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Dodge & Cox®
Worldwide Funds

Higher Yields, Tight Spreads: Patience and Selectivity in Fixed Income

Key Takeaways

- **Higher yields have improved the return outlook for fixed income.** The year-to-date rise in yields has weighed on returns but has set up a more favourable multi-year outlook in our view.
- **While bond yields are attractive today, the compensation for credit risk is not.** With spreads near historical lows, the Global Bond Fund holds less credit than usual and more in government bonds and Agency[1] mortgage-backed securities (MBS). This positioning gives us the capacity to add credit risk when valuations improve.
- **We've faced tight spreads before and are applying a process tested across cycles:** fundamental research, valuation discipline, a three- to five-year horizon, and emphasis on risk management.
- **Tight index credit spreads mask issuer differences but our bottom-up approach is uncovering value:** for example, hyperscalers' bonds cheapened by AI-related issuance and select below investment-grade issuers like Pemex.
- **Global rates and currencies offer additional return potential and diversification.** The Global Bond Fund invests in a broad set of these non-U.S. exposures.

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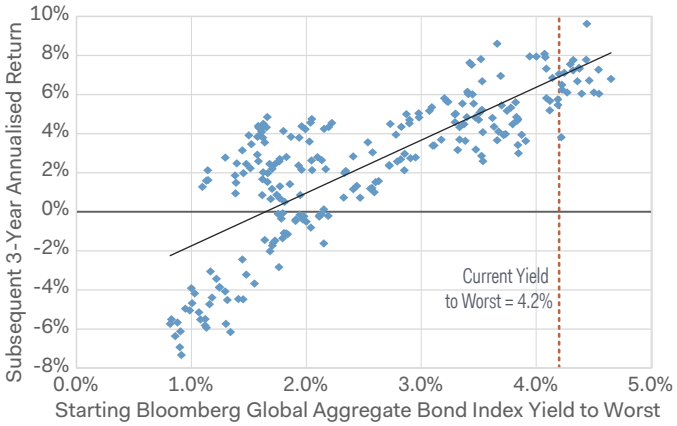
Global investment-grade bond yields remain close to 15-year highs, reflecting the steep rise in U.S. Treasury yields since 2022 and its spillover to other markets, even after easing modestly last month. Corporate credit spreads, by contrast, remain near historic lows, leaving investors less compensation for credit risk and little room for error.

For many of our shareholders, the appeal of today's yields is clear. A harder question is what we can deliver above the broad market's return when credit, historically an important source of our excess returns, offers so little spread. It's a reasonable question, and one we have faced before. Below, we discuss what higher yields mean for return prospects, how we have handled similar credit environments in the past, and where we are finding opportunities in the Dodge & Cox Worldwide Funds—Global Bond Fund.

Higher Yields: A Better Starting Point

At the end of October 2026, the Bloomberg Global Aggregate Bond Index's yield to worst stood at 4.2%, compared with an average of 2.3% since 2010.[2] For bond investors, starting yield has historically been one of the most reliable indicators of subsequent long-term returns. Starting yield is not a forecast, and realised returns will vary with changes in factors such as interest rates, spreads, and defaults. But over a multi-year horizon, today's higher starting yield can provide substantially more income to offset adverse price movements than investors had for much of the post-financial crisis period.

Figure 1. Bloomberg Global Aggregate Bond Index: Starting Yield to Worst vs. Subsequent 3-Year Annualised Total Return



Source: Bloomberg Index Services. Three-year periods ended 31 October 2006 through 31 October 2026 plotted monthly.

That said, much of today's higher yields reflect higher Treasury yields rather than compensation for credit risk, which remains thin. This environment heightens the need for disciplined security selection and careful credit underwriting.

A Process Tested Across Cycles

Our approach continues to rest on fundamental research, strict valuation discipline, a three- to five-year investment horizon, and risk management. That means being selective about what we own, disciplined and long-term in our perspective, and open to opportunities across sectors and markets. Credit is one of several levers we can use, alongside securitised products and duration positioning, in seeking to generate excess returns. We size and shape our credit exposure based on relative valuations. When we don't think we are being adequately compensated for risk, we aim to reduce it. Moving up in quality during times of market exuberance gives us flexibility to add risk when relative valuations subsequently become more attractive. Our experienced investment team has applied this process through multiple market cycles, with members of our Global Fixed Income Investment Committee averaging 18 years of tenure at the firm.

Discipline Through Past Spread Cycles

Our valuation discipline with respect to credit spreads has served Fund shareholders well in the past, as shown in Figure 2.[3] We reduced credit exposure as spreads tightened in 2017 and 2019. In both cases, the Fund performed well compared to its benchmark over the subsequent few years. Conversely, periods of spread widening have weighed on short-term results but often let us add credit at valuations that created long-term value.

