



MERGANSER
CAPITAL MANAGEMENT

PRODUCT COMMENTARY

CORE AGGREGATE COMPOSITE

Fourth 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

Continued easing of monetary policy, decreased interest rate volatility, and tremendous spending on Artificial Intelligence (AI) were among the themes impacting US investment Grade (IG) fixed income markets during the fourth quarter of 2025. The fourth quarter also saw the longest government shutdown in US history (43 days), limiting the availability of key economic data as the Federal Reserve (Fed) navigated the challenging combination of softening labor markets and stubborn inflation. The “K-shaped economy” continued to be a popular moniker during the quarter, with wealthier US consumers (supported by rising equity markets and home prices) driving healthy spending, while lower- and middle-income Americans struggled with affordability. In a term now famously coined by Jamie Dimon, several capital markets “cockroaches” emerged during the quarter, with a subprime auto issuer collapsing amidst widespread allegations of fraud and an auto parts company filing for bankruptcy. Both events sparked concerns regarding lower quality credits. IG corporate credit spreads continued to hover near historic tights during the quarter. While credit metrics remain healthy, we do not believe valuations reflect a myriad of downside risks. According to Deutsche Bank, US IG issuance totaled approximately \$1.66 trillion in 2025, making it the second largest year of issuance on record (second to \$1.82 trillion in 2020). The Federal Reserve (Fed) cut rates by 25 basis points (bps) at both its October and December meetings, marking 75 bps of total policy easing in 2025. The December Summary of Economic Projections revealed increasing dissent among Fed officials regarding the appropriate path forward. The UST yield curve steepened during the quarter as measured by both the 2’s vs. 10’s and 10’s vs. 30’s curves. Front-end yields declined in anticipation of further policy easing, while yields 7-years and longer increased. The 30-year UST yield increased by 11 bps, reflecting higher growth expectations, persistent above-target inflation, and concerns regarding the growing national debt. According to the Bloomberg US Aggregate index, risk sentiment among IG spread sectors was mixed during the quarter. IG corporate credit underperformed USTs by 4 bps, with financials and utilities outperforming by 14 bps and 6 bps, respectively, and industrials underperforming by 17 bps. Agency RMBS was the top performer, outpacing like-duration USTs by 69 bps. The sector benefitted from decreased interest rate volatility and strong demand coupled with limited supply. The ICE BofA MOVE Index continued its steady decline since

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"Liberation Day", ending the quarter at the lowest level since the fall of 2021. Conventional 15-Year and Conventional 30-Year paper outperformed by 53 and 75 bps, respectively. CMBS outperformed by 17 bps. Non-Agency and Agency CMBS outperformed by 25 and 9 bps, respectively. ABS outperformed by 16 bps. Futures markets ended the quarter predicting approximately two 25 basis point rate cuts in 2026. The Bloomberg US Aggregate Index returned 1.09% for the quarter, bringing the 1-year return for 2025 to 7.29%.

POSITIONING CHANGES

Positioning changes were relatively muted for our Core Aggregate portfolios during the fourth quarter. We decreased our allocation to USTs by approximately 2%, bringing it to 33% as of 12/31/25. We continue to 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 enables us to maintain shorter credit exposure. We increased our allocation to Agency RMBS by approximately 1%, bringing it to 24% as of 12/31/25. Option adjusted spreads on 30-year mortgages tightened during the quarter on lower interest rate volatility and reduced supply due to lower housing turnover and refinancing activity. We remain neutral on the basis and favor coupons and collateral features that reduce exposure to negative convexity. We increased our allocation to CMBS by 1%, bringing it to 8% as of 12/31/25. Non-Agency CMBS supply was concentrated in 5-year deals, driving an inverted curve given strong demand for longer duration. Over half of 2025's record issuance (\$158 billion) was floating rate. We favor SASB for sponsor and collateral quality but note the spread pick vs. conduit at the top of the capital stack has decreased. We are avoiding office while favoring other SASB sectors for targeted credit exposures. Troubled office and retail deals are likely to tarnish SASB's historically strong track record, and while losses are growing, this serves to reduce uncertainty moving forward. Spreads in generic multifamily Agency CMBS remain rangebound. We will opportunistically add when we see attractive relative value. Our allocation to corporate credit remained flat quarter-over-quarter (QoQ) at 20%. 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

