MacKay Shields Fixed Income Quarterly Outlooks

January 2026

New York Life Investments

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Macroeconomic 1Q2026

Shifting Into Higher Gear

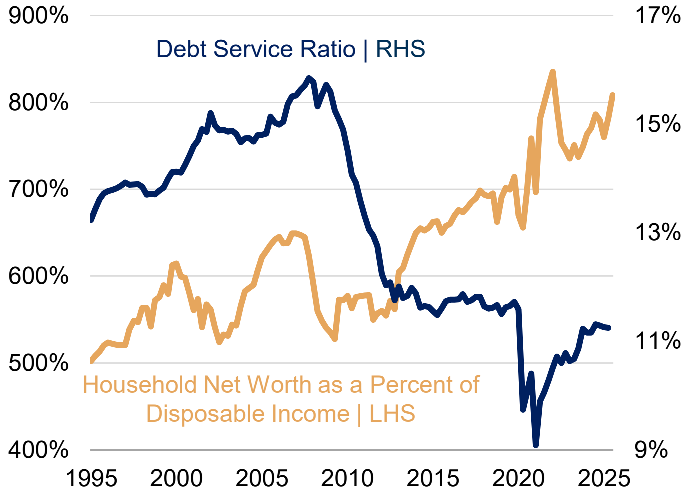
We believe the US economy will regain momentum in 2026, supported by fiscal easing and fading of the trade policy shock. The lagged effects of this year's monetary easing and accommodative financial conditions contribute to our constructive outlook.

With growth set to pick up, a transition from tariff-driven goods inflation to sticky services inflation will forestall any meaningful disinflation progress for another year. This suggests limited scope for Fed easing in 2026.

Risks to our base case center on any unanticipated tightening in financial conditions, including if optimism around the AI investment cycle reverses. We are also attuned to the risk that turnover at the Federal Reserve opens the door to a dovish shift in monetary policy.

While 2025 has been a subpar year for US economic performance, the economy nonetheless displayed remarkable resilience in the face of substantial changes to trade and immigration policy. At time of writing, we estimate the US economy is tracking roughly a 1.8 percent growth rate for the year, only modestly below potential. The economy's resilience has to a large extent stemmed from the investment boom related to the artificial intelligence (AI) build-out, which has also underpinned strong equity gains that have supported household spending despite a cooling labor market. Healthy household and corporate balance sheets, in the aggregate, have also helped to insulate the economy from shocks.

Figure 1: Aggregate household sector balance sheet remains healthy



Source: Board of Governors of the Federal Reserve System, MacKay Shields. Debt Service Ratio is total household interest payments as a percentage of disposable income, through Q2 2025. Household Net Worth through Q3 2025 with third quarter estimate based on quarterly change in S&P500 and home prices.

As the calendar turns to 2026, we believe the economy is poised to regain momentum as growth drivers broaden out, resulting in growth a shade under 2.5 percent. Most importantly, fiscal policy is likely to ease as a result of the administration's signature fiscal package passed this summer. In addition to substantial increases in military and border spending, new household provisions may lead to a strong refund season that increases disposable income, while business investment incentives will support capital expenditures.

Trade policy should also serve as less of a drag going forward, as households and businesses adjust to higher import costs, in part by shifting to lower-cost suppliers. The effective tariff rate on imports should decline over 2026, as the Supreme Court has signaled that it is likely to overturn the administration's use of the International Emergency Economic Powers Act (IEEPA) to implement broad-based global tariffs. While the administration has other authorities it can use to replicate IEEPA tariffs, these will take time to implement and are likely to be less comprehensive.