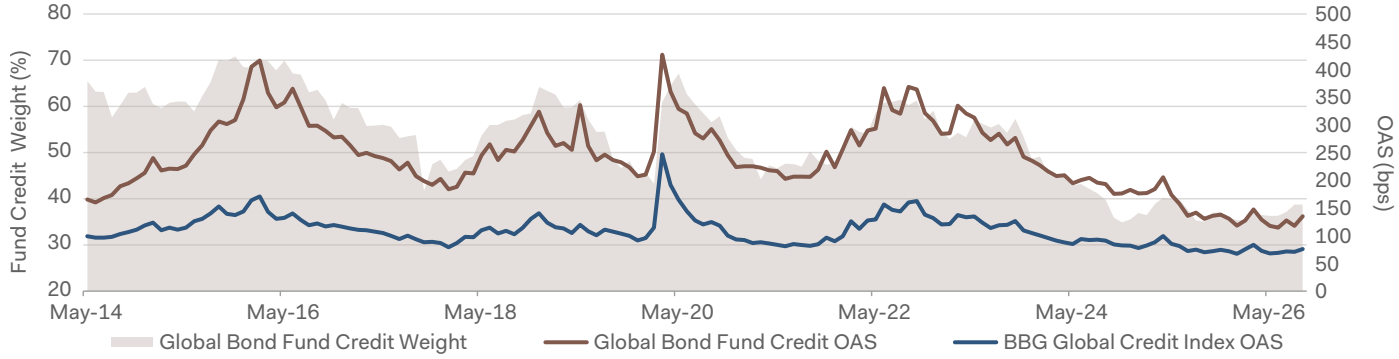
The pandemic provides a clear example of this approach in action. Entering 2020, we had trimmed richly valued corporate bonds and held substantial liquidity in Treasuries and Agency MBS. When spreads widened sharply, we redeployed capital into issuers we knew well at valuations we believed more than compensated for their risks. While the circumstances were exceptional, the discipline—preserving flexibility when valuations are rich and acting when they improve—remains central to our approach.

Holding Less Credit Today, Preserving Capacity to Add

Credit spreads across most sectors are currently near their tightest levels of the past 20 years, leaving investors little cushion if economic conditions or market sentiment deteriorate, or if issuers default.

As credit spreads tightened over the past few years, we meaningfully reduced the Global Bond Fund's credit weighting, shortened the duration of our credit holdings, and trimmed exposure to lower-rated credits. Although spread volatility in 2026 has created opportunities to selectively add credit exposure, the Fund's Credit sector allocation remains below its 10-year historical average: 38.7% vs. 50.2% average.[4] The Fund holds substantial allocations of government bonds and highly liquid Agency MBS. This positioning forgoes some incremental income today. In exchange, it can limit adverse performance impacts from spread widening and give us the capacity to redeploy capital if they do.

Figure 2. Active Credit Positioning Across Spread Cycles



Source: Bloomberg Index Services, Dodge & Cox. As of 30 September 2026.

Selectivity: Value Beneath the Averages

Tight aggregate spreads do not mean every security is overvalued. Across the market, issuer fundamentals vary widely, and valuations do not always reflect them. Where the two diverge, bottom-up research can identify individual opportunities even when the broader market looks expensive. We invest in only a small fraction of the investment-grade credit universe (e.g., the Global Bond Fund held 59 of the over 2,700 credits in the Bloomberg Global Credit Index on 30 September). Despite our cautious overall stance, we have added 13 new credit issuers in the Fund over the past year, where our analysis shows potential long-term value.

AI Borrowing: Weighing Supply, Spending, and Valuation

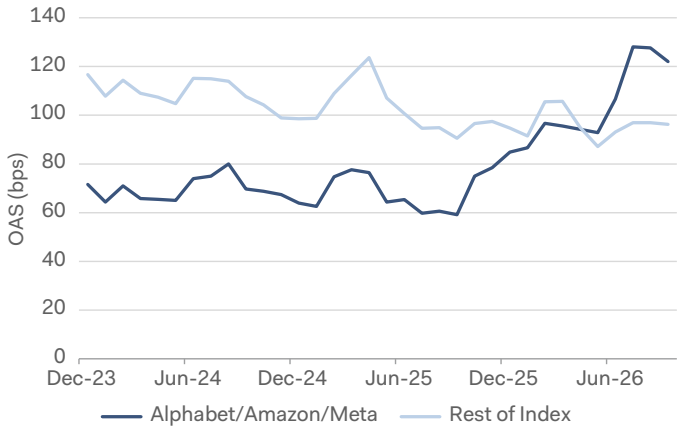
In the current environment, we have been finding opportunities in hyperscalers (large companies involved in artificial intelligence, computing, and networking infrastructure). Capital spending on data centres, semiconductor supply chains, and power infrastructure is creating large financing needs, and hyperscalers are becoming some of the bond market's biggest borrowers. Year to date, the main six (Alphabet, Amazon, Meta, Microsoft, Oracle, and SpaceX) issued more than $275 billion combined of new debt globally.[5] These six hyperscalers made up 5.1% of the U.S. Corporate Investment-Grade Index on 31 October, and we expect that share to grow, with their capital expenditures estimated to exceed $1 trillion in 2027.

