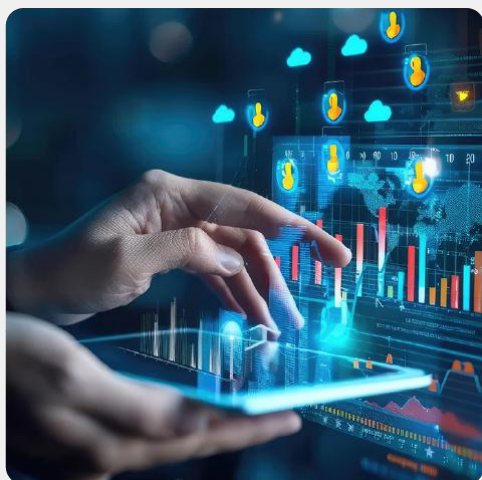


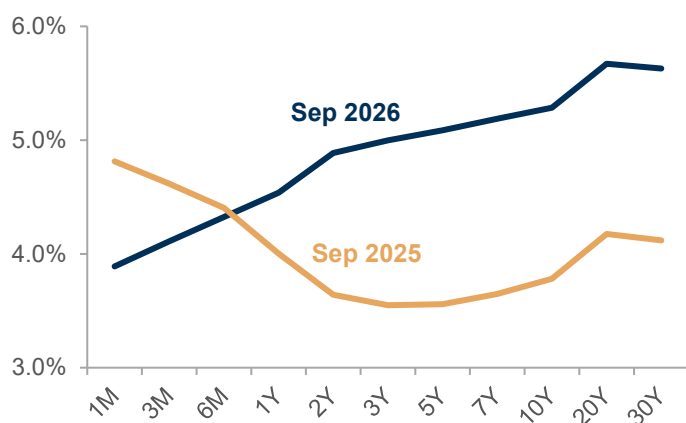


Buy bonds and *carry* on

From Global Fixed Income

Following a significant sell-off in the US Treasury market, all-in yields sit near their highest levels since 2007, while credit spreads have widened only modestly and remain near historical tight. This has been a rates repricing, not a credit event. Growth and earnings remain firm enough to keep credit risk contained while carry continues to be one of the clearest opportunities in the bond market today.

Figure 1: Yield curve



Source: Bloomberg

Higher rates, strong economy

The bond market has re-priced but in our view it is not broken. While there continues to be an ongoing “wall of worry” regarding inflation, monetary policy, the Middle East conflict, AI and midterm elections, nominal bond yields (and real yields) have climbed on a firmer growth impulse, a labor market still adding jobs, inflation that has proven stubbornly sticky, with the BEA reporting core PCE above 3%, and oil above \$100 (source: Bloomberg). The Fed responded with its first hike of this cycle in September, and 30-day Fed Fund futures markets pricing additional hikes through 2027 (source: CME Group), and tightening is global, with the Bank of Japan, European Central Bank and several other central banks also hiking.

Importantly, rising yields driven by strong economic activity and firm earnings represent a different signal than rising yields driven by credit stress or a funding crisis. Corporate balance sheets remain in good shape (Barclay’s reports investment-grade EBITDA grew 19.5% year-over-year in 2Q, with record margins and lower leverage), leveraged loan defaults are near 2% according to BofA Securities, and heavy issuance has been readily absorbed by healthy demand.

Get paid even more to wait

Carry is simply the income an investor earns from yield and price roll-down, independent of whether rates move at



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all. All-in yields across both investment-grade corporate credit and structured credit now sit well above their longer-term historical averages; the Bloomberg U.S. Corporate index yields roughly 6%, more than 100bp higher than a year ago. The repricing has been broad enough that higher rated issuers now offer yields that, in prior cycles, were typically only available further down the credit spectrum—a materially better risk-reward trade-off than reaching for yield in weaker credits.

Elevated starting yields also provide a cushion: at a roughly 6% yield and 6.5-year duration, we estimate that the Bloomberg U.S. Corporate index could absorb a rise of about 90bp in yields over the next year before its total return turns negative — a margin of safety that simply did not exist when yields were much lower.

It's not just about fixed rate income

- Floating rate obligations, including bank loans, CLOs and certain securitized assets, carry minimal duration risk and reset higher as policy tightens — ballast against renewed rate volatility or an inflation surprise.
- Fixed rate investments such as investment-grade corporates, Treasuries, and agency MBS take advantage of the income opportunities available at today's yield levels, and stand to appreciate when policy eventually reverses.

The right mix allows an investor to realize today's income while staying prepared for two possible outcomes: 1) a longer and deeper tightening cycle, or 2) an eventual pivot as inflation cools.

Where we see value

At the margin, we favor high-quality securitized credit over investment-grade corporates. Agency MBS spreads have repriced wider with the rate sell-off while corporate spreads have not: the investment-grade index now yields only 16bp more than the Bloomberg MBS index, versus a 10-year average of 50bp. In corporates, fundamentals are strong, but tight spreads and heavy AI-related issuance argue for issuer selectivity over broad exposure.

Stay in the belly of the curve

We believe the sweet spot is still in the short-to-intermediate part of the yield curve (the “belly”), which offers attractive yield while limiting the reinvestment risk of the front end and the term-premium and volatility exposure of the long end. With markets already pricing roughly 90bp of further hikes, more than most economists expect, intermediate yields offer a cushion should the Fed deliver less than priced. And with 5-year Treasuries yielding over 5% versus roughly 4% on 1-month bills, investors are paid to move out of cash.

Investing is not without risk

Importantly, we see four key risks to our thesis that need to be monitored closely: 1) inflation re-acceleration, particularly if Middle East disruptions keep oil elevated, could force the Fed to tighten more than markets expect, pushing yields higher; 2) fiscal and supply pressure at the long end can further widen the term premium; 3) a sudden growth slowdown would widen credit spreads from tight starting levels; and 4) the scale of AI-related borrowing could pressure spreads in concentrated sectors.

Summary of views

- Favor short-to-intermediate duration for the best trade-off between carry and interest rate risk.
- Blend floating- and fixed-rate exposure rather than making a single bet on the trajectory of policy.
- Stay up in quality—earn compelling carry without extending risk.
- Favor high-quality securitized credit over investment-grade corporates at the margin; be selective in corporates.
- Deploy cash and stay invested.

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