting yields remain one of the most compelling opportunities for fixed income investors. After more than a decade of exceptionally low rates, investors can once again earn attractive levels of income without reaching excessively far down the quality spectrum. Real yields are also near

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the high end of their post-Global Financial Crisis range, making valuations attractive not only from an all-in yield perspective, but also on a real-yield basis. The return of meaningful fixed income inflows reflects this reality, as investors increasingly recognize that income and carry, rather than spread compression, are likely to drive a larger share of future returns.

Demand for high-quality fixed income has also remained exceptionally strong. Yield buyers continue to be drawn to the asset class by attractive income, while many investors remain historically under-allocated to fixed income after years of low yields and strong equity-market performance. At the same time, the scale of equity gains over the past several years has created a natural rebalancing impulse back toward bonds. These flows have helped support high-quality credit and securitized markets, even as issuance has remained elevated.

Perhaps most importantly, debt-capitalization-weighted benchmarks continue to become more concentrated in the most heavily indebted segments of the market. Governments with the largest deficits issue the most debt and therefore command greater benchmark weight. Similarly, sectors with the largest financing needs become larger portions of corporate indexes regardless of valuation, leverage or fundamentals. In the U.S. Aggregate Index, Treasury exposure has more than doubled over the past two decades, while duration has increased meaningfully, leaving passive investors with greater concentration and interest-rate sensitivity than they may realize. In our view, this creates a growing disconnect between benchmark composition and investment opportunity.

This also means that some of the most attractive opportunities may lie outside traditional benchmark exposures. The eligible fixed income universe beyond the U.S. Aggregate Index is larger and more diverse than the index itself, spanning securitized credit, global sovereigns, emerging markets, loans, private and direct lending and other areas where active investors can be more deliberate about valuation, structure, credit quality and liquidity. A purely passive approach may increasingly allocate capital based on where debt has been issued, rather than where investors are being adequately compensated for risk.

This environment reinforces the importance of active management, dynamic asset allocation and resilient portfolio construction. When spreads are tight, macroeconomic outcomes are becoming more dispersed and issuer fundamentals are diverging, investors have less room for error. We believe this argues for upgrading portfolio quality, emphasizing durable business models, stronger balance sheets and sectors where investors are being adequately compensated for risk. Higher-quality fixed income, securitized assets and carefully selected credit exposures provide the opportunity to earn attractive income while remaining resilient across a wide range of economic outcomes. In a world where carry is abundant but spread compression potential is limited, success may depend less on reaching for additional yield and more on preserving capital, avoiding deteriorating credits, rotating dynamically across sectors and countries and allowing income to compound over time.

Key themes for second half 2026

- Increasing macroeconomic dispersion is driving greater differentiation across countries, interest-rate markets, currencies, industries and issuers.
- Central bank policy divergence is becoming a structural feature of the investment landscape, with the Warsh-led Fed adding uncertainty around the U.S. reaction function, and the balance of risks skewed more toward renewed tightening than cuts.
- Higher starting yields continue to provide a compelling opportunity to increase fixed income allocations and improve portfolio income generation.
- Real yields remain near the high end of their post-Global Financial Crisis range, making valuations attractive not only from an all-in yield perspective, but also on a real-yield basis.
- Fixed income flows increasingly reflect the attractiveness of income and carry as primary return drivers, supported by strong demand from yield buyers and investors rebalancing after several years of strong equity-market performance.
- Fiscal deficits are supporting growth but contributing to higher term premiums, greater sovereign differentiation and increased benchmark concentration in highly indebted issuers.
- Uncertainty around Iran, energy markets and the status of peace talks remains a key macro risk, with potential implications for inflation, breakevens, central bank policy, currencies and commodity-sensitive economies.
- AI investment remains a powerful growth driver, but the benefits and costs are unevenly distributed across industries and issuers.
- Tight index-level spreads increase the importance of credit selection, downside-risk management and avoiding uncompensated risks.

- We favor resilience through higher-quality exposures, stronger balance sheets and sectors supported by durable fundamentals.
- Fixed income benchmarks are becoming increasingly concentrated in highly indebted sovereign and corporate issuers, making active allocation more important.
- Securitized credit remains one of our highest-conviction opportunities given attractive relative valuations, strong collateral performance and favorable technicals.
- In a high-carry environment, capital preservation and avoiding future credit losers may prove just as important as identifying future winners.