Although we have long found the fundamentals of high-quality technology issuers attractive, their valuations have often been less compelling. That changed recently, as heavy debt issuance and uncertainty about the ultimate returns on AI capital spending have pushed spreads wider, creating more attractive entry points.

In the Global Bond Fund, we have invested in bonds issued by two of the three AA-rated hyperscalers: Alphabet and Meta.[6] While the scale and potential returns of their AI investments warrant scrutiny, we believe their financial strength and business fundamentals support owning their debt at these valuations (see Figure 3). We believe these high-quality, diversified franchises can comfortably service their debt even if their AI monetisation falls short of expectations. Meta is a striking example: despite its AA credit rating and $1.8 trillion market capitalisation on 30 September, its long-dated bonds traded wider than almost the entire investment-grade corporate bond market.[7]

At current valuations, we believe these hyperscalers' bonds could perform well vs. comparable-duration debt of other investment-grade issuers over our investment horizon. The main risks are if heavy issuance pressures spreads for longer than we expect or if spending outpaces cash generation and weakens their balance sheets.

Figure 3. Credit Spreads: Long AA Hyperscalers vs. Rest of Bloomberg U.S. Long Corporate Index



Source: Bloomberg Index Services. As of 30 September 2026.

Selective Opportunities in High Yield: Pemex and Sovereign Support

While the Fund's benchmark is an investment-grade index, we invest selectively in high yield where our credit research gives us conviction. We require meaningful compensation for taking on that risk.

Pemex, Mexico's state oil company, is a longstanding holding in the Fund that is rated below investment grade by two of the three major rating agencies. Sovereign support, totalling tens of billions of dollars in recent years, has been critical to Pemex and remains central to our investment thesis. Despite the company's ongoing operational and financial challenges, we believe Mexico has both the ability and willingness to provide additional support. Our analysis suggests Mexico's fiscal position is manageable, and the country has sufficient degrees of freedom to continue providing financial support to Pemex. The government's policy signals and 2027 budget proposal are consistent with that view.

We continuously assess risks to that support. The economic and political costs of backing Pemex could rise, USMCA negotiations could end unfavourably for Mexico, and economic growth could slow further, intensifying pressures on the sovereign balance sheet. Overall, however, we believe Pemex's yield, over 7% for a five-year maturity and over 9% for 20- to 30-year maturities, offers adequate compensation for those risks over our investment horizon.

Global Reach: Looking Beyond the U.S.

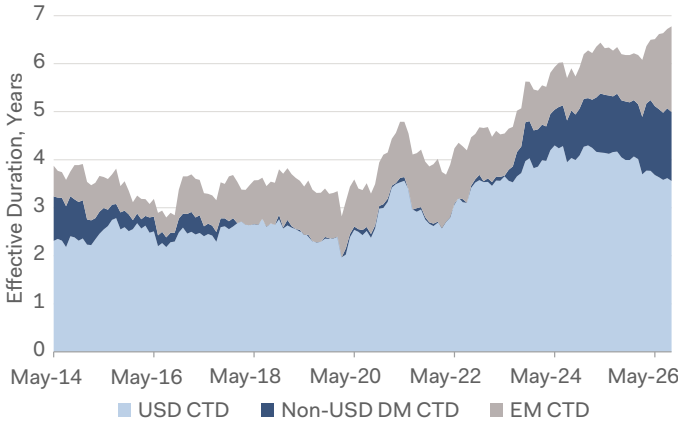
The Global Bond Fund's mandate broadens the opportunity set across rates, currencies, and credit. Non-U.S. rates markets with differing economic and policy outlooks can offer diverse sources of portfolio returns, while currency positions offer return potential distinct from the direction of U.S. rates and credit spreads.

