



Q2 2026

Active Fixed Income Outlook:

Disruption and dispersion



Why is this oil shock different?

How the oil price surge amid the Middle East conflict is reshaping global markets and political landscapes.



Colin Reddie
Head of Active Strategies
/ Co-Head of Global Fixed Income

As we enter the second month of the Middle East conflict, it's important to remind ourselves of the market's expectations when the conflict began. Back then, the prevailing mood was that a spike in oil prices to levels over US\$100 per barrel, or even higher, was not too concerning. It would be a very different story, however, if oil prices were maintained at elevated levels for longer than two months. Such a scenario would require investors to acknowledge the track record of rising oil/energy prices ending previous cycles when they spike unexpectedly.

Despite markets' historic experience of oil shocks, investors' lived experience during this time has not been typical. A useful way to think about the future is to compare how markets should have reacted to a major shock with how they actually did. When prices move unexpectedly, it often signals an emerging force that few are yet to understand — and that's where, in our view, the best opportunities tend to be found.

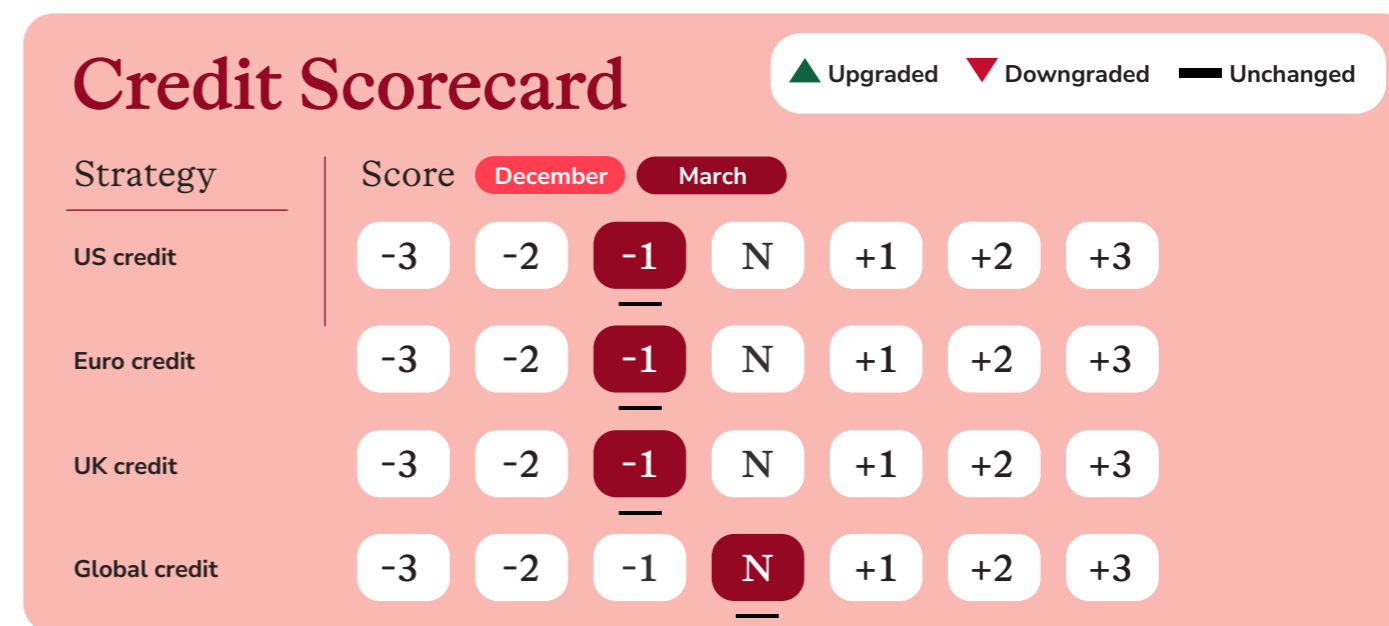
The initial move in risk-free yields was the complete opposite to what most expected, as we tend to see flight-to-quality initially as the safe haven bid overwhelms the transitory inflation impact from higher oil prices. What was different this time? At the very least, it might suggest that we are still in a post-pandemic environment more susceptible to inflation shocks. Our rates team has downgraded its view on the insurance value of duration within portfolios, with rising oil prices increasing the likelihood of a more challenging environment of positive (and less helpful) correlation between spreads and yields.

