DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Second Quarter 2026

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Summary

The oil shock ended in the second quarter. The policy repricing that came with it did not. Why one reversed and the other persisted is the story of the quarter. How that tension resolves will be the story of the second half.

Markets entered April still trading the oil shock. The consensus playbook was straightforward: hedge the inflation spike, wait for the ceasefire to hold, and collect the rate cuts on the other side. Half of that playbook worked. Oil completed a full round trip: WTI settled below $70 in the final week of June for the first time since late February, and Brent, which had traded above $120 at the height of the Hormuz closure, finished the quarter back at pre-war levels.[1] The strait reopened, conditionally and imperfectly. The war premium that dominated the first quarter is gone from the crude curve.

What did not round trip was the price of policy. Jerome Powell's term ended in May. Kevin Warsh took the chair, and his first meeting delivered three things few investors were positioned for: a policy statement cut to roughly 130 words, the elimination of forward guidance, and a projection round in which nine of the eighteen submitted forecasts incorporated at least one hike this year, lifting the median year-end funds rate projection to 3.8%. The new chairman declined to submit a projection of his own. A market that began the year debating how many cuts it would receive finished June debating whether the fall brings a hike.

The 2-year Treasury yield rose 35 basis points over the quarter, from 3.79% on March 31 to 4.14% on June 30, while crude gave back its entire war premium.[2] If the front end had been trading energy, it would have rallied with oil. It sold off instead. That is the single most important fact of the quarter: the repricing was not the supply shock; it was the reaction function.

The inflation data explain why the distinction matters. Headline CPI reached 4.2% year-over-year in May, a three-year high, but the composition matters more than the headline. Energy accounted for more than sixty percent of the monthly increase, with gasoline up roughly 40% from a year earlier. Core inflation sits at 2.9%, and the monthly core print decelerated to 0.2% in May.[3] The labor market, meanwhile, supports neither extreme narrative: May payrolls rose 172,000, and the unemployment rate, at 4.3%, has changed little, even as AI-driven restructurings dominate the layoff headlines.[4] This is not a stagflation economy. It is an economy absorbing a supply shock with the labor market intact, precisely the configuration in which a new Federal Reserve chair can afford to be hawkish.

The consensus error entering the year was pricing a landing too clean to disappoint. The error entering the third quarter is its mirror image: treating headline inflation as though it were demand-driven, and the new chairman's rhetoric as though it were a mechanical hiking cycle, while simultaneously bidding credit spreads back to the tightest decile of the past decade. We do not believe those two positions can both be correct.

Outlook

We wrote in April that the market had less tolerance for error. It now has a Federal Reserve chair with no published reaction function, which is a different problem. Markets do not price levels; they price paths, and Warsh has deliberately withheld the path. What remains is a single message, repeated at the June press conference: the commitment to price stability will be unambiguous.

Our interpretation is that this is credibility acquisition. New chairmen have historically bought credibility early, when it is cheapest, because it is most valuable later. Viewed that way, the hawkishness is less a forecast of hikes than the deliberate construction of optionality. The part the futures market may be slow to internalize is that the talk itself is

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1 Source: Bloomberg; front-month NYMEX WTI and ICE Brent crude oil futures, as of June 30, 2026.
2 Source: U.S. Department of the Treasury, Daily Treasury Par Yield Curve Rates; Bloomberg.
3 Source: U.S. Bureau of Labor Statistics, Consumer Price Index — May 2026, released June 10, 2026.
4 Source: U.S. Bureau of Labor Statistics, The Employment Situation — May 2026, released June 5, 2026.

a form of tightening. The 2-year yield rose 15 basis points on the day of the June statement alone, and 35 basis points across the quarter: more than a full quarter-point move, delivered without a single vote being cast.[5] A chairman who can reprice the front of the curve with a press conference has less need of the funds rate to do the same job.

There is precedent for this reading. Paul Volcker abandoned the federal funds operating target within two months of taking office in 1979, precisely because inherited credibility was insufficient to the task. New chairmen do not inherit their predecessors' inflation-fighting reputations. They establish their own, early, and usually at the market's expense. Each of those transitions was initially mispriced by investors who assumed continuity of the reaction function. The present transition carries an additional feature: the new chairman spent years in public writing criticizing the guidance apparatus he has now dismantled. The June meeting was not an improvisation. It was the execution of a documented view.

We would not claim to know whether the hike currently priced for the fall arrives. What we can observe is that it does not need to. The energy pass-through is mechanical and decays on its own schedule: if crude holds near pre-war levels, headline inflation peaks this quarter and rolls over in the back half. Core is already suggesting the second-round effects are contained: 0.2% monthly does not describe an economy losing its inflation anchor. A central bank that has already extracted a hike's worth of tightening from communication alone retains the option of never delivering it. The futures market is pricing the delivery. It is not pricing the option.

