

Full Discretion Team

Extra Credit

Q4 Round Up: Resilient Growth, Lingering Inflation Concerns, Fed “Stuck In the Middle”

Easing Fed Policy, Fiscal Stimulus & Stable Corporate Fundamentals

Most segments of the global fixed income market generated positive returns during the fourth quarter, further contributing to an already strong year. At the start of the quarter, the US federal government began the longest shutdown in US history, lasting 43 days until a resolution in mid-November. The prolonged shutdown created market volatility, economic data collection issues and brought more uncertainty to the ensuing Federal Reserve (Fed) policy decision. Despite lingering inflation concerns, the Fed followed its September rate cut with 25 basis point cuts in October and December, an approach aimed to stabilize growth as labor market data weakened. The Treasury curve steepened during the quarter as the front end of the curve declined on the back of Fed cuts while long-term yields were slightly higher, likely the result of inflation concerns, tariff uncertainty and a growing US debt burden. In 2025, the 10-year US Treasury fell 40 bps, from 4.57% to 4.17%, while demand for investment grade and high yield corporates remained strong, with spreads marginally tighter. Risk assets were supported throughout the year by the 75 basis points of Fed rate cuts, continued strong earnings growth by corporates and a surge in artificial intelligence (AI) investments.

Looking ahead in 2026, we believe the US economy will remain in the ‘Expansion to Late Cycle’ phase of the credit cycle, supported by easing Fed monetary policy, fiscal stimulus from the One Big Beautiful Bill Act (OBBBA) and stable corporate fundamentals. We expect growth in the US to remain resilient in 2026 and we are not anticipating a recession at this time, rather, our base case calls for trend-like growth. Positive wealth effects and solid aggregate consumer consumption, especially among mid-to-upper-tier households, have been supporting demand. While employment data has cooled, we don’t anticipate widespread layoffs as long as earnings and profitability remain strong. Productivity gains from artificial intelligence (AI) implementation could lead to layoffs, but we do not see that as a near-term risk. Many companies have invested significant capital expenditures in AI and data centers, and we expect this spending to contribute to productivity gains and overall economic momentum globally. Outside the US, The US administration’s willingness to negotiate trade deals with its largest trading partners is a welcome development.

Team Outlook

BASE CASE

CREDIT CYCLE	Expansion to Late Cycle
MACRO	Resilient Growth
INFLATION	Hovering Above the Fed’s Target
POLICY RATES	Fed “Stuck in the Middle”
US RATES	Defensive on Long-End Yields
CORPORATE FUNDAMENTALS	Stable
FX	Potential Diversification Benefits
KEY RISKS	Trump Policies at the Forefront

In Europe, the lack of US security assurances has pushed Eurozone leaders, particularly in Germany, to recommit to more expansionary fiscal policy and massive borrowing for security infrastructure, thus reviving European output including manufacturing. In China, economic data still shows a continued slowdown across all core metrics, driven by a confluence of weak consumer confidence, real estate drag, and lackluster investment. We expect Chinese growth to muddle along at current levels, however, we still have questions about the quality and sustainability of growth moving forward. The tariff reprieve has been welcomed, but a more durable long-term resolution may be more challenging.

Fed "Stuck in the Middle" - Lingering Inflation and Weaker Employment Data

Our view on interest rates is predicated on the basis that US inflation will remain sticky, continuing to print above the Fed's 2% target, and structural factors are weighing on the US fiscal deficit. Inflation is increasingly entrenched in behavior supported by structural factors such as budget deficits, geopolitical fragmentation, increased defense spending and the reconfiguration of supply chains. On a cyclical basis, despite recent inflation readings that show lagged effects of shelter inflation easing, we caution that the combination of stimulus from OBBBA, mortgaged-backed securities (MBS) purchases and other factors could lead to an uptick in inflation later in the year. From a labor market perspective, although recent labor market data has cooled, we are not expecting a massive wave in layoffs and view corporate health as the lynchpin behind the labor market. In this context, the Fed may be comfortable with inflation hovering above their 2% target, while easing monetary policy to help mitigate the labor market from softening further.

With regards to the US fiscal deficit, large nondiscretionary spending – mostly related to entitlements and defense – has led to a deficit that is structural rather than counter-cyclical. Debt servicing costs have also risen significantly, as interest rates have increased and the overall debt burden has expanded. Currently, the fiscal deficit is unsustainable and has the potential to stimulate inflation, which in turn could raise borrowing costs across the economy, in our view. Unless there is significantly higher growth (which we believe is unlikely), expenditures are reduced or another large source of revenue materializes (tariffs), we do not see a stabilization or contraction in the deficit occurring in the near term. As a result, we believe there is a risk to a move higher in long-term interest rates. We believe Treasury supply will continue to be a topic of heavy discussion, which could increase interest rate volatility and put a floor under long-term Treasury yields. We believe long-term fair value for the 10-year US Treasury is approximately 4.00-4.50%, based on a 1.75-2.00% real rate and 2.25-2.50% breakeven rate; however, Trump's policies could push the fair value target slightly higher.