2026 themes and positioning

THEME	POSITIONING
Higher real yields and sticky inflation define the midyear opportunity set.	Favor U.S. TIPS and selective real-yield exposure; maintain inflation-linked strategies where breakevens provide a low hurdle.
Central bank divergence has become more pronounced.	Maintain selective duration exposure rather than broad duration risk; favor markets where growth vulnerability and real-yield valuations are compelling, while remaining cautious where policy normalization creates upside yield risk.
Iran and energy-market uncertainty remain important inflation and volatility risks.	Maintain inflation-linked exposure and selective real-yield strategies; favor country, currency and sector positions that are resilient to energy-price volatility and avoid broad exposures where inflation risk isn't adequately compensated.
Fiscal constraints and political uncertainty continue to drive sovereign differentiation.	Emphasize country selection across developed-market rates; retain long-end real-yield value in select markets but require greater compensation where fiscal credibility is in question.
Risk assets remain resilient, but tight spreads limit broad beta opportunities.	Reduce reliance on spread compression; emphasize carry, income, sector allocation and bottom-up security selection as the primary drivers of excess return.
Securitized credit remains a high-conviction allocation.	Maintain overweight exposure to agency mortgage-backed securities (MBS), non-agency residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS) and select agency-backed securities (ABS), with a focus on high-quality collateral, strong structures and resilient cash flows.
Corporate credit is later cycle, with issuance and capex pressures rising.	Stay underweight investment grade corporates overall, prefer Europe over the U.S., favor financials and remain selective in high-yield, where dispersion creates opportunities.
AI and infrastructure investment remain important growth and issuance drivers.	Maintain a high-quality bias; selectively own issuers with durable cash flows and pricing power while avoiding balance sheets vulnerable to capex pressure, refinancing risk or technology disruption.
Emerging markets (EMs) continue to benefit from carry and real-yield differentials.	Maintain an overweight to select EM sovereigns, corporates and currencies, emphasizing credible policy frameworks, improving fundamentals and attractive real-yield compensation.
Leveraged loans have become more balanced after valuation improvement.	Move to overweight; focus on higher-quality issuers and resilient sectors where current spreads better compensate investors for refinancing risk and macro uncertainty.
Currency markets remain highly sensitive to policy, energy and geopolitical shocks.	Favor selective high-carry currencies supported by fundamentals and valuation, while avoiding broad directional FX exposure where central bank reaction functions remain uncertain.

Sector outlooks: Where we see value

Valuations remain tight across fixed income, but risk assets have continued to show resilience despite sticky inflation, tighter monetary-policy expectations and geopolitical uncertainty. Strong demand for all-in yield, resilient fundamentals and supportive technicals have helped absorb heavy issuance. With broad spread compression increasingly limited, we believe carry, sector allocation and bottom-up security selection will be the key drivers of excess return.

AGENCY MBS AND NON-AGENCY RMBS (OVERWEIGHT)

Agency MBS and non-agency RMBS remain a high-conviction overweight. Agency MBS spreads retraced much of their earlier widening as demand remained strong and mortgage rates moved off recent highs. Current-coupon pools continue to offer attractive relative value compared with both historical levels and other core fixed income sectors, while a higher-for-longer rate backdrop should help keep prepayment risk contained and favor yield pickup over Treasurys.

Technicals remain supportive, with demand from money managers, banks and Government-sponsored enterprises benefiting from attractive all-in yields and improving relative value. Non-agency RMBS also remains attractive, supported by stable home prices, low loan-to-value ratios, improving collateral performance and limited refinancing risk. We also remain constructive on Danish covered bonds, where defensive characteristics, strong legal frameworks and attractive U.S.-dollar-hedged yields support relative value.

CMBS (OVERWEIGHT)

CMBS remains an attractive area of structured credit, though selectivity is critical. Fundamentals are resilient in higher-quality segments, and strong technical demand has continued to support the sector despite the higher-rate environment. We favor hospitality, logistics, storage and high-quality multifamily assets, where operating performance and collateral quality remain comparatively strong.

Issuance has been robust, particularly through the single-asset single-borrower market, but many transactions have been well absorbed. Dispersion across property types, locations and capital structures remains elevated, reinforcing our focus on higher-quality transactions with stronger collateral performance, borrower sponsorship and cash-flow visibility.

ABS (OVERWEIGHT)

ABS remains supported by strong demand, attractive carry and the sector's shorter-duration profile. Issuance has been elevated, but demand for high-quality securitized collateral has remained resilient, helping spreads stay contained despite supply.

We continue to see opportunities in select non-consumer ABS where fundamentals remain stable and valuations are still attractive. We remain more cautious in areas where spreads don't adequately reflect projected supply, technology disruption or uncertain long-term economics.