Macroeconomic 1Q2026 (cont'd)

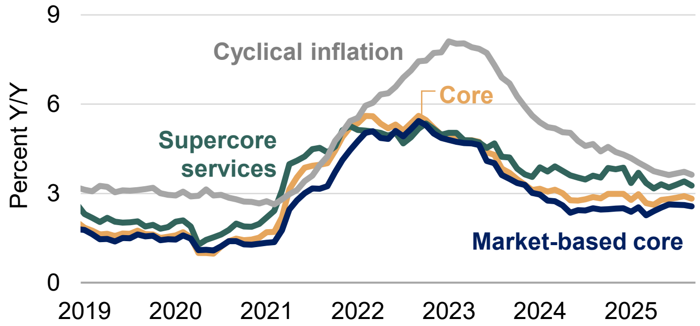
Shifting Into Higher Gear

In addition, overturning IEEPA opens the door to tariff refunds, although the timeline for any such refunds remains highly uncertain. Elimination of IEEPA-based tariffs also deprives the administration of its preferred tool for quickly implementing onerous tariffs in response to any conflicts with foreign governments, as happened on several occasions in 2025. Finally, voter frustration over affordability issues increases the likelihood that the administration will replace the IEEPA tariffs with a new tariff regime that will be less burdensome for households, especially with midterm Congressional elections coming next fall. The midterms also increase the incentive for the administration to seek additional trade deals that lower tariff rates or preclude announced tariffs from being implemented.

In addition to fiscal and trade policy, the administration's broad efforts at deregulation, including in the financial sector, will likely support business confidence and investment. Finally, financial conditions should remain a tailwind to growth, especially with some additional monetary easing in the pipeline for next year. If the recent decline in primary mortgage rates carries over into next year, residential investment should not be the same drag on GDP growth as it was in 2025 and may even turn into a modest tailwind, especially given the anticipated improvement in overall economic momentum.

With growth picking up next year to a pace moderately above potential, inflation is likely to prove sticky, ending 2026 around 2.75 percent. Tariff-related goods inflation should moderate, but demand-driven services inflation is likely to pick back up alongside an improving economy and stabilization in labor demand. In fact, with immigration and deportation policies continuing to weigh on labor force growth, the second half of 2026 is likely to see the labor market begin to tighten again.

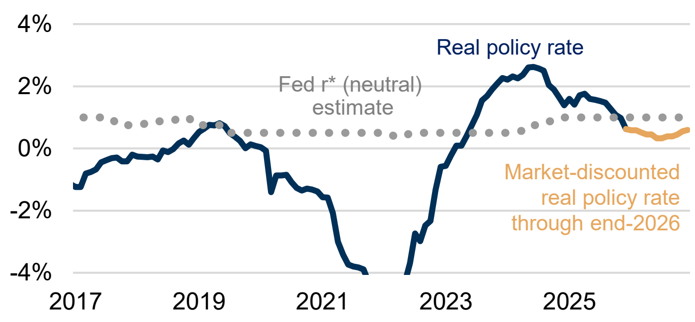
Figure 2: Little Disinflation in 2025



Source: Bureau of Economic Analysis, Federal Reserve Bank of San Francisco, through September 2025. All measures based on the personal consumption expenditures price index and its components. Market-Based core includes only those prices indices for items sold in competitive markets with observable transaction prices. Supercore services excludes owners' equivalent rent and primary rents from core services. Cyclical inflation is based on those PCE price indices that show sensitivity to the business cycle.

The combination of improving economic momentum, a retightening labor market, and sticky inflation should limit the scope for further monetary easing in 2026. It may be challenging for the incoming Federal Reserve chair to build consensus for significant easing given the concerns of many policymakers about still-elevated inflation. Hence, we have penciled in just one additional 25 basis point rate cut, likely in the first half of the year as concerns over weak labor demand remain the focus of policymakers. With such a move, the policy rate would remain slightly below the FOMC's estimate of the neutral real policy rate, after adjusting for inflation expectations.

Figure 3: Monetary Policy is No Longer Restrictive



Source: Bloomberg, Federal Reserve, MacKay Shields. Future real policy rate based on OIS futures prices as of December 11, and median expected inflation from Bloomberg Economist Survey.