Any fiscal response by governments to higher oil prices will be a crucial factor for this relationship and for markets. The UK government has already floated the possibility of helping people with heating bills, while other governments have either suspended fuel taxes, or are considering similar measures. The repricing of the front-end of yield curves has been significant. While we should always respect what markets are telling us, we think central banks will be reluctant to raise interest rates ahead of a potentially growth-eating oil shock.

As the conflict has intensified, risk assets have been forced to acknowledge the increasing uncertainty around the growth and inflation outlook. From being cushioned by rising government bond yields initially, credit spreads have now widened by 10-20% in March.¹ This is on top of already wider spreads seen before the conflict. While it already feels a long time ago, we

were only just recently grappling with the credit impact of the AI disruption theme, funding the enormous capex requirements of the tech hyperscalers and starting to consider the spillover risks to public markets coming from private credit.

The fact that President Trump campaigned on the promise to end American's cost-of-living concerns and lower interest rates is potentially starting to create an issue for his administration. The most important 'price' to Americans has always been the cost of a gallon of gas at the pump — now 40% higher than at the beginning of the year.² Meanwhile, expected interest rate cuts have been priced out following hawkish commentary from central banks. This is a potentially challenging political environment for the Republicans and the President ahead of the November mid-terms elections and could be an important factor in the possible duration of the conflict.



Source: L&G as at 31 March 2026 — can be subject to change at any point.

Key risk

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1. Source: iBoxx index data as of 31 March 2026

2. Source: Bloomberg as of 31st March 2026

Unconstrained strategies: dynamic and defensive plays amid market disruption

Focusing on diversification and flexibility as we seek to reduce risk in the face of uncertain macroeconomic dynamics.



Matthew Rees
Head of Global
Unconstrained Fixed Income



Enda Mulry
Portfolio Manager –
Global Bond Strategies



Amelie Chowna
Head of Fixed Income
Strategic Initiatives



Tom Farrington
Fixed Income Investment
Specialist

The past – what just happened?

Global financial markets have been wrestling with the opposing factors of a weakening labour market, possibly driven by artificial intelligence (AI) advancements, versus the impact of higher oil prices on inflation caused by the war in Iran. Despite a two-week conditional ceasefire between the US and Iran being announced on 8 April, the conflict still has an unknowable end date.

Kevin Warsh’s appointment as the new US Federal Reserve chair in January also created uncertainty – with speculation over how US monetary policy might evolve and the level of influence that President Trump may have.

The spike in oil prices saw expectations for US interest rate cuts by the end of 2026 fall from a previously stable projection of two cuts to almost zero cuts, which we believe looks credible given the high levels of uncertainty.

The present – positioning and performance

Against this uncertain backdrop, our unconstrained strategies continue to focus on diversification and flexibility as we seek to reduce overall portfolio risk and generate long-term returns.

We have a strong toolkit for risk management in times of geopolitical instability, and we regularly assess which hedge may be most effective in any given situation.

For our unconstrained bond portfolios, we consider three key types of hedges: credit default swaps (CDS) indices, duration and liquidity.

Key risk

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Duration is typically a helpful hedge only in events with a significant growth scare. Other episodes of widening in credit spreads driven by inflation fears (2022) have seen government bond yields rise at the same time, which has magnified losses in credit.

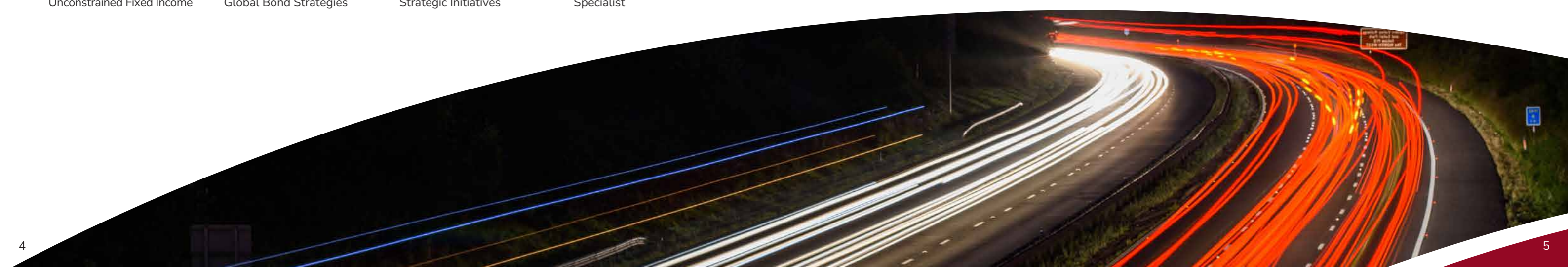
We currently believe the effectiveness of duration as a hedge is diminished and have thus reduced our duration, so we have recently turned to the other two for protection.

