

Q4 2026 Credit Research Outlook

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Higher interest rates are testing credit-market resilience. Strong earnings, healthy balance sheets and sound bank fundamentals remain supportive, but prolonged tightening and fiscal uncertainty increase refinancing and credit-quality risks.

Higher interest rates remain a key focus for credit investors. Nominal 10-year government bond yields have risen materially across major developed markets, but the drivers have not been uniform. In the United States, stronger economic activity, elevated nominal growth, artificial intelligence-related capital investment, persistent fiscal deficits and a higher equilibrium real interest rate have all contributed to the increase. In Europe, higher energy prices, renewed inflation concerns, expectations for additional monetary tightening and sovereign fiscal uncertainty have played a more prominent role. Across the globe, the ultra-low-rate environment that followed the global financial crisis is fading further into the past.

A central question is whether persistently higher rates will become a growing headwind for credit markets. To date, rising yields have not triggered broad deterioration in underlying credit fundamentals. Strong corporate earnings, resilient economic growth, healthy balance sheets and investor demand generated by elevated all-in yields have kept credit markets anchored. However, the longer rates remain elevated, particularly if central banks continue tightening in response to an energy-related supply shock, the greater the risk that higher borrowing costs will weaken investment, job creation, refinancing capacity and, ultimately, credit quality.

Why rates are higher

The credit impact of higher rates depends on the underlying driver. Increases tied to stronger growth and investment can support earnings, while those driven by fiscal risk, inflation expectations or higher risk premiums tighten financial conditions and erode debt-service and refinancing capacity. Both dynamics are evident today. US nominal growth, artificial intelligence investment, credit demand and above-potential activity across developed markets support cash flows but also sustain inflation and elevated policy rates. Historically, US Treasury yields have broadly tracked nominal gross domestic product growth: a 5.5% rolling 10-year nominal growth rate implies an approximate 4.8% 10-year yield. This relationship suggests that current conditions are closer to normal than stressed, unlike the late 1970s and early 1980s, although the 10-year yield is nearing the upper end of its historical range relative to this relationship.¹

The risk is that large fiscal deficits, quantitative tightening, heavier sovereign issuance, artificial intelligence-related financing needs and higher energy prices keep real rates and risk premiums elevated. Credit remains resilient while nominal income and cash flow keep pace with funding costs; vulnerability rises if growth slows, refinancing needs accelerate or yields increasingly reflect fiscal and inflation risk.

Credit fundamentals have provided support for the most exposed segments of the credit markets

Corporate credit fundamentals are broadly supportive. Profits are strong, financial stress is contained and liquidity has improved relative to short-term liabilities. Short-term borrowing costs, the corporate financing gap and slower real final-sales growth warrant monitoring, but current evidence points to slower growth rather than a credit contraction.²

High-yield-rated (HY) corporations, which are most exposed to the rising cost of debt, are also on firmer footing than at similar points in this cycle, at least in aggregate. Second-quarter revenue for US HY corporations rose more than 10% year over year, and operating profit increased by more than 14%, the strongest growth in four years, with gains across rating cohorts and 14 of 18 industries. Aggregate leverage declined to approximately 4.5x, and interest coverage improved to greater than 4.0x, although both remain somewhat weaker than long-term averages.³

To be sure, the aggregate data conceal dispersion. Debt and interest expense continue to rise, 21% of issuers have coverage below 2.0x, and smaller private companies carry materially weaker leverage and coverage. Strong earnings are currently offsetting higher funding costs, but refinancing pressure could drive rapid deterioration among smaller, lower-rated borrowers if growth slows, consistent with a selective default cycle rather than systemic stress.

The policy risk: Tightening into a supply shock

A central risk to the resilient credit backdrop is that central banks tighten into an energy-driven supply shock. Higher oil prices lift inflation while eroding household purchasing power and corporate margins, and, after several years of above-target inflation, policymakers have less scope to look past the shock. Capital Economics estimates energy prices could add roughly 1.25 percentage points to advanced-economy headline inflation, keeping inflation near 3.5% to 4.0% in the United States, United Kingdom and euro area through at least the second quarter of 2027. t

Recent policy decisions highlight this tension. The European Central Bank raised its deposit rate to 2.50% and increased its inflation forecasts, while the Federal Reserve lifted its target range to 3.75% to 4.00% amid resilient growth and 6.3% year-over-year nominal consumer spending growth. Both moves indicate that policymakers are restraining demand despite a partly supply-driven inflation impulse. The credit risk is that policy remains calibrated to current nominal growth after underlying activity weakens.