Macroeconomic 1Q2026 (cont'd)

Shifting Into Higher Gear

While our base case for the US economy is constructive, there are several risks we are monitoring. First, financial conditions have been a meaningful tailwind to growth, but are susceptible to reversal. By way of example, most advanced economies have already finished their easing cycles, and markets are increasingly focused on the potential for higher policy rates going forward. Recent data and central bank communications in Japan, Canada, the euro-area and Australia have revealed how sensitive bond markets are to any shift away from the lower-rate narrative of 2025.

The AI boom also poses risks to financial conditions, given that it has served as the main driver of US equity gains this year. Any developments that call into question the future profits that will accrue from AI investment could prompt a sharp reversal in equities that would weigh on household spending, business capex and hiring.

Finally, while the next Federal Reserve chair is likely to be constrained by more hawkish members of the FOMC, there is a distinct possibility that turnover among Federal Reserve Governors opens the door to a more dovish slate of policymakers and overly stimulative policy, especially in 2027. With the real policy rate already slightly below a neutral setting, such an outcome risks delaying a return of inflation to the two percent objective for even longer, and raising serious questions about the Federal Reserve's commitment to its inflation objective.

Multi-Sector Income 1Q2026

Rates, Risk and Reality

Our core view is that income generation (carry) will replace price appreciation as the primary driver of total returns. With inflation settling at a "sticky" 3%[1] and the term premium rising, we are positioning for a "higher-for-longer" paradigm.

Our approach to portfolio positioning:

1. Duration Discipline – Play Defense, Stay Neutral

The Trade: Neutral duration target with a bias toward the intermediate "belly" (3-7 years).

The Rationale: It is our view that interest rate risk remains mispriced. The market is pricing in an aggressive easing cycle (75-100 bps)[2] that contradicts the reality of resilient growth and structural inflation. We believe the Fed will deliver fewer cuts than anticipated, creating a "policy disappointment" risk that will punish the front end. Simultaneously, the long end is potentially vulnerable to a supply-driven term premium shock.

The Risks: A deterioration in the labor market that sees the unemployment rate rising above 5% would force aggressive Fed easing, justifying a duration extension. Alternatively, a growth scare combined with sticky inflation would pressure real yields negative, necessitating a swift move to defensive duration.

2. The Quiet Winner – Agency MBS

The Trade: We hold the view that an overweight Agency MBS as a core carry position and defensive substitute for tight Corporate Credit.

The Rationale: We maintain that agency MBS is the most attractive high-quality asset in the market, trading cheap relative to historical fair value. The thesis is dual-pronged; 1) a structural housing undersupply (3-4 million units)[3] supports collateral value and 2) we believe demand for mortgages will increase on valuations.

The Risks: If the Fed moves to actively sell MBS (quantitative tightening acceleration) rather than letting them roll off, supply will overwhelm demand. Alternatively, “a sharp rise in rate volatility would increase prepayment risk and damage the convexity profile of the asset class.

1. https://www.bea.gov/data/personal-consumption-expenditures-price-index-excluding-food-and-energy
2. https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html
3. Source: https://www.goldmansachs.com/insights/articles/the-outlook-for-us-housing-supply-and-affordability
4. https://www.bloomberg.com/news/articles/2025-09-29/auto-parts-supplier-first-brands-files-for-bankruptcy
5. https://www.bloomberg.com/news/features/2025-11-10/tricolor-auto-bankruptcy-kicked-off-by-jpmorgan-phone-call
6. Source: https://www.federalreserve.gov/releases/z1/20220909/html/recent_developments.htm

3. Credit Strategy – Fatten the Belly, Starve the Long End

The Trade: It is our view to favor intermediate maturities (3-7 years); avoid long-duration US corporate bonds. Our focus is on defensive sectors (utilities, healthcare) and select European and Emerging Markets for diversification and attractive value.

The Rationale: We believe credit valuations are full, and a technical storm is brewing in the US. We are facing a significant supply headwind from AI infrastructure financing and a backlog of M&A deals. This issuance will likely concentrate in the long end, preventing spread tightening.