Non-U.S. Rates: Different Fundamentals, Different Cycles

While we remain comfortable with U.S. interest rate risk, resilient growth, inflation, and large fiscal deficits may limit how far long-term Treasury yields fall. We see certain other markets offering attractive yields with fundamentals that compare favourably to those of the United States.

Reflecting this view, non-U.S. duration accounted for 53% of the Global Bond Fund's overall duration as of 30 September, the highest share since the Fund's inception (see Figure 4). That positioning diversifies the Fund's return drivers and, we think, improves its risk-reward profile.

Figure 4. Global Bond Fund's Contribution to Duration (CTD)



Source: Dodge & Cox. From 1 May 2014 through 30 September 2026. DM (developed markets) and EM (emerging markets).

Among the Fund's current developed market holdings, countries such as Norway and Australia offer yields similar to those of the United States but have stronger fiscal positions. Ten-year Japanese yields have risen from near zero to around 3%, their highest levels since the 1990s, leading us to initiate the Fund's first-ever position in long-term Japanese government bonds earlier this year. We also believe duration is attractive in select emerging markets. Several Latin American countries to which we have exposure, for example, offer sizeable real and nominal yields, and we believe have credible central banks, strong backstops, and better fiscal outlooks than many developed markets.

Currency: Starting from an Expensive U.S. Dollar

We seek to invest in currencies where the combination of income and expected appreciation creates an attractive range of potential returns. In our experience, starting valuation is an important driver of long-term currency movements and thus a key focus of our research process. Our work suggests the U.S. dollar remains expensive relative to history on a trade-weighted basis and could weaken against several currencies over our multi-year investment horizon. Currency moves are difficult to time, however, and the U.S. dollar could remain strong, particularly during periods of market stress. This is an important reason why we seek currency exposures embedding differentiated domestic and external drivers.

As of 30 September, the Global Bond Fund's 22% non-U.S. dollar exposure spanned a dozen currencies that are underpinned by diverse rationales. For some, valuation is the primary driver: the Japanese yen remains near multi-decade lows relative to our fair-value estimates, and the Bank of Japan's gradual policy normalisation could help close that gap. For the Brazilian real, income plays a larger role: an undervalued currency coupled with an attractive real yield that compensates us even if the currency doesn't appreciate. Still, others benefit from country-specific catalysts, such as South Korea's role in the AI supply chain or an improving policy outlook in Hungary following its recent election. Because these drivers differ, the performance of our currency positions does not depend on any specific macroeconomic scenario materialising.

Bringing It Together

Today's fixed income markets present an unusual combination: attractive starting yields alongside historically tight credit spreads. Higher yields have improved the return outlook for fixed income, while tight spreads limit compensation for taking credit risk and raise the importance of selectivity. We believe this argues for patience but not inactivity. Accordingly, our corporate allocations remain below their historical averages, leaving dry powder ready to deploy, and we continue to invest where bottom-up research identifies compelling value. Our approach—enduring across various market environments—emphasises valuation, fundamental research, and the flexibility to act as opportunities emerge. It is with this mindset that we remain vigilant and opportunistic in our pursuit of strong long-term returns for our shareholders.

We would welcome the opportunity to discuss these perspectives with you.

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1. The U.S. Government does not guarantee the Fund's shares, yield, or net asset value. The agency guarantee (by, for example, Ginnie Mae, Fannie Mae, or Freddie Mac) does not eliminate market risk.
2. Source: Bloomberg Index Services. Yield to worst as of 31 October 2026. Arithmetic average calculated on a monthly basis from 31 December 2010 to 31 October 2026.
3. OAS (option-adjusted spread) is the option-adjusted yield differential between stated index and comparable government bonds. OAS does not translate into a return. One basis point (bps) is equal to 1/100th of 1%.
4. Unless otherwise specified, all Fund weightings, characteristics, and holdings-related statements are as of 30 September 2026.
5. From 1 January 2026 through the date of publication. The use of specific examples does not imply that they are more or less attractive investments than others in the investment universe.
6. Based on the middle of Moody's, Standard & Poor's, and Fitch ratings, which is the methodology used by Bloomberg in constructing its indices. If a security is rated by only two agencies, the lower of the two ratings is used. Please note the Fund applies the highest of Moody's, S&P, and Fitch ratings to determine compliance with the quality requirements stated in their prospectuses. The credit quality of the investments in the portfolio does not apply to the stability or safety of the portfolio or its shares. Ratings agencies generally do not rate issuers, rather they generally rate securities issued by an issuer. S&P and Fitch rank credit quality from AAA (highest) to D (lowest), while Moody's ranks it from Aaa (highest) to C (lowest).
7. As of 31 October, Meta's market capitalisation declined to $1.6 trillion and its option-adjusted spread widened further.