PRODUCT COMMENTARY

CORE AGGREGATE COMPOSITE

Third Quarter 2025

MERGANSER TODAY

Merganser Capital Management is a best-in-class boutique fixed income manager with a fundamentals-based investment approach. Formed in 1985, Merganser is an SEC registered investment advisor focused on the needs of institutional clients.

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MARKET OVERVIEW

Softening labor markets, and by extension, the resumption of the Federal Reserve's (Fed's) easing cycle were among the major themes impacting US Investment Grade (IG) fixed income markets during the third quarter of 2025. At the beginning of August, US employment data revealed that hiring slowed considerably in July. Additionally, revised data for May and June reduced the number of net jobs gains for those two months by a jarring 88%. President Trump responded by questioning the accuracy of the data and promptly firing the head of the Bureau of Labor Statistics. In that vein, the Fed faced unprecedented political pressure during the quarter, culminating with the administration's attempt to forcibly remove Fed governor Lisa Cook through allegations of mortgage fraud. Additionally, President Trump issued threats of firing Fed Chair Powell prior to the end of his term next spring. Questions regarding the central bank's ability to maintain its independence contributed to curve steepening during the quarter. Later in August, investors' focus shifted to the Jackson Hole Economic Policy Symposium, where Fed Chair Powell delivered dovish remarks, opening the door for a September interest rate cut, pushing US Treasury (UST) yields lower. As anticipated, the Fed cut its target rate by 25 basis points (bps) in September, citing weakness in labor markets as the catalyst to resume the easing cycle that's been on hold since December. UST yields decreased modestly during the quarter. The 2-year, 10-year, and 30-year UST yields decreased by 11, 8, and 4 bps, respectively. The yield curve steepened modestly as measured by both the 2's vs. 10's and 10's vs. 30's curves. Despite continued geopolitical tensions, tariff uncertainty and a looming government shutdown, sentiment was considerably risk-on among IG spread sectors, with all sectors outperforming like duration USTs. According to the Bloomberg US Aggregate index, sovereigns posted the strongest excess returns, outperforming by 255 bps. Corporate credit outperformed by 98 bps. Utilities, industrials and financials outperformed by 131, 94 and 94 bps, respectively. Among securitized sectors, Agency RMBS was the star performer, outpacing USTs by 83 bps. 30-year paper outperformed 15-year paper. CMBS outperformed by 48 bps. Non-Agency and Agency CMBS outperformed by 62 and 35 bps, respectively. ABS outperformed by 39 bps. Futures markets ended the quarter predicting approximately two more 25 basis point rate cuts this year, followed by two cuts in 2026. Attractive carry entering the quarter combined with the decline in UST yields and spread compression produced positive total returns for many US IG fixed income indices. The Bloomberg US Aggregate Index returned 2.03%, bringing the year-to-date return to 6.13%.

POSITIONING CHANGES

Longer maturity industrial spreads are reflecting value consistent with a positive fundamental outlook, but they do not account for potential risks from M&A activity, balance sheet-leveraging transactions, or economic downturn scenarios.

During the third quarter, we continued to reduce risk in our Core Aggregate portfolios by decreasing our spread sector allocations and deploying the proceeds in government securities. We increased our allocation to USTs by approximately 4%. We view this allocation as a source of dry powder that can be deployed when spread sector valuations become more attractive. Given the historically tight spread environment out the curve, USTs offer attractive relative value and downside protection. Our UST allocation is our longest duration exposure, another reflection of defensive positioning, in that it enabled us to maintain shorter credit exposure. We increased our allocation to agencies by approximately 2%. While bullet agency paper remains tight and unattractive out the curve, deep discount callable agencies offered a meaningful yield pick to bullets in the secondary market and were purchased at equivalent or wider spreads to high-quality industrials. We decreased our corporate credit allocation by approximately 1%. Longer maturity industrial spreads are reflecting value consistent with a positive fundamental outlook, but they do not account for potential risks from M&A activity, balance sheet-leveraging transactions, or economic downturn scenarios. While we remain supportive of the general industrial sector, we believe current spreads do not fully price in downside risk. Domestic utilities are well insulated from geopolitical impacts and protected from commodity volatility/inflation through rate-base adjustments. Current spreads largely reflect the benefit of highly visible cash flows across this sector. Spreads of utilities with exposure to wildfire risk remain notably wider but do not appear to fully compensate for unpredictable wildfire litigation. Banking spreads have tightened such that it is more challenging to find attractive opportunities in names we prefer, though they remain wide to other corporate sectors. We are constructive on the "too big to fail" banks but expect credit spread volatility to persist, particularly in the Yankee and regional bank sectors. REITs continue to offer limited compensation for risk related to funding costs and uncertainty over property values. We decreased our allocation to Agency RMBS by approximately 4% bringing us underweight vs. the benchmark. During the quarter, the sector benefitted from decreased interest rate volatility and reduced supply. We are favoring coupons and collateral features that reduce exposure to negative convexity. We decreased our allocation to CMBS by approximately 1% via paydowns and opportunistic sales. The market is digesting softer labor data, the key fundamental factor driving commercial real estate (CRE) valuations. Through three quarters, private label issuance of $114 billion has already surpassed the full year of 2024; led by Single-Asset Single-Borrower (up 50% YoY) and CRE CLOs (+230% YoY) and has perhaps led to some deal fatigue.