The Risks: If the "AI Arms Race" cools, capex spending—and the associated debt issuance—could plummet, removing the supply overhang. Elevated recession fears would widen spreads materially, creating an attractive entry point for long-duration credit.

4. Securitized Markets – Idiosyncratic Alpha

The Trade: We are favorable to being long ABS and AAA CLOs; Selective in CMBS.

The Rationale: Recent fraud cases in 2025 look to be idiosyncratic, not systemic.[4,5] They reinforce the need for active underwriting, not sector abandonment. The US consumer remains a bright spot, with aggregate household balance sheets in their strongest position since the 1980s.[6] Certain subsectors within the CMBS market have been unfairly punished from model-driven rating agency downgrades.

The Risks: If commercial real estate (CRE) refinancing stresses regional bank balance sheets, this could trigger a broader tightening of credit conditions.

5. New Frontiers – EM Local Currency

The Trade: We are also long select EM Local Currency Sovereigns (High Real Yields).

The Rationale: It is our view that Emerging Markets are the clear beneficiaries of the improving US macro environment. The convergence of falling domestic inflation in EM and a structurally weaker USD (driven by Fed cuts) creates a tailwind. We are targeting countries with fiscal discipline that offer high real yields, using this as a diversifier against US-centric inflation risks.

The Risks: A "flight to safety" into the greenback would hurt EM returns, while any new aggressive trade tariffs would hurt EM exports and damage their fiscal balances.

Summary

Our base case is constructive, but risks remain (growth scare, policy mistake, higher inflation). Focus on high quality carry while balancing caution and opportunity, accordingly.

Emerging Markets 1Q2026

Emerging Markets enter 2026 on strong footing, supported by Fed easing, resilient commodity prices, and a softer U.S. dollar - factors that continue to underpin EM fixed income. With improving fundamentals and scope for further spread compression, the asset class offers compelling opportunities for selective, research-driven investors as credit quality strengthens, and economic resilience broadens across regions.

The New Paradigm of Pricing Emerging Market Risk

For decades, the pricing of Emerging Market (EM) bonds relied on a simple principle: compare the yield to the gold standard of safety - U.S. Treasury bonds. This benchmark was considered to have a relatively risk-free rate, forming the foundation for global fixed-income valuation.

Figure 1: Chinese Bonds Trading Tighter Than U.S.

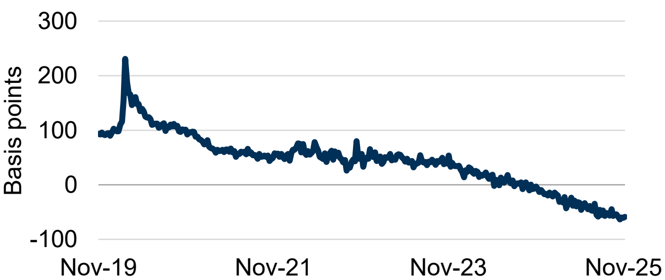
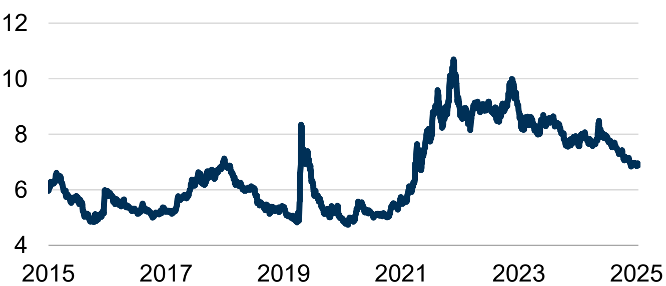


Figure 2: EM Yields Remain Attractive Relative To History



1. Data as of December 5, 2025.
2. Data as of December 12, 2025.
Source: Intercontinental Exchange (ICE), J.P. Morgan EMBI Global Diversified Blended Yield

Market conditions have evolved, prompting a timely reconsideration: How should one define a 'risk-free rate' in current markets? Many investors are increasingly questioning whether U.S. Treasuries continue to serve as a suitable benchmark. Rising fiscal deficits, political polarization, and global macro uncertainty have introduced risks that were once unthinkable for the U.S. government debt market. China can currently borrow in U.S. dollars at rates about 59 basis points lower than the U.S. Treasury on 13-year bonds—even though the dollar is a currency China neither controls nor can print.

