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International (ex US) and emerging market fixed income show value

Despite heightened geopolitical tensions, persistent inflation concerns and ongoing uncertainty around US monetary policy, fixed income continues to offer compelling risk-adjusted return potential heading into the second half of the year, says Payden & Rygel managing director and portfolio manager, Eric Souders.

Markets have been forced to navigate a much more complex environment than many expected at the start of the year, Souders says.

"The US economy remains remarkably resilient, supported by strong consumer spending and what appears to be a generational upswing in investment, driven by AI infrastructure and power demand."

While inflation has moderated from peak levels, he expects it to remain sticky and volatile in the near term.

"Our expectation is that inflation should trend lower over the next six to 12 months, but the path is unlikely to be smooth.

"The challenge for markets is determining whether inflation proves persistent enough to require a more restrictive policy response than is currently priced in."

He believes the Federal Reserve is likely to keep rates unchanged for the remainder of 2026, despite market pricing that implies some probability of additional tightening. However, he cautions that the path is still uncertain.

"If the Fed does decide further tightening is required, it would probably involve multiple hikes, rather than a single symbolic move, to send a signal to markets.

"But our base case is that they do very little for the remainder of the year."

Souders says attractive valuations, higher real bond yields and increased potential for monetary easing have boosted the appeal of international markets.

"We continue to see value in international (ex US) and emerging market fixed income. Beyond return potential, these markets now offer genuine diversification benefits not available to portfolios that are heavily concentrated in US assets."

While private credit continues to offer attractive opportunities, investors should remain selective, Souders says.

“Not all private credit is created equal. The market has attracted significant capital over a relatively short period, much of it during an era of exceptionally low interest rates and optimistic growth assumptions.”

He remains concerned about quality and concentration risks within segments of the private credit market, particularly given the prevalence of lower-rated borrowers and significant exposure to technology and software sectors.

“When liquidity becomes constrained, investor anxiety can increase quickly. We believe there will likely be some challenging outcomes in parts of the market.”

Despite ongoing economic uncertainties, Souders believes the current yield environment presents one of the strongest opportunities for fixed income investors in years.

“Starting yield is one of the best indicators of future returns, and today’s yields are attractive across several segments of the market,” he says.

He nominates BB-rated US high-yield bonds, infrastructure, power, utilities, energy and commercial real estate debt as sectors he is bullish on.

Looking ahead, Souders believes investors should prepare for greater dispersion across markets and sectors rather than broad-based directional moves.

“There are reasons to be optimistic and reasons to be cautious. What matters now is identifying the areas where investors are being adequately compensated for risk.

“In this environment, active management is likely to be the key driver of outcomes, rather than relying on broad market exposure.”

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