

Long-end strains, IG gains

- ▶ Sovereign yield curves have steepened significantly, and we see this continuing in the near-term; we prefer shorter duration rates.
- ▶ Rising long rates point to investor unease with debt sustainability, we expect this dynamic to keep yields at the farther end higher.
- ▶ We remain constructive on IG corporates supported by low recession risk, and a dovish Fed; expect spreads to be range-bound.
- ▶ Within IG, we see opportunities in: 5-7-year by duration, BBBs by rating, utilities and energy by sector; short-end hybrids.

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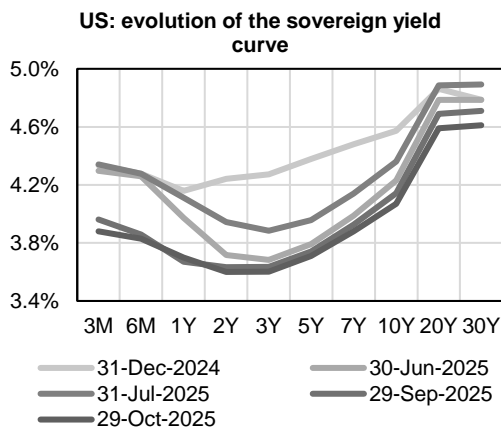
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Developed Market sovereigns: prefer shorter duration; cautious on the long-end

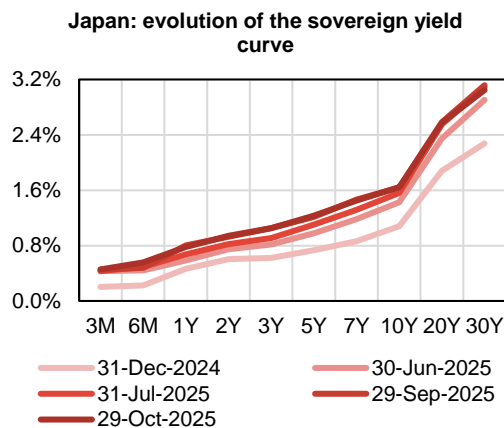
Developed Market (DM) sovereigns, as an asset class, has done well so far this year (with Bloomberg Treasuries index rising c7%) year-to-date. Thanks to the well-behaved inflation and cooling of labour markets around major DM economies, interest rate outlook has incrementally turned benign, if not supportive. However, we note that the yield curves have steepened across the board as long-end rates remained sticky while – the short-end rates fell in anticipation of easier monetary policy in case of the US (exhibit 1) and short-end rates rose as markets expected policy normalization in Japan (exhibit 2). We continue to expect further steepening of the DM sovereign rates curves – and see both scenarios of bull and bear steepening episodes playing out over the next 12 months, with the latter occurring more frequently than the former as we expect growth to reaccelerate into 2026.

Exhibit 1: US yield curves steepened as rates curve shifted downwards



Source: LSEG Workspace, and ADCB Asset Management

Exhibit 2: Japanese yield curves consistently shifted upwards resulting in steeper curve as well



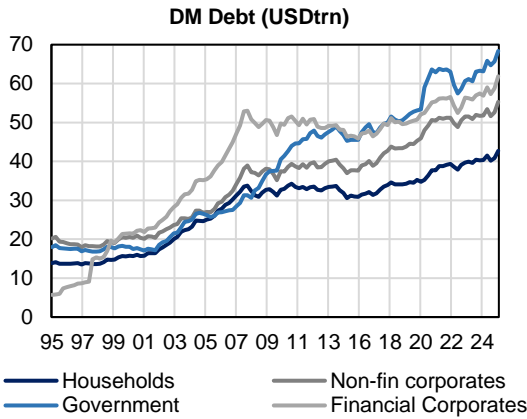
Source: LSEG Workspace, and ADCB Asset Management

In this section, we examine the impact of increasing sovereign debt levels on long-term interest rates, highlighting how these dynamics establish a lower-bound on rates in certain economies while exerting upward pressure in others.