Although EM index credit spreads remain tight by historical standards, investors have increasingly shifted their focus to all-in yields when evaluating the attractiveness of EM debt, as yields remain compelling on a historical basis. Furthermore, we see room for additional spread compression and continued outperformance, supported by a rising share of investment-grade issuers in the index and upward rating momentum among high-yield countries.

Emerging Market Sovereign Credit: Opportunities Ahead In 1Q 2026

EM hard currency sovereign debt has returned approximately 13.67% year-to-date as of December 4, 2025, as measured by the JP Morgan EMBIG Diversified Index. We emphasize main drivers for emerging market sovereign performance in 2026 as structural improvements, supportive political developments, enhanced market access, and potential rating upgrades.

Our outlook remains positive on Ecuador and Argentina, where strong reform momentum under International Monetary Fund ("IMF") programs, are complemented by cooperative relations with the U.S. In Hungary, we see notable upside risk as markets seem to underestimate the chances of a favorable election outcome next year, which could potentially unlock EU funding and significantly boost Hungarian assets. Suriname also stands out, with recent liability management easing investor concerns and offering compelling returns for those backing its long-term reform strategy. On ratings, Morocco's recent move to investment grade reflects solid fiscal progress, while the Bahamas has achieved an upgrade to BB- through substantial debt reduction.

Emerging Markets 1Q2026 (cont'd)

We anticipate further rating improvements in Ivory Coast, driven by robust growth, and in Nigeria, where fiscal reforms and stronger tax collection are encouraging. Lastly, while Romania faces downgrade risk, current valuations more than compensate for this uncertainty.

A Weaker U.S. Dollar Can Create A Virtuous Cycle For Emerging Markets

A weaker US dollar is a powerful tailwind for emerging-market debt because it improves fundamentals and, crucially, creates room for central banks to ease policy. As EM currencies appreciate, imported inflation and FX pass-through pressures fade, helping anchor inflation expectations. That gives central banks the confidence to cut rates or shift to a more accommodative stance without risking a renewed inflation spike or currency stress. Lower policy rates feed directly into lower local bond yields and cheaper domestic credit. At the same time, the local-currency value of US-dollar debt falls, improving debt ratios and reducing interest burdens, supporting capital inflows and cheaper external funding.

These dynamics set up a potential “virtuous circle” for EM fixed income. Stronger FX, lower inflation and rate cuts support domestic demand and investment, reinforcing the improvement in debt sustainability and credit quality. Investors respond to the combination of credible easing cycles and better macro data by reallocating capital into EM local and hard-currency bonds, compressing yields and spreads. In effect, a softer dollar not only reduces the burden of dollar liabilities, but it also unlocks and extends EM easing cycles, turning into a self-reinforcing support for EM debt.

EM Local Currency Debt: Leading the Charge

Local currency EM sovereign bonds have significantly outperformed hard currency peers, delivering 18.25% YTD as of December 4, 2025 (JP Morgan GBI-EM Global Diversified Index), with 7.73% of this return driven by FX appreciation. Amid this ongoing virtuous cycle, we see attractive opportunities across several EM local markets. We are constructive on Hungary, highlighting asymmetric upside should EU fund flows be restored following the April 2026 parliamentary elections. In South Africa, we continue to find value in both FX and rates markets, supported by improving medium-term budget projections and the recent adoption of a lower inflation target. We see value in high-yielding EM local markets that remain underappreciated due to their idiosyncratic nature. Continued progress in inflation-targeting frameworks and improving macro fundamentals reinforce the investment case, particularly given the attractive yields offered by countries such as Uzbekistan, Egypt, and Uruguay.