We have increased exposure to the subordinated financials CDS index. Despite trimming exposure to the physical bonds, subordinated debt is the largest exposure in the funds and the CDS continues to trade at a relatively attractive level, hence we deemed this the most appropriate hedge.

We have increased liquidity in the portfolios in a bid for more control during periods of heightened uncertainty, with a view to deploying capital should spreads widen materially. To date, we have not seen sufficient spread decompression to warrant adding risk. Credit spreads remain resilient as yield-focused buyers step in following moves in government bond yields.

From a sector perspective, spreads remain tight across most of investment grade credit, but we believe yields remain compelling in certain high income areas within the strategy. We continue to favour corporate hybrids and emerging market debt (EMD).

We’re also finding select opportunities within subordinated financials – while these credits are subordinated in their capital structure, they are rated as investment grade. In particular, European banks have been consistently beating their earnings estimates and have strong capital buffers – averaging around 400 basis points compared to a typically ‘comfortable’ level of 200bps, which means it would be unlikely they would miss AT1 coupon payments or dividends.



We have become more cautious on developed market high yield assets. Rising default indicators, weak fundamentals in software-exposed areas, and the risk of contagion from leveraged loans and private credit – amplified by historically high cross-market correlations – warrant a more defensive stance, in our view.

Duration positioning has turned more defensive. While AI related disinflation narratives previously supported the insurance value of duration, markets are now pricing in a more inflationary outlook. Higher oil prices, coupled with geopolitical uncertainty increases the likelihood of a positive correlation between interest rates and credit spreads. As a result, we have reduced duration exposure in the portfolios.

While the US is still positioned for a small amount of rate cuts this year, Europe and the UK are now pricing hikes given the greater sensitivity to energy pricing.

AI remains a powerful structural force. We expect hyperscalers may increasingly rely on both private and public debt to fund growth, allowing flexibility and rapid scaling as AI compute demand rises. We also believe regulated utility companies are likely to use subordinated debt to finance AI data centre energy needs, which may lead to offering higher yields compared to senior debt from the same issuers.

What could go wrong?

The key risk is geopolitical, with conflicts potentially leading to significant market moves – including oil-driven inflation spikes that could derail central bank easing cycles. While the timing and scale of geopolitical conflicts are uncertain, their combination with concerns over AI’s long-term effects could prompt significant credit spread repricing – something not seen recently due to sustained demand for fixed income. Against a backdrop of repeated market shocks, we are prepared to use flexible hedges including credit default swaps, duration and liquidity to lessen any adverse portfolio impact.



Outlook

The macro backdrop is less certain given the implication of events in the Middle East. Inflation expectations are rising and the growth outlook is being marked down globally. Valuations – particularly in investment grade credit remain rich by historical standards.

Credit Scorecard

▲ Upgraded ▼ Downgraded — Unchanged

Strategy	Score	December	March		+1	+2	+3
Global IG USD	-3	-2	-1	N	+1	+2	+3
Global IG EUR	-3	-2	-1	N	+1	+2	+3
Global IG GBP	-3	-2	-1	N	+1	+2	+3
US Securitized	-3	-2	-1	N	+1	+2	+3
Subordinated Debt	-3	-2	-1	N	+1	+2	+3
Global High Yield	-3	-2	-1	N	+1	+2	+3
Emerging Market Debt	-3	-2	-1	N	+1	+2	+3
Cash	-3	-2	-1	N	+1	+2	+3
Duration	-3	-2	-1	N	+1	+2	+3

Source: L&G as at 31 March 2026 – can be subject to change at any point. This scorecard represents the views of the L&G Global Unconstrained Bond Team when investing across key markets shown in the scorecard. Their scores may differ from the scores shown in the other sections of the outlook, which express views on individual markets on a stand-alone basis.



Euro credit: Steadying the ship and seeking selective opportunities

European IG credit has held firm in the face of shifting macro signals and emerging risks.



