

PRODUCT COMMENTARY

STB 1-3 Year Gov/Credit Composite

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.

There was no shortage of geopolitical shocks for investors to digest.

The quarter began with the US capture of Venezuelan leader Nicolás Maduro and ended with the US and Israel at war with Iran.

MARKET OVERVIEW

War in the Middle East sent energy prices surging higher during the first quarter, sparking concerns regarding resurgent inflation and pushing US Treasury (UST) yields higher. The 2-year, 10-year and 30-year UST yields increased by 32, 15 and 7 basis points (bps) during the quarter, respectively. Front-end yields repriced forecasts for further policy easing, while longer yields responded to higher inflation expectations. The UST yield curve flattened as measured by both the 2's vs. 10's and 10's vs. 30's curves. There was no shortage of geopolitical shocks for investors to digest. The quarter began with the US capture of Venezuelan leader Nicolás Maduro and ended with the US and Israel at war with Iran. The Iran conflict roiled global energy markets as cargo travelling through the Strait of Hormuz grinded to a halt. According to the 1–5-year portion of the Bloomberg US Aggregate index, risk sentiment among front-end Investment Grade (IG) spread sectors was mixed during the quarter. Front-end IG corporate credit spreads widened and the sector underperformed USTs by 5 bps. Industrials and utilities both outperformed by 2 bps, while financials underperformed by 16 bps. Headlines regarding weakness in private credit spilled over to IG markets across several sectors during the quarter, most notably in financials. Other catalysts for spread widening included heavy supply and AI disruption related concerns. The US Supreme Court ruled against President Trump's Liberation Day tariffs, indicating he had exceeded his authority. President Trump quickly responded with a new round of tariffs on imports, making the long-term implications of trade policy increasingly unclear. Among front-end securitized sectors, CMBS was the top performer, outpacing like-duration USTs by 30 bps. Front-end ABS outperformed by 15 bps. Remittance reports for consumer receivables continued to reflect differentiation between prime and subprime borrowers. Front-end Agency RMBS underperformed USTs by 7 bps. The Federal Reserve (Fed) left its target range unchanged at 3.50% - 3.75% at both its January and


March meetings. Futures markets ended the quarter predicting effectively no changes to the Fed Funds target rate during 2026. Kevin Warsh is slated to become the next Fed Chair during 2Q26. The Bloomberg US 1-3 Year Government/Credit Index returned 0.28% for the quarter, bringing the trailing 12-month return as of 3/31/2026 to 3.96%.

POSITIONING CHANGES

During the first quarter, we opportunistically deployed capital in our Short Term Bond 1-3 Year Government/Credit portfolios by decreasing our allocation to government guaranteed securities and increasing our allocation to short duration corporate credit. Agency RMBS spreads tightened sharply following the administration's January announcement of the \$200 billion purchase program by the GSE's. The tone in Agency RMBS had knock-on effects in Agency CMBS, where we maintained an 11% allocation entering the quarter. We reduced this allocation to 9% by selling richly valued, short duration securities. Agency CMBS has proved to be an effective store of value in the tight spread environment of the last several years. We also decreased our allocation to US Treasuries by approximately 1%. We increased our allocation to corporate credit from 34% to 36%. A dramatic increase in supply from M&A, hyperscaler capex, and emerging AI disruption risks have pushed spreads wider for many industrial sub-sectors. The risks in the sector are better reflected in spreads after the recent move wider and we expect to continue to selectively add exposure. Domestic utilities are relatively insulated from geopolitical impacts and 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 value, especially relative to other less defensive sectors in corporate credit. Our allocation to ABS was unchanged during the quarter at 21%. 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 with increased rate volatility and a changing economic landscape. We are opportunistically looking to add in high quality liquid ABS subsectors. In Non-Agency CMBS, 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

Agency CMBS has proved to be **an effective store of value** in the tight spread environment of the last several years.

A dramatic **increase in supply from M&A, hyperscaler capex, and emerging AI disruption risks** have pushed spreads wider for many industrial sub-sectors.



year, we are taking a patient approach, waiting for a better entry point as high quality spreads are 70-80 bps tighter. We continue to favor SASB where we have found attractive floating rate opportunities. We reduced our allocation to Agency RMBS by 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 will wait for a better entry point. Our overall duration positioning was unchanged at neutral vs. the benchmark.

OUTLOOK

U.S. growth remains resilient, supported by AI related investment and selective fiscal measures, even as labor data (softer job openings, rising layoff announcements) point to mounting slack. The expansion is increasingly K shaped with wealthier US consumers (supported by rising equity markets and home prices) driving healthy spending, while lower- and middle-income Americans struggled with affordability. Policy and trade uncertainty have returned after the Supreme Court curtailed executive tariff authority. Meanwhile, the Iran war heightens concerns about already challenging debt and deficit dynamics. With oil near the low \$100s, the risk of stickier inflation raises the odds of a higher for longer rate path and a slower growth trajectory. In March, the Fed kept its target rate unchanged, overall leaning hawkish. Their latest forecast pointed to slightly higher medium-term inflation and PCE forecasts were revised upward to 2.7% and 2.2% for 2026 and 2027 on the heels of the Iran war. Meanwhile, the transition to incoming Chair Kevin Warsh adds a layer of policy uncertainty: Warsh has argued the Fed has been too slow to cut and could support at least two 25 bp cuts in 2026 while advocating for a leaner, shorter duration balance sheet. 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) were stable and trending lower until a sharp move higher

U.S. growth remains resilient, supported by AI related investment and selective fiscal measures, even as labor data (softer job openings, rising layoff announcements) point to mounting slack.