Figure 3: U.S. Dollar Index: One of The Sharpest Slides in A Decade

Data as of December 12, 2025
Source: Macrobond 2025

High Yield 1Q2026

Further growth in the supply of high yield bonds may be on the way. After several subdued years, corporate M&A activity has shown renewed signs of life. Large-scale LBO activity, which had also been dormant, has picked up as well. Video game maker Electronic Arts recently announced plans to go private in what would be the largest LBO in history. The [$55 billion enterprise value includes $20 billion of debt], which is expected to be financed in the leveraged loan and high yield markets.

High yield supply may also come from an unexpected source: AI infrastructure. Earlier this year, AI computing power provider and first-time high yield issuer CoreWeave[1] sold $3.75 billion of high yield holding company bonds to help finance its purchase of computer power from Nvidia. Cryptocurrency miner and another debut issuer, TeraWulf, announced plans to raise $3.2 billion of high yield bonds to finance part of a data center expansion.

In recent years, bullish investor sentiment toward credit has led to a sharp compression in the liquidity premium—the extra yield on top of the premium for credit risk that investors demand to hold smaller, private, or less transparent companies. Historically, investors required meaningful additional yield to compensate for this risk. Today, many are rushing into private credit, willing to sacrifice liquidity for the prospect of modestly higher returns. Tricolor[2] and First Brands[3] serve as cautionary reminders that this premium should probably be higher.

Overall, we observe that high yield credit fundamentals remain strong. High yield issuers are mostly exposed to the U.S. economy, which has avoided a recession. As shown below, the leverage ratio for high yield companies has declined below the historical average and the interest coverage ratio remains higher than past levels.

Figure 1: High Yield Leverage
LTM Debt/EBITDA

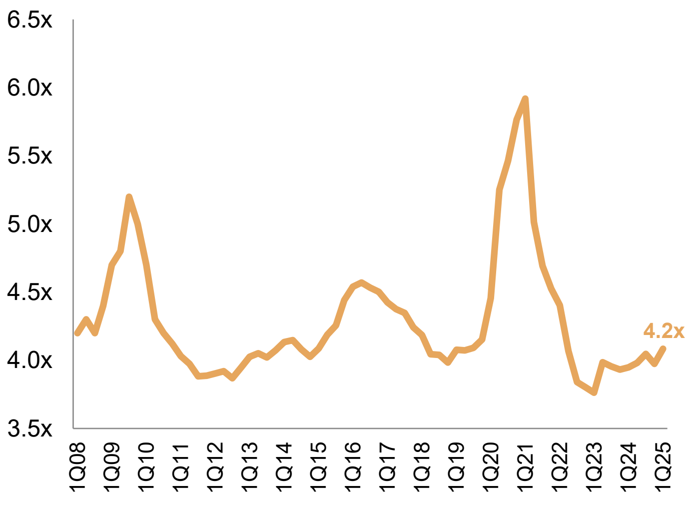
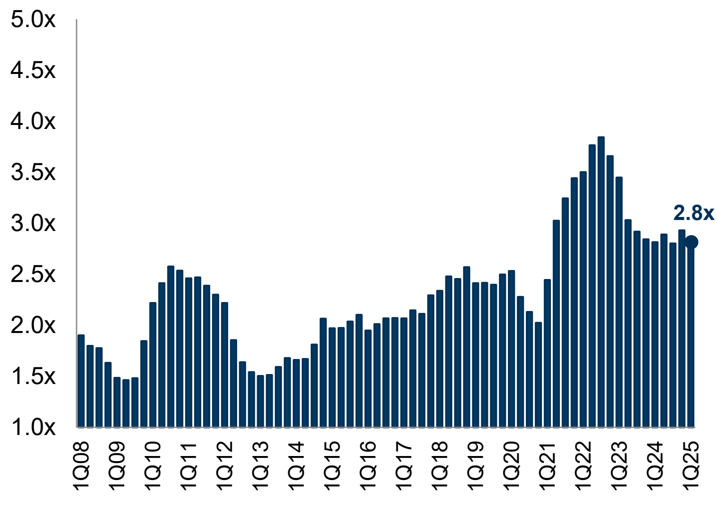


Figure 2: High Yield Interest Coverage
EBITDA-CapEx/Interest Expense



As of June 30, 2025
Source: JP Morgan, US High Yield Universe.