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appear to fully compensate for unpredictable wildfire litigation. Banking spreads have tightened such that it is more challenging to find attractive opportunities in our preferred names, though they are still wider than other corporate sectors. We remain constructive on the "too big to fail" banks but expect spread volatility to persist, particularly for Yankee and regional banks. REITs continue to offer limited compensation for risk related to funding costs and uncertainty over property values. Our allocation to ABS remained flat QoQ at 14%. Primary market spreads in traditional ABS segments offer a modest spread concession compared to secondary market opportunities. While collateral performance has shown some deterioration, deals remain well enhanced. Many esoteric ABS subsectors continue to appear overvalued and are likely to experience greater spread volatility amid increased rate volatility and a shifting economic landscape. We plan to opportunistically add in high quality, liquid ABS subsectors. Our allocation to agencies remained flat QoQ at 2%. Bullet agency paper remains tight and unattractive out the curve. However, deeply discounted callables provide a meaningful pick to bullets in the secondary market and in many cases can be purchased flat, or even wide, to high quality industrials, making them attractive in a tight spread environment. Our overall duration positioning was unchanged at neutral vs. the benchmark. 30-year credit continues to look exceptionally rich and is our largest underweight in terms of contribution to duration.

OUTLOOK

As the data fog lifts, we see a mixed picture for the US. Softer labor conditions suggest slower potential growth; for now held at bay by the A.I./data center boom and an on-going easing cycle. Job growth is sluggish, rolling 3-month non-farm payroll growth has declined from 209k at the end of 2024 to just 22k as of Nov 2025. The unemployment rate has been rising for 2.5 years from its post-pandemic low of 3.4% to 4.6%; a level last seen in 2017 (excluding Covid). Retail sales remain a bright spot as the upper end of the K shaped consumer economy continues to spend. For the third time in a row in December, the Fed cut its target rate by 25 basis points (bps) to protect against further weakness in labor markets. In December, Fed Chair Powell stated, "the adjustments to our policy stance since September bring it within a range of plausible estimates of neutral," where they view policy as neither restrictive nor stimulative. Dissent is rising; but dot plots suggest a divided Fed favors more cuts in 2026 even if they are on hold in January. The latest Summary of Economic Projections reveals higher growth and lower inflation expectations. The long end of the yield curve has traded within a wide range (70 bps) since the beginning of the easing cycle in September of 2024. Forward expectations of interest rate volatility (as measured by MOVE) have been shockingly stable and trending lower over the past six months. Progress toward the Fed's elusive 2% goal remains stalled, at best. Given the government shutdown, there were reported gaps in the November CPI data, reported as 2.7% YoY. The Fed's preferred Core PCE, still as of September,

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is 2.8%. University of Michigan 1-year inflation expectations rose to 4.2%, but longer term (5–10-year) expectations remain stable at 3.2%.

The normalization of supply/demand within corporate credit has begun to take hold with a dramatic increase in supply from M&A and hyperscaler capex putting pressure on spreads, particularly out the curve where valuations were most compressed. Estimated supply for 2026 is likely to continue this trend. We see pockets of value in the government-related and banking spaces but are maintaining a defensive posture at these spread levels. Agency Mortgage spreads have tightened sharply during the last six months in response to dramatically 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 range bound in the near term, and don't see a catalyst for spread tightening until there is increased demand from banks. While most consumer credit strata are showing signs of weakness, the relative weakness varies dramatically between prime and subprime borrowers. Collateral performance in prime receivables continues to show modest deterioration. Many subprime consumer shelves 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 will set a new post-GFC record for 2025 (over \$156 billion, dominated by SASB) and is expected to accelerate with the easing cycle increasing transaction activity despite softer labor data and still rising delinquencies. Depressed new construction (ex. data centers) will help supply/demand dynamics improve. With spreads at multi-year tights, we remain very selective, with a preference for non-office SASB, and a focus on the top of the capital stack. We are less dismissive of softer labor markets and remain patient for another risk-off event for a better entry-point. Spreads will continue to take their cue from IG credit.

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