Marc Rovers
Head of European Credit



Magdi Yasin
Fixed Income Investment Specialist

The past – what just happened?

European investment grade (IG) credit ended the first quarter of 2026 in steady shape even though the backdrop became more complex as the weeks progressed. Spread moves were contained despite the geopolitical picture in the Middle East leading to a sharp rise in energy prices. Markets experienced brief risk off periods, but Euro IG absorbed the headlines with limited volatility, helped by a deep buyer base and the ongoing preference for high quality euro credit during uncertain periods.

Macro signals were uneven. Rate markets adjusted repeatedly as expectations for European Central Bank (ECB) policy shifted upwards. Early hopes for swift cuts gave way to a more cautious view and reversed into expectations of multiple hikes as inflation expectations increased and the market took a page out of the 2022 playbook. The front end absorbed most of this repricing, while the long end remained relatively calm, which helped overall returns stay stable.

Key risk

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Primary supply continued to set the tone. Europe handled sustained issuance from large global corporates, including several US technology firms tapping the market in size. These transactions came with modest concessions but were met with strong demand, reinforcing the appeal of Europe as a funding venue even through geopolitical stress and shifting macro expectations.

Flows lost some momentum late in the quarter, breaking a long run of consistent inflows. This signalled a degree of caution, but it did not change the broader supportive technical backdrop. Demand for high quality issuers remained firm, and the softening in flows was too small to disrupt market stability.

By quarter end, spreads were only modestly wider and outperformed other major risk markets. Euro IG total returns continued to demonstrate resilience despite persistent macro and geopolitical noise.

The present — positioning and performance

We held a neutral to slightly positive stance as spreads remained tight with limited further upside. Seasonality and negative net supply supported conditions, although risks linked to AI-related funding needs, rising concerns about private credit, sudden rate shifts and uneven sector profitability led us to maintain a more cautious approach while keeping flexibility.

We stayed close to neutral beta and continued to favour quality issuers based on rigorous credit analyses. Credit default swaps remained our preferred tool for expressing macro or tactical views, given the difficulty of adjusting exposure in secondary cash markets. Risk was reduced in late February, with the option to add again through primary deals when valuations improved.

Issuer dispersion rose, making selection more important. We stayed selective in cyclicals and real estate linked names while maintaining conviction in well capitalised banks.

Stress in private credit also became more relevant for sentiment. With spreads staying into low percentiles, we finished the quarter with a higher liquidity buffer and closer to neutral beta stance.

Utilities remained a defensive anchor, and we kept a clear quality bias as BBB valuations stayed compressed relative to higher rated peers.



Outlook

Macro uncertainty has increased, but Euro IG fundamentals remain stable. Risks linked to AI disruption, labour markets, commodity moves and developments in private credit are more visible, although technical support remains strong and global demand has held firm. The conflict in Iran has added another consideration, yet the impact so far has been limited, with spreads responding mostly through energy markets and selective spread widening rather than broad credit repositioning. We continue to expect a more range bound market unless the current situation prolongs for an extended period and the probability of a major macro shock in the form of a deeper recession emerges. Dispersion is likely to keep rising across sectors and issuers while heavy supply should continue to offer selective investment opportunities, in our view. The ECB remains data dependent, and market pricing has shifted toward a higher for longer stance. Valuations remain tight but still compare favourably to some sovereign markets, which support the role of Euro IG within overall asset allocations.

What could go wrong?

- A sustained rise in oil or broader commodity disruption could pressure spreads, particularly if shipping routes are affected and volatility in energy markets further increases.
- A combination of weaker growth and renewed inflation pressure could weaken the safe-haven behaviour Euro IG has recently exhibited and trigger a flight to quality to German government bonds.
- Rapid adoption of AI could raise unemployment if automation accelerates, placing strain on consumer linked credits and bank retail exposures.
- Stress in private credit with further negative headlines remains a risk. Rising default rates and funding pressure may spill into public markets by reducing liquidity and weakening demand for especially lower quality BBB credit as the risk of crossing over becomes more prominent.
- A further escalation of geopolitical tensions could feed through markets and increase volatility. Additional restrictions on trade and technology exports could affect supply chains and negatively impact corporate confidence.
- Fiscal concerns remain relevant and can be further exacerbated by concerns about growth. Renewed volatility in sovereign markets such as France, Italy or the United Kingdom could affect credit through the rates channel.
- Heavy supply has been absorbed well, but a sudden rise in yields or an unexpected outflow could overwhelm demand and create temporary indigestion or dislocations.