Rising debt burdens across DMs

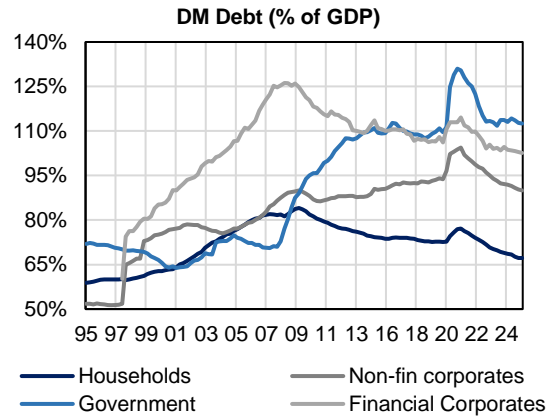
DM government debt continues to rise relentlessly, with FitchRatings estimating another USD6trn to be added in 2025 alone and outpacing the growth of debt in other sectors of the economy (exhibit 3). Even as share of GDP, government debt is high and stable while other sectors posted declines (exhibit 4). The US and France stand out as the fastest-rising debt-to-GDP cases, driven by persistent budget deficits. While Eurozone periphery countries such as Italy, Spain, Portugal, and Slovenia have seen relative improvements in debt ratios and even rating upgrades by Fitch, several “core” sovereigns (France, Belgium, Austria, and Finland) have faced downgrades due to deteriorating public finances. Overall, in Eurozone, debt burdens in the periphery are stabilizing or falling, while in the core they are rising, narrowing the gap in credit profiles.

Exhibit 3: DM debt levels are on the rise as government debt outpaces other sectors



Source: The Institute of International Finance, and ADCB Asset Management

Exhibit 4: Government debt continues to rise at the pace of the GDP

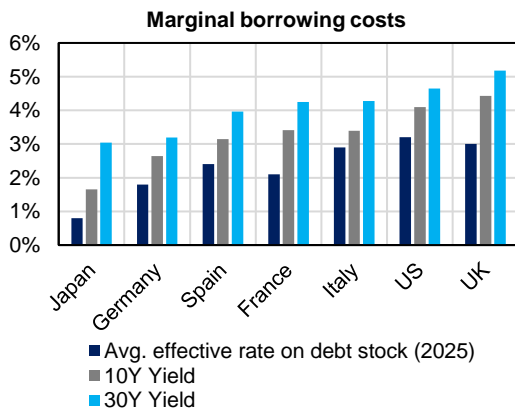


Source: The Institute of International Finance, and ADCB Asset Management

Incrementally, debt dynamics are becoming more challenging across most DMs. The key metric is the interest-growth differential. When borrowing costs exceed growth potential, governments must run tighter primary balances to stabilize debt. For most DM sovereigns, this differential is indeed worsening, implying that fiscal tightening will be required just to prevent debt ratios from climbing further. Average debt maturities provide some breathing room in case of UK, Japan, France, and Spain which have longer maturities, slowing the pass-through of higher yields into debt servicing costs. But over time, refinancing at higher rates will weigh heavily. In case of the US, Germany, and Italy, where the average debt maturity is short, risks could be more evident.

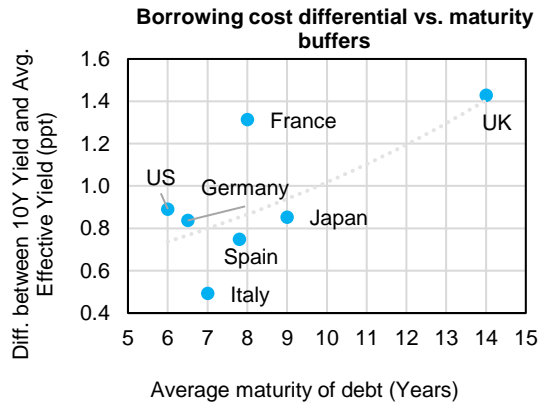
A central theme is that marginal borrowing costs are now above the average effective rate on outstanding debt in most DM sovereigns. This means that every new bond issued increases the average cost of debt. Here, UK, and France stand out with marginal borrowing costs well above their effective rate on outstanding standing debt (exhibit 5).