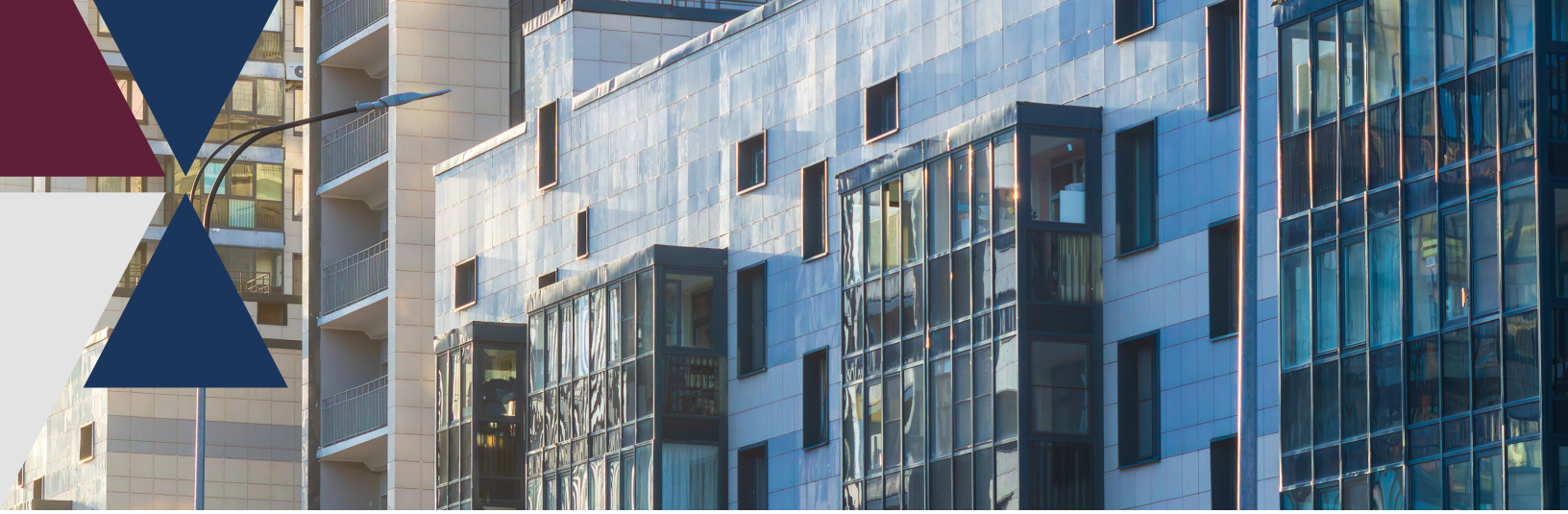
With oil near the low \$100s, the risk of stickier inflation raises the odds of a higher for longer rate path and a slower growth trajectory.

recently due to the Iran war. The number of Fed cuts expected has decreased, and for the first time in a number of years, the future path of rates looks two sided; the next move could either be lower or higher. Inflation risks have tilted modestly higher in the near term, driven by a sharp spike in oil and market expectations for a Fed cut have been re-racked sharply lower. Despite these near-term pressures, intermediate-term inflation expectations remain relatively anchored, gradually moderating due to a cooling labor market. The Fed's latest projections continue to see core PCE easing toward ~2.7% in 2026.

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. Estimated supply for 2026 (up as much as 20% YoY) is likely to continue this trend. We continue to maintain a defensive posture but are ready to selectively add risk as spreads move wider due to AI disruption fears or heightened supply. Following the administration's early January announcement of \$200bn in GSE purchases to support housing affordability, markets saw an immediate tightening in spreads, leading certain areas of the market to become overvalued. Since then, the MBS basis has retraced to pre-announcement levels amid geopolitical uncertainty and elevated interest rate volatility. Valuations are approaching an area that would be attractive, but relative value remains dynamic as other sectors have also seen spreads move wider. Technicals remain supportive for the MBS sector, with low net supply driven by persistently weak housing affordability and mortgage rates that remain range bound. 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



While most consumer credit strata are showing signs of weakness, **the relative weakness varies dramatically between prime and subprime borrowers.**



the subprime market and focusing on the highest quality consumer and commercial related collateral. Strong CMBS issuance volumes should continue through macro volatility unless/until true labor market softness emerges or a recession precipitates a pull-back in lending. To date, global macro induced widening has been more acute in subordinate CMBS classes while senior bonds have been less impacted. With sticky AAA spreads, borrowers have not felt a large impact and lending markets are wide open. We expect that to continue as CMBS is not in the eye of the storm. In this environment we remain focused at the top of the stack in non-office SASB.



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.