Credit Scorecard

▲ Upgraded ▼ Downgraded — Unchanged

Strategy

Score **December** March

Euro credit

-3 -2 **-1** N +1 +2 +3

Source: L&G as at 31 March 2026 – can be subject to change at any point.

Key risk

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Emerging market debt: **resilience** amid increasing **uncertainty**

Emerging market fundamentals remain robust, but we are cautious of growing geopolitical risks.



Raza Agha
Head of Emerging Market Sovereign Strategy



Viraj Nadgir
Senior Fixed Income Specialist

The past – what just happened?

After a strong start to the year, the Iran war has led emerging market debt (EMD) to pare back some of its gains, though the asset class has demonstrated resilience. As of 12 March, EM hard currency sovereign bonds had returned 0.4% year-to-date, while corporates were up 0.7%. These gains were largely driven by the high yield segment, with carry playing a significant role, while the rates sell-off weighed on investment grade performance. Over the same period, EM local markets underperformed, delivering a -0.4% return, primarily due to a stronger US dollar in March.

The present – positioning and performance

As noted earlier, EM spreads rebounded sharply in mid March following the initial sell off triggered by the conflict. In context, the hard currency sovereign index is only 4 basis points (bps) wider year to date, while the hard currency corporate index is 1bp tighter (as of 12 March).

Key risk

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A key factor underpinning this resilience has been the continuation of inflows into the asset class, with the first week of March recording a faster pace of inflows than both January and February. Ratings momentum has also remained supportive, with EM upgrades exceeding downgrades for the 27th consecutive month, including during the week in which the conflict began. This backdrop has supported record issuance, already approaching one third of full year broker estimates. Despite tight valuations and low cash buffers, new issues have attracted large order books and have generally performed well in the secondary market.

Importantly, EM entered the conflict from a position of relative strength. Growth remains resilient, inflation is on a downward trajectory, and public finances have benefited from strong nominal growth, easing monetary cycles, and debt ratios that remain well below those of developed markets. External positions are also robust, with EM as a whole running current account surpluses, supported not only by strong trade balances but also by resilient remittance flows.





Outlook

On 8 April, the US and Iran agreed to a two-week conditional ceasefire. However, if the conflict persists afterwards, disruptions to oil and gas markets will weigh on EMs via higher commodity prices – for hydrocarbons

and fertilisers, in particular – and from the hit to global markets and investor sentiments. On a regional basis, EM Asia and the Middle East are particularly vulnerable given the former is a net energy importer, while hydrocarbon production and exports from the Gulf sovereigns are being impacted by supply disruptions in the Strait of Hormuz. That said, many sovereigns in both regions have strong balance sheets, reflected in investment grade ratings and large buffers of sovereign assets.

Our EMD portfolios were underweight Middle East at the beginning of the recent escalations in region. This reflected our view that **elevated geopolitical risks were not adequately priced into regional valuations** amid record issuance from the most exposed issuers. Our overall beta was relatively modest and declining given overall valuations, with our core exposure comprising credits anchored by economic reforms, International Monetary Fund programmes providing financing along with policy support and/or favourable commodity endowments. Our beta remains modest, while we have used the sell off to partially reduce underweights in weaker credits or add selectively to positions we like in a gradual manner.

Meanwhile, the potential inflationary impact of higher oil prices in the US has tempered expectations for US Federal Reserve interest rate cuts. As a result, we remain cautious on duration and continue to keep it broadly in line with benchmarks across our portfolios.

What could go wrong?

A sustained ceasefire that culminates in a peace agreement acceptable to all sides still faces considerable uncertainties. Further, the current Iran war is unfolding against a range of challenges including elevated AI related issuance, emerging stresses in private credit markets, and historically tight EM spreads, particularly within investment grade. Markets appear complacent on these fronts, in our view, and too quick to assume that the Iran conflict will be short lived. If this does not turn out to be the case, the global ramifications will be more pronounced, with longer disruptions to hydrocarbon and chemicals/fertiliser supplies implying higher prices, which will filter through to higher inflation, and a broader risk off across asset classes. These uncertainties have led us to reduce our overall risk score to neutral from +1.