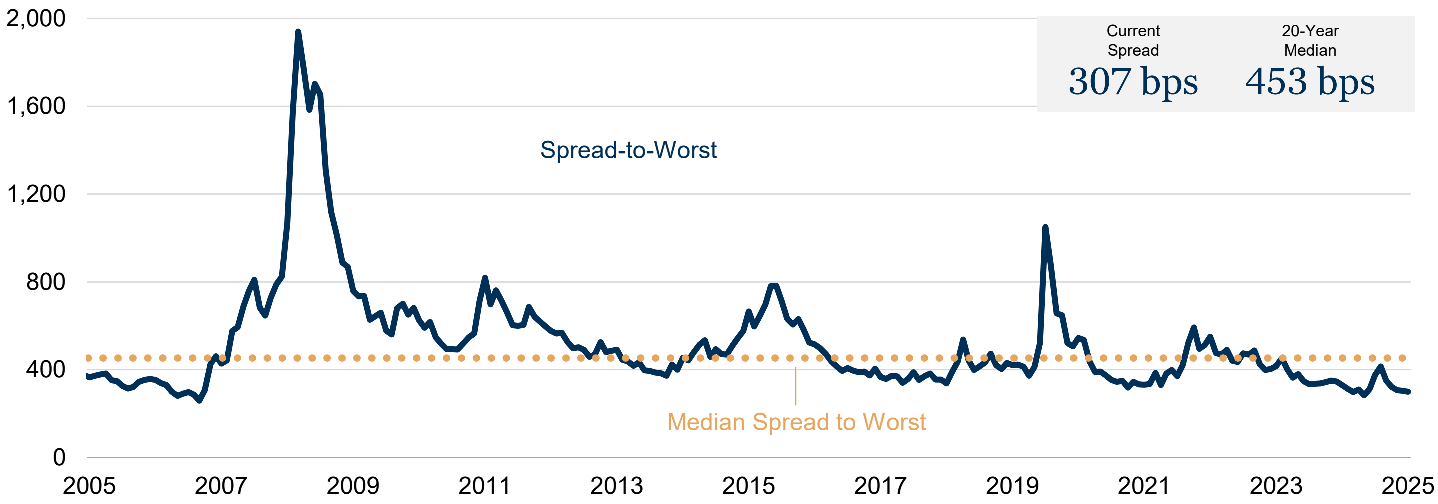
1. https://investors.coreweave.com/news/news-details/2025/CoreWeave-Announces-Agreement-to-Power-Runways-Next-Generation-AI-Video-Models/default.aspx
2. https://www.bloomberg.com/news/features/2025-11-10/tricolor-auto-bankruptcy-kicked-off-by-jpmorgan-phone-call
3. https://www.bloomberg.com/news/articles/2025-09-29/auto-parts-supplier-first-brands-files-for-bankruptcy

High Yield 1Q2026 (cont'd)

Valuations fully reflect the combination of favorable supply/demand, strong credit fundamentals, and bullish investor sentiment. As of November 30, 2025. the ICE BofA U.S. High Yield Index spread-to-worst of 307 bps is lower than its historical median and the post-GFC "non-panic" range of 325-525 bps, as illustrated below:

While tighter-than-average high yield spreads are consistent with the current “everything rally” environment, in our view overall yields in U.S. High Yield remain attractive. Current yields of 6.7% compare favorably to the post-2009 average yield of approximately 6.5% on the ICE BofA U.S. High Yield Index, especially when factoring in the improved credit quality of the market over that period.