Monetary tightening affects construction, investment, hiring, consumer credit and refinancing with a lag. Oil near \$100 per barrel would create a stagflationary impulse and initially reinforce hawkish policy, but a more disruptive shock could ultimately halt tightening. One or two additional hikes appear absorbable, but a prolonged hiking cycle would raise the probability that financing costs outpace cash-flow growth, especially for leveraged borrowers, interest-sensitive consumers and issuers reliant on continuous market access.

Implications for the cash investment universe

As our readers know, the Global Cash investment universe is more concentrated in the obligations of large, systemically important banks and other highly rated financial institutions. The latest operating results and management commentary remain reassuring. Systemically important US, Canadian and European banks continue to benefit from resilient net interest income, loan growth, fee income, wealth management revenue and investment banking activity. Capital, liquidity and asset quality remain sound, providing significant capacity to absorb a weaker macroeconomic environment should one develop.

No broad-based emerging credit-loss category is currently evident across our bank investment universe. Asset quality remains a strong component of the credit profile, with consumer credit generally normalizing rather than deteriorating and commercial credit trends improving from a healthy base. Most recently, net interest income guidance was more frequently increased than reduced, and deposit franchises continued to fund loan growth without material reliance on higher-cost wholesale markets.

Higher rates can continue to support bank earnings, but the benefit has limits. Many banks remain asset-sensitive, so modest additional increases should bolster net interest income. However, rising deposit betas offset some of this benefit as funding shifts toward interest-bearing deposits and certificates of deposit. More importantly, management teams have warned that further hikes could weaken loan demand; one US bank identified three additional increases as the threshold for material loan-demand headwinds. Thus, near-term earnings may remain supported even as the risk of a subsequent slowdown rises.

The principal bank-specific watch items are therefore not current asset quality or liquidity. They are the quality and sustainability of earnings, the gradual movement toward more expensive deposit funding and, in the case of major US banks, the normalization of capital targets based partly on regulatory relief that is not yet final. Management teams are increasingly planning to operate with less excess common equity capital while continuing buybacks and balance-sheet growth. This does not presently undermine the credit profiles of the major Cash investment counterparties, but it increases the importance of distinguishing institutions with diversified earnings and deep deposit franchises from those more dependent on spread income or optimistic regulatory outcomes.

Outside the US, Canadian banks delivered strong results, including broad consensus beats, positive earnings revisions and double-digit pretax, pre-provision earnings growth outside capital markets at most institutions. Commercial lending accelerated, credit trends improved, and stable capital, ample liquidity and excess capital provided meaningful downside protection. Key risks are whether loan growth maintains pricing and underwriting discipline, deposit growth keeps pace and mortgage losses remain contained amid Canada-US trade uncertainty.

European bank results have been similarly uneventful from a creditor perspective, supported by loan growth, net interest income, hedging, wealth management fees and investment banking revenue. Strong capital generation provides a buffer against normalized losses and distributions, although elevated valuations, reliance on capital markets activity and limited management concern warrant caution as rates rise. European sovereign risk remains an additional vulnerability: weak growth, persistent fiscal deficits and wider spreads could pressure domestic funding, securities valuations, confidence and banks' cost of capital. French banks are particularly exposed to a material widening in French sovereign spreads, but their current operating profiles remain sound, supported by strong earnings, capital, liquidity and diversified businesses.

For our credit process, the appropriate response to these types of risks is continued issuer-level differentiation. We will monitor sovereign spread behavior, the progress of fiscal policy, the effect of sovereign yields on bank securities portfolios and any evidence that political or fiscal uncertainty is affecting deposits, wholesale funding or capital markets access. If those risks begin to alter individual bank credit profiles, our primary risk-mitigation tool remains the ability to reduce permitted maturities while preserving access to fundamentally strong counterparties.

Concluding thoughts

We have described credit conditions as late-cycle for an extended period, and the cycle has continued longer than many investors expected. It reflects the durability of nominal growth, strong corporate profitability, substantial capital markets liquidity and the ability of companies and banks to adapt to a higher cost of capital.

Nevertheless, vulnerability is pronounced because valuations and policy leave limited room for error. Higher rates are manageable when they reflect stronger growth and earnings. They become increasingly unfriendly to credit markets when they persist after activity and employment weaken, when refinancing costs rise faster than cash flows or when the increase is driven by fiscal and inflation risk rather than productive investment.

We continue to believe that credit spreads are vulnerable to widening from historically compressed levels. A repricing would not necessarily signal a systemic credit event. It would more likely reflect a normalization in compensation for macroeconomic uncertainty, policy risk and the uneven effect of higher borrowing costs across issuers. The most exposed areas remain highly leveraged borrowers, smaller private companies, issuers with limited refinancing flexibility and sectors where earnings are insufficient to absorb higher interest expense.