The present is already in the price. The relevant question is not what May's inflation print said but what the world looks like twelve to eighteen months from now, because prices will migrate toward that world well before it arrives. Our version of mid-2027 is not exotic: the energy base effects have washed out of the year-over-year figures, headline has converged back toward a core rate that is already at 2.9% and decelerating, the chairman is holding credibility he acquired cheaply and has not had to spend, and the funds rate has room to come down for the first time in two years. Against that picture, a front end priced above 4% is an artifact of the last three CPI prints, not the next twelve. The market is pricing the quarter it just lived through. We would rather price the one after next.

The risk case is equally clear, and it does not require imagination: it played out twice in June alone. The ceasefire is a memorandum of understanding, not a treaty. Tankers were attacked and strikes were exchanged within weeks of the Hormuz reopening. A second sustained spike in crude, landing on an economy where headline is already above 4%, forces the new chairman to prove his rhetoric with action. That is the environment in which the hike gets delivered and risk assets priced at the tights discover what they were not being paid for.

The opposing view is not a weak one. Headline inflation has accelerated for three consecutive months, from 3.3% in March to 3.8% in April to 4.2% in May.[6] Inflation expectations, while still contained, have stopped improving. And the historical record on supply shocks is uncomfortable: they remain temporary only until wage-setting adapts, and by the time that adaptation is visible in the data, the central bank is already behind it. If services inflation reaccelerates into the fall, our characterization of the pass-through as mechanical will have been wrong, and the repricing will extend well beyond the front of the curve. We assign that path a meaningful probability — not the highest, but far too high to construct portfolios that ignore it.

One structural development deserves more attention than it received in a quarter dominated by geopolitics: the AI capital-expenditure cycle has become the economy's marginal borrower. Data centers, power generation, grid capacity, and defense are increasingly financed in the public bond market, and hyperscale issuance is shaping up as the most significant investment grade supply event in a generation. Layer war-related fiscal spending on top of structural deficits, and the long end of the curve has a supply problem the Federal Reserve does not control.

The rest of the world spent the quarter delivering its own verdict on the same repricing. The dollar was a consensus short entering 2026, premised on Federal Reserve cuts; instead, the dollar index broke above 100 in June for the first

5 Source: Bloomberg; U.S. Department of the Treasury. Board of Governors of the Federal Reserve System, FOMC statement, June 17, 2026.
6 Source: U.S. Bureau of Labor Statistics, Consumer Price Index news releases for March, April, and May 2026.

time in over a year and closed the quarter at 101.3.[7] The European Central Bank raised rates in June, its first increase since 2023, with eurozone inflation above 3%.[8] Yet the dollar strengthened, because the one central bank the market expected to converge downward signaled the opposite. Dollar strength of this kind operates as a quiet tightening for the rest of the world and a modest disinflationary offset at home. It is also a reminder that the marginal buyer of long-dated Treasuries has become price-sensitive: a foreign official sector that once absorbed duration as a byproduct of reserve accumulation now weighs it against gold, against alternative settlement arrangements, and against fiscal deficits that remain historically large for an economy in expansion. That calculus bears on the long end of the curve, not the front. Treasuries and foreign exchange are the two deepest markets in the world, and they delivered the same verdict independently this quarter. Both repriced the reaction function. Neither repriced the war.

Risks to this outlook include:

- A renewed closure or contested reopening of the Strait of Hormuz driving a second energy spike
- Energy pass-through into core services and wages, converting a supply shock into an inflation regime
- An untested Fed reaction function under new leadership, with policy communicated deliberately sparingly
- Heavy Treasury and AI-related corporate issuance repricing term premium at the long end

None of this calls for heroics. It calls for attention to what is priced, and to the variable that actually moved this quarter: liquidity. Asset prices follow liquidity more closely than they follow earnings, and the quarter's message was that the liquidity the market had assumed for 2026 is not arriving on schedule. Across credit, spreads at these levels amount to an implicit sale of optionality against a central bank that has stated plainly which way it is prepared to surprise.

Sector Analysis

US Interest Rates

For most of the past year, the front end of the curve was expensive. It no longer is.

The 2-year yield finished the quarter at 4.14% against a funds target of 3.50%–3.75%, roughly 40 basis points above the top of the target range.[9] For the first time in this cycle, the front end is priced for tightening rather than easing. That changes the asymmetry. A year ago, front-end investors needed the optimistic outcome to be right in order to be paid; today the pessimistic outcome is the one embedded in the curve. We make no prediction about the July or September meetings. But when a market prices the feared outcome as the base case, the cost of being wrong falls and the reward for being early rises. The sector deserves more attention now, not less.

