PORTFOLIO MANAGEMENT OUTLOOK

Sound Credit Fundamentals and Elevated Yields to Weather Tail Risks to Our Outlook

This report is excerpted from the Third Quarter 2026 Fixed-Income Sector Views.

The economic backdrop for fixed income remains attractive. Our baseline U.S. economic outlook calls for real gross domestic product (GDP) growth to stay around 2 percent this year and into next, supported by business investment in artificial intelligence (AI), higher end consumer spending tied to rising AI-related stock prices, and near-term fiscal stimulus. We expect inflation to cool later this year as the effects of tariffs and higher energy prices fade, allowing the Federal Reserve (Fed) to remain on hold. Still, prolonged escalation in the Middle East, sticky inflation, or an interruption in the AI thesis that leads to a pullback in AI capital expenditure (capex) and consumer spending pose risks to our baseline outlook.

Credit and Risk Positioning

Our investment approach is guided by several key dynamics: all-in yields remain attractive; credit spreads in many sectors are near all-time tights; and credit fundamentals are strong but diverging among industries more exposed to tariffs, technology shifts, and interest rates.

In this environment, our positioning emphasizes income generation and diversification. We remain neutral relative to our long-term credit beta targets and have added hedges amid ongoing volatility. We prefer high carry instruments within defensive sectors, including senior commercial ABS and non-Agency RMBS. Within corporate credit, our investment-grade strategies still lean long financials, while our high yield strategies remain up in quality and selective within industries with uncertain earnings trajectories. Across strategies, we are preserving dry powder and risk capacity to withstand a range of outcomes and take advantage of market dislocations when they occur.

Duration and Interest Rate Views

Since the onset of the Iran conflict, the Treasury yield curve has flattened as front-end rates moved higher, prodded by higher oil prices and Fed Chair Kevin Warsh's hawkish remarks at his first press conference. A resilient economy and persistent fiscal deficits should keep long rates elevated, with the 10-year Treasury yield likely remaining in its recent range. Yields are attractive at the short and intermediate part of the curve, and we are adding exposure in the two- to five-year segment while tactically rotating in and out of the 10-year tenor as it moves within our expected range. In either scenario, Treasury Inflation-Protected Securities (TIPS) offer a compelling risk-reward profile, providing meaningful upside if the Fed stays patient and a durable hedge if inflation reaccelerates.

As investors get accustomed to the Fed's reaction function and communication policies under its new leadership, we are navigating a solid economic environment and smoothly functioning markets, with an array of tail risks to our base case. Against this backdrop, we believe rigorously vetted higher quality credit offers attractive yields, potential price appreciation, and portfolio ballast to weather a range of outcomes.

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