Exhibit 5: Effective rate on debt stock is only set to rise across major developed markets



Source: FitchRatings

Exhibit 6: Despite the breathing room due to higher average maturity of debt, UK, and France remain vulnerable



Source: FitchRatings

Long-end sovereign bond outlook

While 10Y yields have remained broadly stable through 2025, 30Y yields have risen, creating a steeper curve and signalling investor caution about long-term fiscal sustainability. In our view, the long end of the curve is where risks are most visible at this stage.

30Y yields are climbing relative to 10Y yields, pointing to higher term risk premium as investors seek greater compensation for duration and heightened fiscal uncertainty. While we do not anticipate a bond market shock with rates rising sharply from the current levels as our central scenario, we note that should marginal borrowing costs move towards with 30Y yields, fiscal trajectories could deteriorate markedly, leading to wider deficits and increased debt-to-GDP ratios. This scenario risks creating a negative feedback loop in which higher long-end yields drive up debt servicing costs, resulting in larger deficits, eroding market confidence, and further upward pressure on yields. Consequently, according to FitchRatings, sovereign credit ratings may come under strain if governments fail to deliver credible fiscal consolidation plans, with France standing out as particularly exposed due to political fragmentation that clouds fiscal clarity.

If markets doubt governments' ability to deliver fiscal tightening, credibility gaps may emerge, causing long-end yields to rise further. At the same time, political incapacity – such as legislative gridlock or populist pressures – can hinder necessary fiscal adjustments. The resulting increase in long-end yields can dampen GDP growth, and efforts to implement fiscal tightening as a countermeasure may also weaken economic growth, thereby reinforcing the overall debt challenges faced by these economies. We see UK, and France becoming vulnerable to this dynamic (exhibit 6). As such, we maintain our preference for the short-end of the sovereign bond spectrum and stay very selective about our long-end exposure.

Corporate credit: Constructive IG Outlook, and selective opportunities

In September, the ICE BofA Investment Grade (IG) index tightened by 6bps to approximately 76bps, hovering near cyclical lows, while excess returns reached +46bps, led by robust performance in sectors such as Metals & Mining, Pipelines, and Aerospace/Defence. IG corporates delivered a return of +1.42% for the month, outperforming Treasuries at +0.92% and high yield at +0.76%, with BBBs notably surpassing higher-quality IG credits, reflecting the favourable environment for carry trades. IG bond funds attracted in inflows during September – slightly lower than August but still robust – and October continued this positive trend with average daily inflows of USD2.2bn which is the second strongest after August over the prior 12 months. On the supply side, new issuance reached a record USD212bn in September, with October issuance forecast (by BofA Global Research) at USD115bn; despite this heavy gross supply, net supply is moderating, which is helping to keep technical conditions supportive.

Investment grade credit outlook: Still constructive

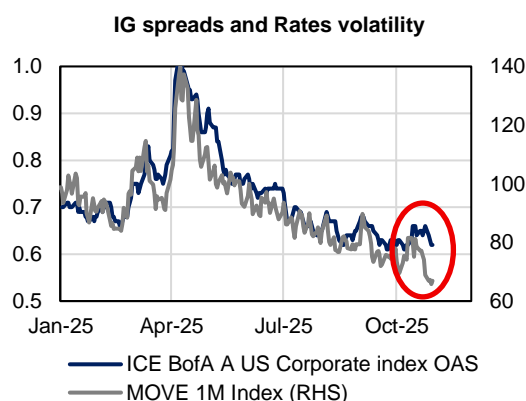
Looking ahead, we expect IG spreads to remain within a tight 80–100bps range over the next six months, supported by low recession risk, a dovish Federal Reserve, strong demand, and improving credit quality. Concerns about private credit may be premature, making IG cash bond valuations appear attractive after recent volatility. Although concerns regarding credit continue to influence spreads, such issues are unlikely to arise while the economy remains robust. Recent Q3 earnings reports from major banks indicate an overall improvement in credit quality. The recent impressive performance of equities (exhibit 7) and fading of rates volatility (exhibit 8) suggests that the IG spreads have scope to tighten in the near-term.