The 10-year told a subtler story. It rose from 4.30% to 4.44% over the quarter, but the path matters more than the endpoints: it traded as high as 4.67% in mid-May, when the inflation prints landed hardest, then retraced most of that move as oil collapsed back to pre-war levels, touching 4.38% in the final week of June before the quarter-end backup.[10] The long end, in other words, round-tripped the inflation scare; the front end did not round-trip the policy scare. The 2s10s curve flattened from 51 basis points to 30 over the quarter, driven entirely from the front end of the curve. The curve is conveying the same message the 2-year did: this repricing was policy credibility, not growth and not, ultimately, energy.

The long end remains the part of the curve where compensation is least adequate for the risks being underwritten. It provided no protection this quarter: long yields finished higher through both the war repricing and the June policy repricing, and the correlation regime that once made duration a form of portfolio insurance has not returned. The

7 Source: Bloomberg; ICE U.S. Dollar Index (DXY), as of June 30, 2026.
8 Source: European Central Bank, Monetary Policy Decisions, June 11, 2026; Eurostat, euro area annual HICP inflation, May 2026.
9 Source: Board of Governors of the Federal Reserve System, FOMC statement, June 17, 2026; U.S. Department of the Treasury.
10 Source: U.S. Department of the Treasury, Daily Treasury Par Yield Curve Rates; Bloomberg.

supply picture, meanwhile, deteriorated: war-related expenditure layered on structural deficits, rising interest expense, and now a private-sector duration wave as AI infrastructure issuance migrates toward longer maturities. The Federal Reserve can anchor the front of the curve with credibility. Only buyers anchor the long end, and buyers are being asked to absorb more supply every quarter.

Our rates framework is unchanged in structure and updated in emphasis. The most favorable risk-reward on the curve continues to sit where an investor is compensated for the policy cycle without underwriting the fiscal trajectory. The front end has become more interesting than at any point in this cycle, for reasons of pricing rather than prediction. And long-duration exposure remains a risk that must be explicitly compensated, not a hedge that arrives free of charge.

Securitized Products

The war extended the lock-in, and the market has largely ignored what that is worth. Mortgage rates above 6% against an outstanding coupon stock concentrated far below that level mean the refinancing option remains deeply out of the money, prepayment risk stays dormant, and the carry accrues month after month. Rate volatility is the sector's true profit-and-loss driver, and the quarter's principal source of it, the war premium in the crude curve, was gone by the end of June. A Federal Reserve on hold without forward guidance is, counterintuitively, a favorable environment for current-coupon mortgage carry: no refinancing wave, stable cash flows, and spread over Treasuries earned without assuming corporate balance-sheet risk.

The discipline requirement has not changed. This is a coupon-selection and convexity-management market, not an allocation market. The scenario that hurts is not higher-for-longer; it is a rapid dovish reversal that re-arms the prepayment option. The emphasis remains on cash-flow profiles that survive that scenario: seasoned collateral, demonstrable prepayment protection, and structures where the convexity cost is visible and priced rather than embedded and dependent on continued calm.

In consumer ABS, the energy shock is a tax aimed at precisely the borrower who collateralizes the bottom of the capital stack. An energy bill of this size lands on lower-income households first and hardest, and that stress will surface in subprime delinquency data before it appears anywhere else in fixed income. Our preference remains senior, prime, and seasoned, where enhancement and payment priority are doing identifiable work. Spread that exists specifically to compensate for the risk we have just described is not, in our view, spread worth reaching for.

CMBS remains a collateral business, not an index. Office is still structurally impaired and lower rates would not fix obsolescence. The standout is data infrastructure, where the AI capex cycle has converted a property type into a growth industry with investment-grade tenants signing long leases. Industrial, multifamily, and select retail remain workable through sponsor-level and debt-service-coverage discipline. We continue to underwrite at the asset level, not the index level.

Investment Grade Credit

Investment grade credit spent the quarter priced for very little to go wrong. The ICE BofA US Corporate Index option-adjusted spread traded at 77 basis points in mid-May, in the tightest decile of its post-crisis history, even as the quarter delivered a war, a Federal Reserve chair transition, and a projection round that put hikes back on the table.[11] That resilience is partly a statement about fundamentals, which remain sound: balance sheets are stable, market access is unimpaired, and this is not a solvency story. But it is also a statement about complacency, and at these valuations the two are indistinguishable until tested.