Approximately half of our CMBS allocation is Agency-backed, another reflection of our defensive posture. Our overall duration positioning was unchanged at neutral vs. the benchmark. Following September's decrease in yields, we shifted our key rate exposure to be more closely aligned with the benchmark. 30-year credit continues to look exceptionally rich and is our largest underweight in terms of contribution to duration.

OUTLOOK

Softening labor conditions with material shocks to labor supply suggest slower growth ahead. The unemployment rate has been rising for 2.5 years from its post-pandemic low of 3.4% to 4.3%. That is not sounding alarm bells, but substantial negative revisions to job growth means the US screens as an underachiever vs potential growth. The eyepopping capex spend on AI capacity building bears watching for overbuild/long-term viability. Retail sales have been a bright spot while housing remains weak. The hope is that an easing cycle can inject new life into housing and stave off further weakness in labor markets. In September, the Fed cut its target rate by 25 basis points (bps) in recognition that the balance of risks between jobs and inflation has shifted in favor of protecting against further weakness in labor markets. The fight against inflation takes a back seat for now. Fed officials find themselves between a rock and a hard place with inflation stubbornly above target and rising, while labor markets soften. The latest Summary of Economic Projections reveals a bias towards easing and less dissent than expected, demonstrating that Fed Chair has built consensus in a hyper politicly charged environment. The long end of the yield curve has traded within a wide range (100 bps) since the beginning of the easing cycle in September of 2024. Interest rate volatility (as measured by MOVE) has been shockingly stable and trending lower over the past six months. Progress toward the Fed's elusive 2% inflation target has stalled. Core PCE of 2.9% in July is up from the post-pandemic low of 2.6% in April. University of Michigan 1-year expectations were unchanged at 4.8% month-over-month, but longer term (5–10-year) expectations, which were expected to decline, rose from 3.5% to 3.9%.

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Corporate Credit spreads have compressed back to the tights. The easing regulatory backdrop continues to drive a blitz of M&A activity, pressuring future industrial balance sheets, but setting up a strong 2025 for money center banks. Within credit, we continue to prefer shorter exposures and remain circumspect when it comes to tech, pharma/healthcare, retail and autos. We see pockets of value in the government related and agency subsectors. Agency mortgage spreads have tightened sharply during the last six months in response to lower interest rate volatility and the rally in US Treasuries. That said, 30-year mortgage rates remain sticky, leaving much of the universe out-of-the-money to refinance. While we view this government guaranteed sector as providing a reasonable rate of return and exceptional

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liquidity, we believe spreads will be rangebound in the near term, and don't see a catalyst for spread tightening until there is increased bank demand. While most consumer credit strata are showing signs of weakness, the relative weakness varies dramatically between prime and subprime. Collateral performance in prime receivables continues to show a modest increase in delinquencies. Many subprime shelves and unsecured consumer loans have deteriorated noticeably and bear watching. We are avoiding the subprime market and focusing on the highest quality consumer and commercial related collateral. CMBS supply (up 50% year-over-year) is bound to accelerate with the easing cycle despite softer labor data and still rising delinquencies. The market's preference (both issuers and investors) for SASB, large piles of dry-powder at Private Equity firms, a surge in corporate M&A activity, and a growing acceptance of office collateral all suggest REIT go-private deals ahead. We remain very selective, with a preference for non-office SASB, and a focus on the top of the capital stack.

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