For the Global Cash investment universe, the risk outlook is more constructive. The large, systemically important banks that comprise the core of our approved investment universe are entering a potentially weaker environment with strong capital, abundant liquidity, diversified earnings and sound asset quality. These institutions are not immune to slower growth, sovereign market volatility or stress among leveraged borrowers. However, they have sufficient financial capacity to absorb meaningful deterioration without materially weakening their short-term credit profiles.

As cash investors, our objective is not to predict the precise end of the credit cycle. It is to ensure that the approved credit universe and associated maturity restrictions remain appropriate across a range of outcomes. Higher rates, tighter monetary policy and sovereign fiscal concerns warrant vigilance. They do not presently warrant a broad change in our assessment of the strongest global banking counterparties. We remain prepared to shorten maturities where issuer-specific risks increase while maintaining confidence that the high-quality institutions in our Cash investment universe are positioned to withstand a more challenging credit environment.

Financial Institutions

US banks delivered exceptionally strong 2Q26 results, with revenue and earnings broadly exceeding expectations on robust capital markets activity, elevated client engagement and accelerating commercial lending. Bank credit spreads were largely unchanged relative to industrials as Corporate America reported one of its strongest earnings seasons on record, although bank equities slumped late in the quarter amid concerns that consumer artificial intelligence agents could increase deposit competition, alongside headwinds from higher oil prices, rising rates and renewed Fed tightening. Despite these challenges, economic growth remained resilient, supported by strong corporate profitability, healthy consumer spending and the ongoing artificial intelligence investment cycle. While lending standards are not objectively loose, they have eased sufficiently from the 2022-2023 hiking cycle, and the rapid buildout of artificial intelligence infrastructure is creating incremental demand for financing and capital markets activity. Although net interest income and margin performance were mixed, credit trends remained favorable, with lower-than-expected provisions and generally improving problem loan metrics. Overall, pretax, pre-provision earnings, the sector's first line of defense against credit losses, grew at a

healthy double-digit pace from the prior year, while artificial intelligence continues to offer opportunities to enhance underwriting, fraud detection, customer service and efficiency, even as related cyber risks are underappreciated in our view.

Interest rates rose throughout the quarter as investors grappled with sticky inflation, higher oil prices, large fiscal deficits, heavy Treasury supply and rising artificial intelligence-related capital spending, culminating in the Fed's September rate hike, its first since July 2023. The narrative that rising rates are unambiguously good for banks is partially correct but incomplete. Banks are generally asset-sensitive businesses, so loan yields initially reprice faster than deposit costs, supporting margins and earnings. While investors have focused on a flatter 2s/10s curve and higher funding costs, the 3m/5y curve, which has historically shown a stronger relationship with bank margins, remained supportive. Ultimately, credit quality is the key arbiter of performance. If the Fed tightens too aggressively and triggers a recession, rising loan losses can overwhelm the benefit from higher margins. Higher rates also create unrealized securities losses, intensify deposit competition and may eventually constrain loan demand. For now, credit trends remain healthy and private-sector debt relative to gross domestic product is near a 25-year low. This is reassuring, as sharp increases in private leverage have often preceded credit downturns, although the growth of artificial intelligence-related borrowing and opaque leverage across nonbank financial institutions warrant close monitoring.

The near-term fundamental outlook remains constructive, but the sector is increasingly shifting from an early-cycle earnings story toward a test of funding discipline and risk selection. Commercial lending and artificial intelligence-related financing should support revenue trends, while benign consumer and corporate credit provide banks with a meaningful cushion. At the same time, deposit competition is intensifying, loan pricing is becoming more competitive, and several regional banks are deliberately limiting exposure to private credit, nonbank financial institutions and less transparent forms of artificial intelligence infrastructure financing. Capital and liquidity remain strong, but higher rates will continue to weigh on market capital ratios and could expose weaker underwriting outside the traditional banking system. We remain constructive on bank credit while favoring institutions with diversified revenue, durable low-cost deposits, disciplined underwriting and limited exposure to hidden leverage.

European bank 2Q26 results were released through July and August and were largely a continuation of 1Q26 trends. Roughly half of the banks beat estimates and half were in line. A little more than a third of banks upgraded their full-year 2026 forecast. The hawkish tilt from central banks provides a more favorable outlook for net interest income. The sector's return on equity now stands in the low teens, which is a much stronger level of return than in prior years

.Most banks experienced higher year-over-year loan growth, hedging, net interest income, wealth fees and investment banking performance. Sequentially versus 1Q26, they benefited less than US banks from the capital markets backdrop. Loan losses are normalizing but remain low from a historical perspective. During their post-earnings-release calls, bank management teams were extremely optimistic, with minimal concerns.