Credit Scorecard

▲ Upgraded ▼ Downgraded — Unchanged

Strategy

Score **December** **March**

Emerging market debt

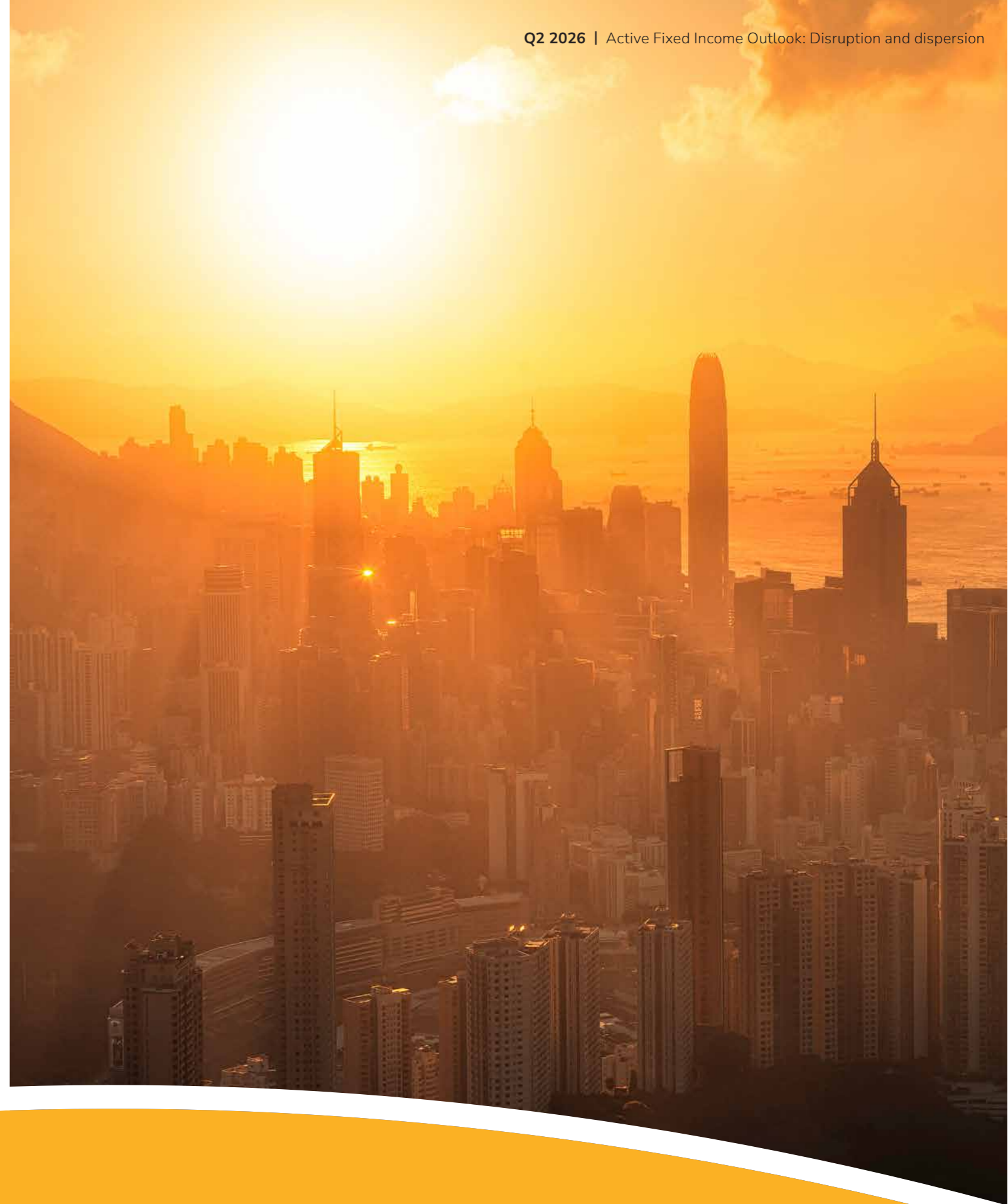
-3 -2 -1 **N** +1 +2 +3



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Key risk

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Global high yield: when risks overlap in 2026

A supportive carry backdrop but layered risks warrant a more defensive, flexible stance.



John Ryan
Head of Global High Yield



Sophia Hunt
Senior Fixed Income Investment Specialist

The past – what just happened?

Markets entered the first quarter of 2026 with firmer risk appetite, supported by resilient macro data and sustained demand for income. However, geopolitical tensions in the Middle East and ongoing adjustments in AI-exposed software names kept volatility elevated and contributed to greater dispersion across markets.