The new development is supply. The AI buildout has drawn a traditionally conservative set of issuers into one of the largest financing cycles the investment grade market has seen, and the issuance is concentrated in longer

[11] Source: ICE Data Indices, LLC, ICE BofA US Corporate Index Option-Adjusted Spread; retrieved from FRED, Federal Reserve Bank of St. Louis.

maturities. Supply aimed at the back of the credit curve argues for the same conclusion we reached in Treasuries: the front end and the belly sit outside its path. Curve positioning within credit now matters as much as issuer selection.

On selection itself, the standard is unchanged: issuers who can fund themselves when markets are less generous. Pricing power, recurring free cash flow, manageable maturity walls. The credits to avoid are the ones whose comfort depends on strong margins, resilient demand, and an open capital-market window all holding simultaneously. That is not defensive credit; it is hidden beta, and it is what accumulates in portfolios late in a cycle. We would rather forgo the last ten basis points of spread than find out in a repricing which holdings it was.

High Yield

High yield spreads spent the quarter's final weeks below 300 basis points. The ICE BofA US High Yield Index option-adjusted spread traded at 2.82% in mid-May, in the tightest fifth of its ten-year range and barely 200 basis points over investment grade.[12] The central bank has just told the market its next move may be up. Those prices are not consistent with one another, and at least one of them will adjust.

The index level hides the tiering underneath it. Software and AI-displacement stress is producing genuine dispersion in sectors previously treated as stable. The market functions normally for the top of the quality stack and is quietly closed for the bottom: a two-tier structure in which the next default cycle incubates not through a macro event but through refinancing attrition, one CCC at a time.

The June projections changed the arithmetic for the weakest capital structures. A CCC issuer that refinanced at a double-digit coupon on the assumption that 2026 would deliver rate relief has now seen that relief repriced out of the curve. We wrote last quarter that these structures required rate cuts to work. The June projections removed the rate cuts. We see no reason to underwrite balance sheets whose viability depends on a policy path the central bank has just disavowed.

Our preference is unchanged: BBs and select single-Bs with durable business models, visible free cash flow, identifiable asset coverage, and no near-term maturity wall. These are issuers for whom the capital markets are a convenience rather than a life-support system. The carry in that segment is real, and the balance sheets can survive a financing environment that stays unfriendly longer than consensus expects. Below that line, headline yield is not value; it is credit risk that has not yet been priced.

Conclusion

The first quarter's lesson was that the market had priced a landing too clean to disappoint. It is our belief that the second quarter's lesson is that the market has a new central bank and has not finished pricing it. Oil round-tripped; policy did not.

The defining fact of the quarter is that the front end sold off while the war premium collapsed. That is not an energy story. It is a credibility story: a new chairman acquiring optionality, at low cost, in an economy strong enough to let him. That view may prove wrong; the reaction function is new and deliberately undisclosed. But the practical implication does not require certainty. Communication is currently doing the work of policy. The outcome the market fears most is already priced at the front of the curve. And the outcomes the market fears least, in credit, are the ones it is being paid least to insure against.

In rates, the opportunity remains concentrated where policy transmission is direct and the fiscal trajectory is not the investor's to underwrite; the long end is a supply question, not a hedge. In securitized products, the emphasis

12 Source: ICE Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread; retrieved from FRED, Federal Reserve Bank of St. Louis.

remains on disciplined convexity, structural seniority, and collateral that can be underwritten on its own terms, with data infrastructure the clear standout among property types. In investment grade, the premium belongs on balance sheets that fund themselves and on parts of the credit curve the coming supply wave is not aimed at. In high yield, the distinction that matters is between issuers for whom the capital markets are optional and issuers for whom they are not.

The consensus spent the first quarter positioned for a landing it did not get and the second quarter hedging a war the market ultimately absorbed. The setup entering the third quarter is less dramatic and, for that reason, carries its own risk: spreads at the tights, a chairman building credibility he has not yet had to spend, and an energy truce that rests on a memorandum. We cannot forecast which of those holds and which breaks. What we can do is prefer risk where the compensation is explicit and the balance sheet does not depend on a friendlier Federal Reserve, and decline to pay for outcomes the central bank has advised the market not to assume. The present, at these prices, is fully accounted for. The next twelve months are not. The distance between the two is where returns will be earned.

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The ICE BofA US Corporate Index tracks the performance of US dollar-denominated, investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), a fixed coupon schedule, and at least one year remaining term to final maturity. Option-adjusted spread (OAS) measures the spread of the index over the spot Treasury curve, adjusted for embedded options.

The ICE BofA US High Yield Index tracks the performance of US dollar-denominated, below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), a fixed coupon schedule, and at least one year remaining term to final maturity. Option-adjusted spread (OAS) measures the spread of the index over the spot Treasury curve, adjusted for embedded options.

The ICE U.S. Dollar Index (DXY) measures the value of the US dollar relative to a basket of six major foreign currencies: the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc.