

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.

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MARKET OVERVIEW

The third quarter was marked by a rapid repricing of the U.S. Treasury (UST) curve, resulting in negative total returns across nearly all segments of the fixed income market. Sticky inflation, volatile energy prices, elevated corporate bond issuance, and ongoing concerns surrounding the U.S. fiscal outlook all contributed to the move. However, the primary catalyst was a hawkish shift in monetary policy and the anticipation of additional rate hikes from the Fed. The economy remained largely resilient throughout the quarter, supported by solid consumer spending, continued labor market strength, and ongoing business investment, particularly in AI-related infrastructure projects. That underlying economic strength, while positive from a growth perspective, reinforced concerns that inflationary pressures could remain above the Federal Reserve's target for longer than previously anticipated.

After remaining on hold since 2025, the Federal Reserve, now led by Chair Warsh, raised its benchmark rate to a range of 3.75% to 4.00% in an effort to combat persistently elevated inflation. While refraining from providing explicit forward guidance, his repeated emphasis on price stability, including the observation that "inflation is too high and has been for too long," signaled a strong commitment to restoring inflation back to target. At the same time, 12 of 18 FOMC participants indicated that at least one additional rate hike could be warranted before year-end 2026.

The UST curve experienced a bear flattening during the quarter, with the largest moves occurring in the intermediate part of the curve. Three-year and five-year UST yields rose 86 and 85 basis points, respectively. Longer-dated maturities also sold off, though to a lesser extent, with the 10-year and 30-year UST yields increasing by 82 and 68 basis points, respectively. Following the

September FOMC meeting, futures markets repriced meaningfully, ultimately reflecting expectations for one additional rate hike in December and two rate cuts during 2027 as investors weighed the tension between resilient economic growth and the eventual effects of tighter monetary policy.

POSITIONING CHANGES

During the third quarter, sector allocations remained largely unchanged, with most trading activity focused on reducing out-of-index exposure beyond three years. We shifted our key rate duration positioning from a relatively barbelled structure to a more bullet-oriented stance in response to recent curve movements, utilizing both spread products and U.S. Treasuries to implement the change.

While overall spread sector allocations were mostly stable, we were active in both ABS and Credit, recycling shorter-duration holdings into longer-dated opportunities. Continued bond supply related to M&A activity, hyperscaler capital expenditure needs, and emerging AI-related disruption risks has contributed to wider spreads for many industrial issuers. However, index spreads remain relatively tight, reflecting the growing bifurcation in how these capex-related risks are impacting individual credits. Following the recent widening, valuations for certain issuers more appropriately reflect these risks, and we expect to selectively add exposure where opportunities emerge.

We modestly increased our ABS allocation by 1%, ending the quarter at 21%. We participated actively in new issue auto ABS transactions, where higher-quality tranches remain well insulated from potential deterioration in collateral performance. In contrast, many esoteric ABS subsectors continue to appear richly valued and may be more susceptible to spread volatility. Our CMBS allocation remained stable at 13%. Within non-agency CMBS, certain conduit transactions with higher levels of defeasance appear attractive, particularly in a higher-rate environment where refinancing risk has become increasingly relevant. We also have greater confidence in recently issued collateral that was originated and underwritten with a higher rate regime in mind, reducing uncertainty around future refinancing outcomes. Within agency CMBS, we extended duration by selling shorter-dated securities (less than one year) and redeploying proceeds into the two- to three-year portion of the curve. Our

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allocation to Agency RMBS remained unchanged at 3%. Despite weakness across other spread sectors, both nominal and option adjusted spreads on 15-year Agency RMBS have remained relatively well contained. Given tight spreads and limited secondary market supply, we do not believe current valuations adequately compensate investors for liquidity considerations in shorter-duration securities and, as a result, are waiting for a more attractive entry point.

Looking ahead, should spread weakness continue, we would expect to reduce liquidity balances and take advantage of the resulting investment opportunities.

OUTLOOK

U.S. growth remains resilient, supported by solid consumer spending and strong business investment. Recent employment data point to a cooling labor market, with September payroll growth falling short of expectations, downward revisions to prior months' job gains, and a modest uptick in unemployment suggesting a gradual easing in labor demand. Persistently higher energy prices are likely to pressure energy sensitive sectors, while also keeping financial conditions tighter for longer. Overall, the outlook is for moderate U.S. growth, with upside from sustained business investment balanced against downside risks from persistent inflation and elevated borrowing costs.

The Fed's September rate hike validated a more hawkish policy posture, reflecting persistent inflation and resilient labor market conditions. The policy path beyond September remains uncertain, with Fed funds futures markets currently pricing in three additional rate hikes by next June. Persistent services inflation and resilient growth could support additional tightening, while the absence of a wage-price spiral and the restraint already being delivered by higher market rates argue for a measured, data-dependent approach. Reduced forward guidance and internal committee divisions should keep uncertainty around the pace and extent of further tightening elevated, contributing to continued rate volatility.

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UST approaching recent highs, while the 10-year UST moved well above 5%. The Treasury's attempts at stabilizing long-term yields through buybacks have not had their intended consequence and rates are expected to remain elevated as inflation, strong economic activity, and large fiscal deficits continue to pressure the term structure. Yield curve dynamics are expected to remain highly sensitive to inflation data and evolving Fed expectations.

While pockets of value do exist, most investment grade spread sectors screen overvalued to us despite solid corporate credit fundamentals and a resilient consumer. Given the recent widening in spreads amid heightened rate volatility and as the 10-year UST yield approached 5%, we are looking to increase our allocation to Agency MBS while remaining mindful of extension and negative convexity risks. Supply is running well below historical norms as elevated mortgage rates suppress refinancing and new origination activity. Extension risk and rate volatility remain the primary headwinds, but absent meaningful labor market deterioration or further geopolitical escalation, the sector should continue to offer attractive carry relative to Treasuries.

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