



MERGANSER
CAPITAL MANAGEMENT

PRODUCT COMMENTARY

STB 1-3 YEAR GOV/CREDIT 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.

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 1-5-year portion of the Bloomberg US Aggregate index, sentiment was risk-on among front-end IG spread sectors during the quarter. Front-end IG corporate credit outperformed USTs by 10 bps, with utilities, financials, and industrials outperforming by 14 bps, 10 bps, and 8 bps, respectively. Front-end Agency RMBS was the top performer, outpacing like-duration USTs by 56 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 “Liberation Day”, ending the quarter at the lowest level since the fall of 2021. Front-end CMBS outperformed by 18 bps. Front-end

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ABS outperformed by 10 bps. Futures markets ended the quarter predicting approximately two 25 basis point rate cuts in 2026. The Bloomberg 1-3 Year US Government/Credit Index returned 1.16% for the quarter, bringing the 1-year return for 2025 to 5.35%.

POSITIONING CHANGES

During the fourth 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 2%, bringing it to 27% as of 12/31/25. We view this allocation as a source of dry powder that can be deployed when spread sector valuations become more attractive. Given the unattractive 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 increased our allocation to corporate credit by approximately 1%, bringing it to 34% as of 12/31/25. High quality, short duration industrials are currently priced at unattractive risk/reward levels, with strong technical demand 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. Front-end utility operating company spreads currently provide some value, especially relative to other defensive sectors in corporate credit. 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. We decreased our allocation to CMBS by approximately 2%, bringing it to 14% as of 12/31/25. The outlook for refinance activity remains a tug-of-war between lower long-term rates offset by slower job growth. After aggressively reducing our conduit exposure last year, we are taking a patient approach, waiting for a better entry point as high quality, short duration spreads are tight. We continue to favor SASB where we have found attractive floating rate opportunities. Spreads in generic multifamily Agency CMBS have remained rangebound. Given tight credit spreads elsewhere, we are buying seasoned shorter duration bonds with upside from early payoffs. Our allocation to ABS decreased by 1%, mostly through attrition during a period of low supply, bringing it to 21% as of 12/31/25. While there has been some deterioration in collateral performance, 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.

Given the unattractive spread environment, USTs offer attractive relative value and downside protection. Our UST allocation is our longest duration exposure, another reflection of defensive positioning

The outlook for refinance activity remains a tug-of-war between lower long-term rates offset by slower job growth.

We plan to opportunistically add in high quality, liquid ABS subsectors. Our allocation to Agency RMBS remained flat quarter-over-quarter (QoQ) at 5%. 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 continue to wait for a more attractive entry point. 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 by 3% in response to steepening UST and credit curves.

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 inflation target of 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, 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

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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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