INVESTMENT-GRADE CREDIT (UNDERWEIGHT)

We remain underweight on investment-grade (IG) corporates because of tight valuations and limited room for broad spread compression. Credit fundamentals remain solid, supported by healthy balance sheets, low downgrade risk and resilient earnings. However, strong demand for all-in yield has already compressed spreads, leaving carry as the primary driver of expected returns and reducing the margin for error.

The market is also moving into a later-cycle phase marked by elevated merger and acquisition (M&A) activity, AI- and infrastructure-related capex, higher shareholder distributions and continued issuance from large technology and hyperscale issuers. Regionally, we prefer Europe over the U.S. given more balanced supply dynamics and stronger demand for high-quality carry. By sector, we favor financials—particularly banks—and remain cautious on single-A non-financials, where M&A and capex pressures could weigh on balance sheets.

HIGH-YIELD CREDIT (SMALL OVERWEIGHT)

We maintain a modest overweight to select high-yield issuers in the U.S. and Europe. Fundamentals remain supportive, with improved average credit quality, manageable leverage and contained default expectations. Resilient growth, fiscal support and demand for income continue to support the asset class.

That said, spreads remain historically tight, and much of the good news is priced in. We favor issuers with durable cash flows, pricing power, lower refinancing risk and less exposure to cyclical demand pressure. Dispersion across sectors and issuers remains a key source of opportunity.

EMERGING MARKETS (OVERWEIGHT)

Emerging market (EM) sovereign and corporate debt remains attractive, supported by elevated real yields, resilient technicals and improving fundamentals in select countries. Carry and income remain central return drivers, though country selection is critical given wide dispersion across regions.

Higher energy prices continue to create divergence between commodity exporters and importers, while local politics remain an important source of idiosyncratic risk and opportunity. We favor countries with credible monetary frameworks, improving fundamentals and attractive real-yield differentials. Select local and hard-currency markets continue to offer compelling risk-adjusted return potential.

LEVERAGED LOANS (OVERWEIGHT)

We've moved to a more overweight stance on leveraged loans as wider dispersion and spread widening have improved valuations across parts of the market. Centralized loan obligation demand remains supportive, and investor preference continues to focus on higher-quality issuers and resilient sectors.

Software- and technology-linked issuers remain an area of caution given uncertainty around AI disruption, but the selloff has also created selective opportunities in mission-critical businesses with durable cash flows, proprietary data advantages and high switching costs. More broadly, economically sensitive sectors remain pressured by elevated financing costs and inflation uncertainty. Selectivity remains paramount, but current valuations increasingly compensate investors for refinancing risk and macro uncertainty in higher-quality segments.

Macro breakdown: Where we see value across rates and FX

RATES AND FX (LONG-DURATION, NEUTRAL CURVE POSITIONING AND SELECTIVE HIGH-CARRY FX)

The sector views above are grounded in a macro environment where country differentiation is becoming increasingly important. The market narrative has continued to shift away from recession concerns and toward the durability of growth and inflation. In the U.S., stronger-than-expected labor-market data, resilient consumption and firm inflation readings have led investors to reprice monetary-policy expectations toward a more restrictive path than was expected at the beginning of the year. Elsewhere in developed markets, much of this repricing occurred earlier, though inflation and energy-related risks continue to influence central bank expectations.

Against this backdrop, we maintain a long-duration stance across developed markets, though positioning remains selective and focused on regions where growth appears more vulnerable to tighter financial conditions and where valuations are compelling. Exposure is concentrated in front-end rates markets outside the U.S., alongside a long position in U.S. TIPS.

Inflation remains the primary macro risk. Although longer-dated inflation expectations have retraced modestly, core inflation measures and producer-price pressures remain firm. We therefore maintain some exposure to U.S. inflation-linked markets, where we continue to see value in managing portfolios against the risk that inflation remains above central bank targets for longer than currently anticipated.

Curve dynamics have generally stabilized following the sharp repricing earlier in the year, and we remain neutral on outright curve positioning. While elevated fiscal deficits, AI-related investment spending and energy-market uncertainty continue to support higher term premiums over the medium term, recent moves have reduced the attractiveness of broad directional curve expressions.

In foreign exchange, we continue to favor selective high-carry EM currencies where fundamentals and valuations remain supportive. Positioning is focused on differentiated opportunities in EM, where carry characteristics and domestic drivers remain attractive with funding of long positions moved partially away from U.S. dollar to lower-yielding and lower-growth European currencies. More broadly, we expect currency markets to remain highly sensitive to evolving central bank expectations, energy prices and geopolitical developments, with relative growth and inflation dynamics continuing to drive performance across developed and emerging markets.

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