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Can credit markets continue to provide capital growth?

Credit markets delivered robust total returns in 2025, after shrugging off short-lived wobbles around 'Liberation Day' and political risks in France. A key driver was a continued tightening of credit spreads, which ended the year near 10-year lows in some segments. If spreads widen and revert to more 'normal' levels this year, investors could see these gains eroded – that's an important risk to navigate.

Fortunately, there is significant dispersion across the global credit market, but investors will need to search harder for capital growth and work smarter to avoid parts of the market where valuations have become expensive (i.e., where credit spreads are very tight). Those with the flexibility to invest across a broad range of credit markets – including more specialist areas – will have a distinct advantage, as we noted here.

Why invest in credit when government bond yields are so high?

Government bonds have provided a very generous yield over the past year or so. Yet that's only part of the story. Spikes in volatility in many of the world's largest bond markets – reflecting mounting fears over the sustainability of public finances – have resulted in relatively poor risk-adjusted returns. That is showing no signs of shifting, as our fixed income colleagues have noted.

The content of this communication is intended for readers with existing knowledge of financial markets.

Against this backdrop, credit still offers a great source of income (i.e., yield), which is a key driver of long-term investment returns. However, as noted above, investors should be careful to minimise the risk of capital losses from credit spread moves. Put another way, not all yield sources are equal – investors will need to be selective, as outlined here.

An important distinction to make is that a selective approach to investing does not equate to a narrow credit-market focus; investors should cast a wide net in their search for income. By exploring specialist areas of the market, investors can limit their exposure to interest rate risk relative to more mainstream markets – for example, floating-rate coupons (regular interest payments) can provide useful protection should interest rates rise again. Given the uncertain outlook for monetary policy, investors relying on more concentrated credit strategies look rather exposed.

Are systemic risks emerging in the market?

Recent high-profile failures in the US private credit market have sparked concern over broader risk. While there are certainly lessons for investors who missed some clear red flags in the riskiest parts of the leveraged loan market, we do not think this is a systemic issue. Stress has been relatively contained and is largely explained by a hangover from the leverage buyout boom of 2020-2022, when a surge of private-market dealmaking resulted in riskier investment decisions.

However, it's a different story in public credit markets. For instance, leaving aside how expensive it has become, the high-yield market has maintained better credit quality on average than the US private credit market, largely because the riskiest lending has happened outside of public markets in recent years. That said, credit investors should continue to do their homework on underlying fundamentals, given the inherent disparity of creditworthiness in this vast investment universe.

How will supply/demand dynamics impact the asset class?

For several years, the combination of reduced new issuance (after the records set in 2020) and strong investor demand – thanks to the high yields on offer – has provided a strong 'technical' support for the overall market. But both factors look set to shift: a surge in tech-sector issuance – related to investing in artificial intelligence – will increase supply, while a fall in yields may dampen demand, as noted here. Combine this with credit spreads that have been anchored at historically low levels, and investors should brace for relatively higher credit-spread volatility in the major US investment-grade credit market. In 2026, we think investors will find a more favourable technical backdrop in specialist segments such as the loan market, bank capital, and select parts of the high-yield market.

How should investors position for the year ahead?

As the era of 'easy income and capital growth' draws to a close, credit investors will need to work harder – tight spreads mean mainstream credit market indices are likely to disappoint. Turning again to the dispersion point, a key characteristic of the environment in 2026 is likely to be increasing divergence across economic sectors. While wealthy consumers have benefitted from a multi-year appreciation in the stock and housing markets, the low- to middle-income consumer is seemingly in a silent recession. With consumption patterns likely to shift in reflection of this, there will be winners and losers across the corporate sector. All of this points to a rich hunting ground for bottom-up investors.

In terms of how to construct their portfolios, we think investors will be best served by holding a core of high-yielding issuers that offer defensive properties (i.e., 'defensive carry' sources), while being active in exploiting alpha-capture opportunities as they arise. As these opportunities can be found in many different parts of the credit investment universe and nothing is constant, investors should look at the full global opportunity set and take a dynamic approach.

General risks. All investments carry the risk of capital loss. The value of investments, and any income generated from them, can fall as well as rise and will be affected by changes in interest rates, currency fluctuations, general market conditions and other political, social and economic developments, as well as by specific matters relating to the assets in which the investment strategy invests. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Past performance is not a reliable indicator of future results. Environmental, social or governance-related risk events or factors, if they occur, could cause a negative impact on the value of investments. No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided. Individual securities named in this material are included for illustrative purposes only. The views expressed are those of the contributor and do not necessarily represent Ninety One's house view. The information should not be seen as a forecast of how such securities will perform and should not be construed as investment advice or a recommendation.

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