

March 2026

Volatility and opportunity: fixed income markets react to the Middle East conflict

The escalation of the conflict in the Middle East over the last month has introduced a renewed bout of geopolitical uncertainty into markets already grappling with uneven global growth, shifting monetary policy expectations, and lingering inflation pressures.

Energy prices have moved sharply higher, global risk appetite has wavered, and volatility has picked up across several asset classes. But the fixed income reaction has not been uniform. Rates markets have absorbed the most immediate impact, investment grade credit has seen modest 'spread' widening but remained fundamentally robust, and high yield – while not historically the most resilient segment within fixed income – has nevertheless shown notable resilience, particularly relative to equities, experiencing far smaller drawdowns than global stock markets. We have observed before that high yield has in recent periods been a relatively safe haven compared to government bonds.

Across all three areas, an important theme emerges: volatility is creating opportunity, particularly for investors applying a disciplined, high-conviction approach that blends bottom-up credit selection with active use of macro valuation signals.

Rates repricing to reflect regional exposure to energy shock

Government bonds have been the primary mechanism through which markets have priced the potential macroeconomic impact of the conflict. The parallels with the 2022 energy shock are understandable, but today's macro backdrop is very different: inflation is lower, policy rates are restrictive rather than accommodative, and growth across the US, UK and Europe was already mixed heading into this episode. This context is critical to understanding how rates have adjusted.

The key market question is not merely whether oil and gas prices rise, but how persistent those increases might be. A temporary spike simply adds noise to inflation expectations; a sustained one would test household budgets, corporate margins and central bank reaction functions. This uncertainty has driven a broad rise in volatility across government bond markets, though the effects have varied sharply by region.

US Treasuries have responded relatively calmly. While yields have adjusted, the overall move has been contained, reflecting both the US economy's greater insulation from external energy shocks and the perception that this conflict may nudge inflation at the margin rather than fundamentally altering the policy path.

European government bonds and UK gilts have absorbed more pronounced moves. Europe remains vulnerable to a renewed rise in energy costs, and this has fed into both higher inflation uncertainty and concerns about an already fragile growth environment. The UK shows similar sensitivity, with gilts particularly reactive to shifts in

inflation expectations amid signs of domestic economic slowdown. Indeed, markets have started to price in rate hikes in the UK into the end of the year, even with the anaemic domestic growth picture.

Rates markets are currently pricing an exceptionally wide distribution of outcomes. When uncertainty is high, short-term mis-pricings often arise – especially in regions most exposed to energy dynamics. If energy markets stabilise and the conflict remains contained, some of the recent repricing in European and UK yields may look excessive relative to fundamentals. Indeed, we continue to favour UK gilt exposure in funds. If they do not stabilise, at some point markets will have to consider the growth implications of the oil shock.

Measured widening in investment grade spreads reflects strong fundamentals

Investment grade credit spreads have widened, but in a measured and orderly fashion. Global spreads have moved about 10 basis points wider, a reaction which is far from disorderly. Investment grade credit entered this period from a position of strength, supported by conservative balance sheets, ample liquidity and steady investor positioning.

The reaction to the conflict has been more pronounced in Europe, given its more direct exposure to energy prices, higher operating costs for energy-intensive sectors, and the added pressure of shipping disruptions. After an initial widening, spreads regained some ground as the market reassessed the likelihood of a prolonged shock. Primary markets remain open, as shown by large transactions such as Amazon's recent large bond issue ('mega cap' tech company bond issuance continues to be a theme).

Some of the pricing dynamics remind us of the 2022 playbook and with such opportunities we are looking to exploit where we can add quality to portfolios. A key example is switching out of a junior bond in BT Group's capital structure into a senior BT bond, where higher yield is available alongside improved structural protection. This kind of capital structure optimisation reflects the way we combine bottom-up fundamental work with active portfolio management: adding risk selectively where mispricing arises.

Resilient high yield markets

High yield has seen a bit more volatility and dispersion, but it *has* displayed meaningful resilience relative to equities. Since the conflict began, European high yield is down about 1.8% (US dollar terms, as at 19.03.26) and US high yield about 0.95%, moves that highlight the asset class's ability to absorb macro shocks more calmly than equities.

Europe's decline has been broad across BB, B and CCC bonds, indicating a macro-driven repricing rather than an emergence of credit-specific distress. Chemicals, autos and real estate have been under the most pressure, reflecting their sensitivity to growth expectations and energy costs. Importantly, moves have remained orderly, with no signs of forced selling.

In the US, higher-quality BBs have underperformed due to duration and liquidity dynamics – [investors tend to sell the most liquid bonds first when reducing risk](#). By contrast, B and CCC segments have held up better. Sector softness has been most evident in media, leisure and financials, while energy and technology have remained comparatively resilient.

Because this has not been a classic "flight from risk," the dislocations created are giving rise to selective opportunities. Two ideas we find particularly compelling are:

- Softbank bonds: in the GF High Yield Bond Fund, we have increased exposure to Softbank, where we see attractive risk-adjusted returns supported by strong asset coverage and compelling yields (close to 8%) for the credit quality (BB).
- A US-healthcare-linked property REIT: we are also adding exposure to a property REIT primarily tied to US healthcare real estate, where improving prospects and underlying cash flows come alongside an appealing yield (~8%).

Like 2022, tech and real estate were two areas punished by the market. These opportunities illustrate how, even amid volatility, high yield markets can offer attractive compensation for risk – particularly where spreads have widened more than fundamentals warrant.

A disciplined approach to finding value amid volatility

The latest conflict has created volatility, but not disorder. Rates markets have moved sharply, particularly in Europe and the UK; investment-grade credit has widened modestly but constructively; and high yield has been resilient and particularly so versus equities, with controlled adjustments and pockets of opportunity emerging.

Across all three areas, a clear takeaway is emerging: volatility is not merely a challenge – it can also create opportunity. Periods of uncertainty can lead to market moves that run ahead of near-term fundamentals, even without pricing extreme outcomes. In such environments, disciplined investors can use both company-specific analysis and macro valuation signals to add risk selectively and with conviction.

Our philosophy remains focused on identifying mispriced risk, maintaining resilience through credit selection, and using volatility to position portfolios for stronger long-term outcomes. This period, while uncomfortable, is providing precisely those opportunities.

Meanwhile, yields have moved higher, providing what we believe will be a good source of returns for long-term investors in fixed income.

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

The fixed income Funds managed by the Multi-Asset Team:

Consider environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Funds.

May hold overseas investments that may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of a Fund.

Hold Bonds. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result; The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay.

May encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.

May, under certain circumstances, invest in derivatives, but it is not intended that their use will materially affect volatility. Derivatives are used to protect against currencies, credit and interest rate moves or for investment purposes. There is a risk that losses could be made on derivative positions or that the counterparties could fail to complete on transactions. The use of derivatives may create leverage or gearing resulting in potentially greater volatility or fluctuations in the net asset value of the Fund. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead. The use of derivative contracts may help us to control Fund volatility in both up and down markets by hedging against the general market.

The use of derivative instruments that may result in higher cash levels. Cash may be deposited with several credit counterparties (e.g. international banks) or in short-dated bonds. A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

May invest in emerging markets which carries a higher risk than investment in more developed countries. This may result in higher volatility and larger drops in the value of the funds over the short term.

May be exposed to Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

May target an absolute return. There is no guarantee that an absolute return will be generated over the time period stated in the fund objective or any other time period.

The risks detailed above are reflective of the full range of fixed income Funds managed by the Multi-Asset Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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