Figure 3: Spread-to-Worst



As of November 30, 2025
Source: ICE Data.
Index: ICE BofA US High Yield Index

Definitions:

Leverage Ratio is a measurement used to determine the relationship between a company's debt and assets. It can be used to measure the amount of capital in the form of debt and loans, or to assess a company's ability to meet its financial obligations.

Interest coverage ratio is a debt and profitability ratio. It shows how easily a company can pay interest on its outstanding debt. The ratio divides a company’s earnings before interest and taxes (EBIT) by its interest expense over a specific period.

Convertibles 1Q2026

2025 has been a very good period for the U.S Convertible market. Through the first eleven months of the year, the ICE BofA U.S. Convertible Index is up 18.48%, slightly ahead of the S&P 500's 17.79% advance but trailing the NASDAQ's 21.74% gain.

Performance

Despite the presence of many small and mid cap companies in the U.S. convertible market, the asset class has not been dragged down by the performance of the small cap Russell 2000 Index which is up 13.45% year-to-date. The solid performance of convertible securities relative to stocks has been helped by the large gains of several Index securities tied to AI infrastructure spending and nuclear energy which has seen renewed enthusiasm tied to the potential of supplying electric power to newly built data centers.

While this year's gains are impressive, they have been relatively concentrated in securities within the Information Technology and Industrials sectors and more specifically to companies seen as beneficiaries of the enormous spending that is expected to go to the buildout of data centers, data storage, and power demands related to the needs of AI infrastructure. In addition, almost all of these securities are either not rated or rated speculative. While the ICE BofA U.S. Convertible Index is up 18.48% year-to-date, the Investment Grade portion of that Index is up just 9.71% for the same time period, highlighting the outperformance of speculative securities versus their higher quality peers.

Issuance

Through the end of the November 2025, new issuance totaled $107.1 billion, (from Bank of America data) ahead of last year's $73.0 billion of new issuance for the same period. At the current pace, new issuance may exceed the record $113 billion seen in 2020 when companies, desperate to raise capital during the pandemic, issued convertible securities to raise funds with a lower cost of capital than what was available in the straight high yield market. This year, companies are issuing convertible securities at a rapid pace to fund projects tied to AI spending and often to refinance securities issued in 2020 and 2021 that are nearing maturity. In addition, while interest rates have declined somewhat since the start of the year, they remain well above the lows of two years ago and investment grade companies, particularly in the Utilities sector continue to issue low coupon convertible notes to refinance maturing debt that would otherwise be refinanced with higher cost straight debt. We purchased numerous new issue offerings this year in companies that as we believe have solid underlying businesses, strong prospects for growth, and reasonable valuations based on prospective free cash flow estimates. We expect new issuance to continue at a healthy clip as many companies are comfortable issuing a low coupon security linked to a share price that in many cases is at or close to record high levels. We continue to exercise caution in evaluating new issues particularly from companies that have no identifiable use for the capital.

Positioning and Outlook

The convertible market's tremendous performance, up over 18% year-to-date, has prompted us to take a slightly more cautious view of the equity-linked asset class. In addition, the increased equity sensitivity of the average convertible bond makes the market slightly more vulnerable in the event of an equity selloff. We have reduced our exposure to several securities with elevated bond prices, high degrees of equity sensitivity and lack of downside protection. More importantly, we have not chased those segments of the markets such as cryptocurrency, whose valuation is not supported by a sound underlying business and free cash flow. While we are cautious around the direction of equities, we maintain a measured and agnostic stance on the broad market's direction, focusing instead on valuation discipline and issuer fundamentals. We are not incorporating any macro-economic view into our investment decisions. Our largest exposure is to the Information Technology sector which also has the largest representation in the U.S. convertible universe. We are relatively in-line with the benchmark's 29% weighting to that sector. We remain overweight the Healthcare sector and underweight Utilities and Financials. We continue to believe that our process, which emphasizes strong company fundamentals and reasonable valuation, will outperform over a complete market or economic cycle.

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