Exhibit 7: US IG Credit spreads have underperformed equities over the past month



Source: S&P, ICE BofA indices, and ADCB Asset Management

Exhibit 8: Fading rate volatility points to the scope of further compression in IG spreads

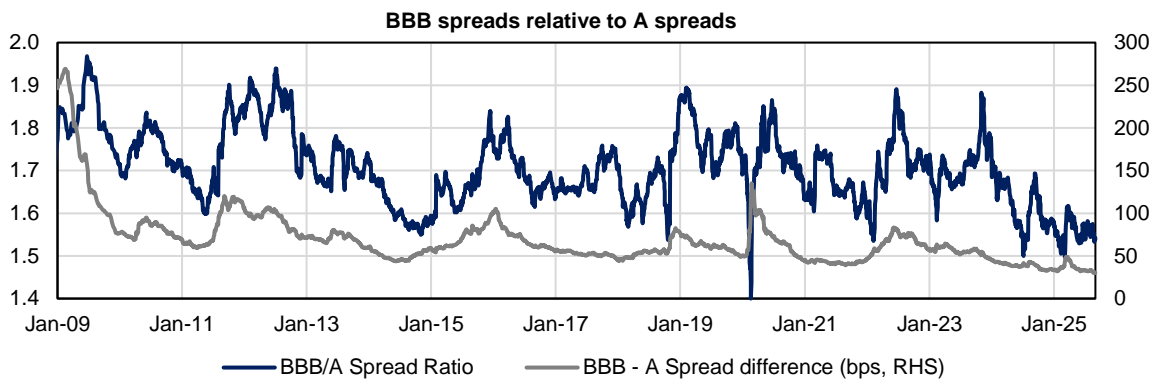


Source: ICE BofA indices, and ADCB Asset Management

Relative opportunities within IG space

- Given the relative value and lower re-leveraging risk, we favour BBBs over single-As (exhibit 9), with the 5-7-year part of the BBBs curve offering the most attractive opportunities.
- Both the 5s10s and 10s30s IG curves are likely to stay flat, presenting appealing yields but with limited potential for steepening.
- In terms of sectors, we prefer a defensive tilt to areas such as utilities and energy, while we hedge against growth and tariff risks.
- One of the most attractive opportunities in the current bond landscape is in hybrids, which according to BofA Global Research offer approximately 40% more spread compared to senior bonds with similar ratings and maturities. In the intermediate 5-10-year segment, hybrids trade about 38% cheaper than their senior counterparts, while in the shorter 1-5-year range, spreads are nearly 90% wider, making them notably compelling from a value perspective. Despite carrying ratings similar to low-BBB industrials, hybrids consistently trade at wider spreads, presenting a strong relative value case. The market for hybrids is expanding at a rapid pace, with year-to-date growth reaching 21%, primarily driven by new issuance from Utilities and Insurance companies, and in the BBB and BB categories. This surge in market size is enhancing sector depth and providing investors with greater diversification choices. However, investors should be mindful of the associated risks, particularly the potential for poorer liquidity and extension risk. Overall, while not without risks, hybrids stand out as an interesting theme, offering outsized spread pick-up, compelling relative value, and increasing market depth while technicals remain supportive and demand stays strong.

Exhibit 9: BBB-A spreads have scope to narrow in the near-term



Source: ICE – BofA indices, FRED, and ADCB Asset Management

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