For us, broader market valuations are a watch area. Investment banking activity played a material role in 1H26 earnings. A correction in the artificial intelligence-fueled stock market could significantly temper those revenues. Europe's macro backdrop remains a vulnerability. Unsustainable deficits and gradual but persistent sovereign deterioration in France, Belgium and the UK are potential sources of volatility, and those risks are compounded by the recent rise in global government yields.

While mindful of these threats, banks are still in a strong position to weather such risks, as evidenced by their current earnings buffers and past stress-test performance, which includes severe market sell-off

scenarios. The resilience of the sector contributes to a stable outlook for Cash buy-and-hold restrictions.

Canadian banks delivered another strong quarter, supported by robust capital markets and wealth management results, accelerating commercial loan growth, stable expenses and positive operating leverage. Business and corporate lending strengthened meaningfully, driven by infrastructure, energy, artificial intelligence-related investment and other large-scale projects tied to Prime Minister Mark Carney's nation-building agenda. Net interest margins largely stabilized as favorable deposit trends and core deposit growth offset competitive pressures. Credit performance was better than expected, with impaired loan formation moderating, provisions declining and early signs of stabilization across consumer portfolios, though banks remain cautious given uncertainty surrounding US-Canada trade relations and tariffs. The macro backdrop remains mixed, with modest growth, subdued housing activity and rate-sensitive consumers offset by healthy capital markets activity, corporate investment and commercial lending pipelines. Higher-for-longer rates continue to support margins but could weigh on mortgage demand and extend the credit cycle.

From a creditor perspective, Canadian banks continue to benefit from strong capital, liquidity, earnings diversification and reserve levels, leaving the sector well positioned to navigate trade-related volatility and slower growth, while key watchpoints remain consumer credit, housing affordability, tariffs and the path of interest rates

Australian banks continue to benefit from an oligopolistic market structure, strong retail franchises and conservative regulation, though conditions have become more challenging as the Reserve Bank of Australia maintains a hawkish stance and additional rate hikes remain possible. Results this quarter highlighted resilient profitability, supported by strong business lending, stable credit performance and healthy net interest income, while also underscoring pressure on mortgage growth and margins from intense competition and rising deposit costs. As household lending slows amid affordability pressures, higher borrowing costs and policy measures targeting investor housing demand, business and institutional lending have become the primary growth drivers, supported by infrastructure, energy transition, artificial intelligence-related investment and broader capital expenditure activity. While favorable for earnings, this shift increases exposure to more cyclical sectors than traditional residential mortgages.

The housing market has softened materially, with home prices declining for several consecutive months and turnover weakening, raising the risk that restrictive policy eventually weighs on consumption and residential investment. Credit metrics remain sound, with arrears and loss rates low by historical standards, although banks are reporting larger watchlists and emerging stress in commercial property, construction and other rate-sensitive borrower segments. Capital, liquidity and funding remain key strengths, with common equity tier 1 ratios among the strongest globally and regulation continuing to favor system stability.

Japanese banks remain among the clearest beneficiaries of global rate normalization, with rising domestic interest rates continuing to lift net interest income, loan-deposit spreads, fee revenue and profitability after decades of ultra-low rates. Recent results were notably strong, with credit costs remaining well contained, asset quality healthy and capital and liquidity levels robust, reinforcing the sector's strong creditor profile. At the same time, the macro backdrop remains constructive but not without challenges, as modest economic growth, persistent inflation, wage dynamics and an aging population continue to shape the operating environment. Importantly, borrowers have thus far demonstrated a high tolerance for rising rates, while private credit and other higher-risk exposures remain relatively limited and predominantly investment grade.

Looking ahead, we expect fundamentals to remain supportive as banks benefit from improving pricing power and strong domestic and overseas corporate activity, though key watchpoints include deposit competition, the pace of Bank of Japan normalization and execution around international growth initiatives. Overall, we continue to view Japanese bank credit fundamentals as defensive, supported by strong capitalization, abundant liquidity, resilient asset quality and growing earnings capacity.

1 Deutsche Bank research; Call of the Day; Jim Reid; 9/8/26 2 Dynamic Economic Strategy; Volume 9/ Issue 24; John E Silvia; 7/29/30 3 JP Morgan North American Credit Research; 2Q2026 High Yield Credit Fundamentals; 9/15/26 4 Capital Economics: Chief Economist Note; 9/14/27

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The value of the debt securities may increase or decrease as a result of the following: market fluctuations, increases in interest rates, inability of issuers to repay principal and interest or illiquidity in the debt securities markets; the risk of low rates of return due to reinvestment of securities during periods of falling interest rates or repayment by issuers with higher coupon or interest rates; and/or the risk of low income due to falling interest rates. To the extent that interest rates rise, certain underlying obligations may be paid off substantially slower than originally anticipated and the value of those securities may fall sharply. This may result in a reduction in income from debt securities income.

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