The knock-on effects of the conflict were most visible in oil and gas, with secondary impacts across diesel, kerosene, fertilisers and industrial chemicals. These pressures were felt most acutely in Europe and parts of Asia, where energy dependency and supply-chain sensitivity are notably higher.

In this environment of heightened volatility, investors have generally preferred to stay cautiously invested rather than meaningfully de-risk, consistent with the absence of large outflows or recession signals. From a ratings perspective, so far this has translated into a preference for higher-quality carry, with BB credits modestly outperforming B-rated issuers.

Key risk

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The present – prioritising liquidity and quality in a more fragile market

We entered February with a positive stance. However, this was revised down to neutral stance on midway through the month, reflecting relatively tight spreads and a balanced assessment of risks and opportunities. At the beginning of March, we moved the strategy to -1, as the escalation of Iran-related geopolitical risks added to a market already navigating AI-driven disruption, credit stress in software and direct lending, and a generally more fragile macro environment. In our view, these developments increase the likelihood of spread widening from here, with our base case now centred on moves towards the 10th-40th percentile range, and as much as 100-150bps of widening in more stressed scenarios. A tightening episode over the next three to six months appears more of an upside case.

Against this backdrop, we have raised liquidity in most portfolios, focusing on reducing exposure to CCC and D-downside credits and reallocating selectively towards higher-quality B-downside opportunities. We are also actively reviewing industry positioning in light of evolving sector-level risks. However, we maintain our overweight exposure to higher spread energy names, which should benefit from this environment.

Our effective beta is expected to move closer to neutral, reflecting a more cautious position in the current environment. Under normal conditions we would aim to generate more income than the benchmark, but we are temporarily forgoing some of this additional carry in light of what we view as an elevated risk of spread widening.





Outlook – a more cautious stance as layered risks build

Our current global high yield stance is more cautious than it was earlier in the year. We moved from a neutral view to a negative score because the balance of risks has shifted: markets are now contending with several pressures at the same time, including heightened geopolitical uncertainty around Iran, ongoing disruption from AI, and pockets of credit stress in software and direct lending. When multiple shocks overlap, market behaviour can become non-linear – risk appetite and liquidity can deteriorate faster than fundamentals would imply.

Importantly, this is not a recession call. Rather, it reflects our view that spreads have limited room to tighten from already demanding levels, while the probability of a pull-back has increased. In the current environment, the balance of outcomes is skewed: we see greater potential for spreads to widen than to grind tighter over the coming months, with tightening now firmly an upside scenario. In short, the asymmetry is now working against us.

Regionally, Europe appears more exposed to the current set of risks, given its greater sensitivity to energy and gas prices and the broader knock-on effects. Corporate fundamentals remain broadly sound – supported by the region’s higher-quality mix, with over 70% of high yield issuers rated BB – but volatility and narrative risks are elevated. By contrast, the US is likely to prove more resilient if the shock remains primarily energy-driven.

Given this backdrop, we are prioritising flexibility and downside management. We have reduced credit risk, increased liquidity and shifted the portfolio away from the most vulnerable lower-quality exposures, while redeploying selectively into higher-quality opportunities with shorter duration. We anticipate greater sector divergence and therefore looking at deploying that tactically across regions.

What could challenge our view and positioning?

A number of developments could shift the balance of risks and lead us to reassess our current more cautious stance:

- Geopolitical risks recede and energy prices normalise:**
 If tensions in the Middle East ease and oil and gas prices stabilise, the macro environment could look materially less fragile. This would reduce one of the key drivers of our expectation for wider spreads.
- AI disruption proves more manageable than feared:**
 A steadier, more complementary adoption of AI – supporting productivity rather than displacing existing business models – would help underpin earnings and keep default expectations low. A benign AI narrative would reduce one of the main sources of market volatility.
- Private credit stress remains contained:**
 If challenges in private credit and leveraged loans stay isolated – without meaningful contagion into public high yield – it could reinforce demand for liquid HY markets, potentially positioning the asset class as a relative safe haven.

Credit Scorecard

▲ Upgraded ▼ Downgraded ■ Unchanged

Strategy

Score

December

March

Global high yield

-3

-2

-1

N

+1

+2

+3

Source: L&G as at 31 March 2026 – can be subject to change at any point.

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