Credit Fundamentals Remain Healthy

Our investment process lends itself to constantly reassessing value through our risk premium framework. Our Credit Health Index (CHIN) within investment grade and high yield corporate credit suggest defaults/losses will be below historical averages for this part of the cycle. Bottom-up fundamentals have stayed robust despite slight weakening in leverage and interest coverage, while profit margins have continued to strengthen and the outlook for earnings growth remains positive. A combination of solid credit fundamentals and supportive technical backdrop have helped push spreads and risk premiums to tight levels, however, it is difficult to see any real signs of credit deterioration. In our opinion, corporate balance sheets can weather potential volatility in the macroeconomic backdrop.

Potential Risks Could Create Buying Opportunities

We are mindful of the risks going forward, such as sticky inflation and a growing US deficit, either of which could force the market to reprice Fed expectations and potentially push rates back up. In addition, we continue to monitor the risk that AI investments do not deliver on optimistic revenue projections or large-scale productivity gains, the potential for further escalation in geopolitical risk and security concerns, as well as the impact of long-term structural trends such as deglobalization, decarbonization and aging demographics. Each of these risks could further elevate market volatility and create additional buying opportunities in credit, interest rates and currencies, for which we would consider redeploying reserves faster.

Maintain Flexibility in the Current Environment

We believe that long-term value has returned to fixed income markets with a combination of discount-to-par (positive convexity) and favorable yields. As investors sit on record levels of cash, we expect strong demand will likely support bond markets. Given our expectation for a relatively benign loss environment, we believe investors should consider moderately leaning into credit risk for any potential extra carry pick-up. Compressed credit spreads have led us to remain diversified in our credit exposure across the fixed income markets. In today's environment, we believe bond investors should maintain flexibility with regard to interest rate and credit risk, considering the risk/reward of the intermediate part of the curve against the long-term risks associated with long-end curve exposures while being selective in potential opportunities in investment grade credit, high yield credit, bank loans and securitized credit, in our opinion. Convergence between public and private credit markets is accelerating, creating opportunities for multi-sector investors. In addition, we believe diversifying portfolios across non-US-dollar exposure is a worthwhile strategy as the current macroeconomic backdrop suggests a flight-to-safety bid is unlikely to buoy the US dollar, in our view, and investors can seek higher yields and potential for currency appreciation outside the US.

Meet the Team

MATT EAGAN, CFA

Head of Full Discretion, Portfolio Manager

BRIAN KENNEDY

Portfolio Manager

PETER SHEEHAN

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MICHAEL KLAWITTER, CFA

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DAVID ZIELINSKI, CFA

Investment Director

CHERYL STOBER

Investment Director

KRISTEN DOYLE

Associate Investment Director

About the Team

The Full Discretion team brings decades of expertise and collaboration to create tailored solutions for their clients.

27

Investment Professionals

23+

Years of Industry Experience
(Portfolio Management Team)

\$85.6

Team Assets Under Management
(Billion USD)

Team Philosophy

We have a legacy of independent thinking and leaning into the market when others may be pulling away. We take a deep-value, equity-like approach to credit selection across global fixed income markets. Our disciplined process helps gives us confidence in seeking to identify macro trends, formulate a clear view on market sectors, and invest throughout the credit cycle.

For more than 40 years, we have been applying our distinctive style of bond picking to deliver portfolios designed to provide excess yield potential and have low correlations to traditional benchmark-focused fixed income strategies.

Source: Loomis Sayles, as of 12/31/2025

Average years of expertise reflected at portfolio management level

Important Disclosure:

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The Credit Health Index (CHIN) is a macro tool created by Loomis Sayles. The CHIN is currently managed by the Loomis Sayles Applied IQ team. It is a proprietary framework that utilizes a combination of macro, financial market and policy variables to project US corporate health.

Commodity, interest and derivative trading involves substantial risk of loss. Diversification does not ensure a profit or guarantee against a loss.

Market conditions are extremely fluid and change frequently.

Any investment that has the possibility for profits also has the possibility of losses, including loss of principal. There is no guarantee that any investment objective will be realized, or that the strategy will be able to generate any positive or excess returns.

Past performance is no guarantee of future results.