



MERGANSER
CAPITAL MANAGEMENT

PRODUCT COMMENTARY

STB 1-3 YEAR GOV/CREDIT 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.

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.

MARKET OVERVIEW

Softening labor markets and 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 front-end IG spread sectors, with most sectors outperforming like duration USTs. According to the Bloomberg 1-5 Year US Aggregate index, front-end sovereigns posted the strongest excess returns, outperforming by 69 bps. Corporate credit outperformed by 43 bps. Utilities, financials and industrials outperformed by 50, 48, and 38 bps, respectively. Among securitized sectors, front-end CMBS was the star performer, outpacing USTs by 45 bps. ABS outperformed by 29 bps. Front-end Agency RMBS outperformed by 27 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 1-3 Year US Government/Credit Index returned 1.19%, bringing the year-to-date return to 4.14%.

The outlook for refinance activity will be a tug-of-war between slower growth and higher long-term rates, the opposite of the environment only a few months ago.

After aggressively reducing our conduit exposure earlier this year, we are taking a patient approach, waiting for a better entry point as high quality spreads are back to pre-Liberation-Day levels.

POSITIONING CHANGES

During the third quarter, we continued to reduce risk in our Short Term Bond 1-3 Year Government/Credit 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, 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 decreased our corporate credit allocation by approximately 2%. High quality, short duration industrials are currently priced at unattractive risk/reward levels, with strong technical demand for front-end non-financials continuing to push these names tighter. Very few downside scenarios are accurately priced in, and the best time to purchase tends to be at new issue. Domestic utilities are relatively insulated from geopolitical impacts and from commodity volatility/inflation through rate-base adjustments. Highly visible cash flows at investor-owned utilities are also more reliable through various economic scenarios, but current valuations fully reflect the defensive nature of the sector, and we continue to avoid issuers with elevated wildfire liability risks. Banking spreads have tightened such that it is getting harder to find attractive opportunities in names we prefer, though still wide when compared to other corporate sectors. We remain 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 1%. Nominal and option-adjusted spreads for 15-year mortgages have been rangebound since the start of the year. Given limited supply of new production 15-year paper and tight spreads on secondary inventory, we are waiting for a more attractive entry point. We decreased our allocation to ABS by approximately 1%. While there has been some deterioration in collateral performance, deals remain well enhanced. Many of the esoteric ABS sub-sectors continue to appear overvalued and are likely to experience greater spread volatility in an environment of higher rates, increased rate volatility, and a changing economic landscape. We are opportunistically adding paper from high quality, liquid ABS subsectors. Our allocation to CMBS was unchanged at 15%. Spreads in generic multifamily Agency CMBS have remained rangebound. Given tight credit spreads elsewhere, we purchased seasoned shorter duration bonds with upside from early payoffs. The outlook for refinance activity will be a tug-of-war between slower growth and higher long-term rates, the opposite of the environment only a few months ago. After aggressively reducing our conduit exposure earlier this year, we are taking a patient approach, waiting for a better entry point as high quality spreads are back to pre-Liberation-Day levels. We continue to favor SASB where we have found attractive floating rate opportunities. Our overall duration positioning was unchanged at neutral vs. the benchmark. We increased our out-of-index exposure to the 3-5-year part of the curve in response to steepening UST and credit curves.

The eyepopping capex spend on AI capacity building bears watching for overbuild/long-term viability.

Fed officials find themselves between a rock and a hard place with inflation stubbornly above target and rising, while labor markets soften.

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 politically 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%.

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 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.

CONTACT INFORMATION

**Merganser Capital
Management**
99 High Street
Boston, MA 02110
www.merganser.com

**Consultant Relations &
Business Development**
P: 617.528.4863
info@merganser.com

This article has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. This memorandum contains or incorporates by reference certain forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue" or similar terms or variations on those terms or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors. Past performance is no guarantee of future results; investments can and may lose money. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Merganser Capital Management.