DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

First Quarter 2026

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US Economy

Summary

The first quarter exposed the market's core assumption.

Investors entered 2026 expecting a clean soft landing: inflation would continue to moderate, growth would remain positive, the Federal Reserve would begin easing, and credit markets would continue to deliver carry with limited disruption. That was an optimistic setup, not a conservative one.

The economy is not breaking. Labor is cooling, not collapsing. Consumers are slowing, but aggregate demand remains intact. Corporate balance sheets are weaker at the margin, but not impaired at the system level. Capital markets remain open. This is not a recessionary credit event.

The issue is valuation and policy flexibility. Risk assets entered the year priced for a narrow path: continued disinflation, steady growth, gradual Fed easing, and limited volatility. The first quarter made that path less certain.

The Fed's March statement captured the tension directly: economic activity was still expanding at a solid pace, unemployment had changed little, and inflation remained somewhat elevated. That is the constraint. Inflation has improved, but it is not defeated. Services inflation remains persistent. Wage growth has cooled, but not enough to give the Fed full confidence. Shelter is moving lower, but slowly. Energy has re-emerged as a meaningful risk. Oil does not need to remain elevated indefinitely to matter; it only needs to remain elevated long enough to complicate the timing and credibility of rate cuts.

The Fed's constraint is straightforward: growth is not weak enough to force aggressive easing, and inflation is not clean enough to permit it without risk.

The market wants policy relief. The Fed wants optionality. Oil, fiscal deficits, and term premium are making the path narrower.

This is not a crisis environment. It is an environment where underwriting, security selection, and curve exposure matter more than broad beta.

Outlook

Our base case remains continued expansion, but with less tolerance for error.

The U.S. economy still has support. Nominal income growth remains positive. Corporate investment remains active. Capital spending tied to AI infrastructure, power, defense, automation, reshoring, and energy capacity remains a real source of demand. These are not temporary market themes; they are capital allocation trends.

That is why recession is not our base case. But an economy does not need to enter recession for investors to lose money. It only needs to deliver a less favorable outcome than the one already embedded in valuations.

The easier phase of disinflation is behind us. Goods inflation has largely corrected. The next phase is more difficult. Services, wages, shelter, insurance, healthcare, and energy do not move cleanly lower on command. Treating inflation as fully resolved is premature.

The Fed is closer to cutting than hiking. The relevant question is whether it can cut on the market's preferred schedule without compromising inflation credibility. We do not think the Fed has that much flexibility.

The Fed can ease into cooling inflation and moderating growth. It cannot ease aggressively into renewed inflation pressure without creating a credibility problem. That distinction matters for both rates and credit.

Our expectation is measured easing, not rescue easing. That is supportive for high-quality fixed income. It does not justify owning weak credit, low-quality spread, or assets that require immediate rate relief to perform.

The risk case is clear: oil remains elevated, inflation expectations become less comfortable, consumption slows, and the Fed cannot respond as quickly as markets would like. In that environment, the economy may avoid recession, but risk assets can still reprice.

We favor intermediate duration, senior cash flows, collateral-backed structures, and issuers with the balance sheet strength to withstand less generous financing conditions.

We are more cautious on long-duration exposure that relies on fiscal complacency, low-quality credit dependent on cheap capital, and spread products priced with limited margin for error.

This is not the time to hide from risk. It is also not the time to own risk indiscriminately. The opportunity is in being selective, not broad.

Sector Analysis

US Interest Rates

The rates market is directionally reasonable but too casual on the path.

The next major Fed move is more likely lower than higher. That is widely understood. The more important question is where along the curve investors are being compensated for the uncertainty around timing, inflation, and term premium.

The answer is not the entire curve.

Based on quarter-end Treasury market data, the 2-year Treasury yield rose roughly 32 basis points during the quarter, while the 10-year Treasury yield rose roughly 15 basis points. The move was not simply a stronger-growth signal. It was a repricing of the path to easier policy, with the front end adjusting more aggressively as markets reassessed how quickly the Fed could cut.

The front end remains primarily a Fed trade. It will rally when the Fed is confident enough to begin easing. Until then, it remains dependent on inflation data, labor market moderation, and Fed communication.

The intermediate part of the curve offers the better risk-reward. The 2- to 7-year sector provides exposure to eventual policy normalization without requiring investors to take the full fiscal and term-premium risk embedded in the long end. If the Fed cuts gradually, the intermediate sector should benefit. If growth slows more meaningfully, it should also provide portfolio protection.

The long end is more complicated. Long Treasuries remain useful in a growth shock, but they are no longer a simple recession hedge. They are also exposed to fiscal credibility, Treasury supply, inflation volatility, and term premium. Deficits remain large. Issuance remains heavy. Interest expense is rising. The Fed can influence the front end of the curve, but it cannot force investors to accept low long-term yields.

Long yields can decline if growth slows and inflation volatility falls. But that outcome requires more than a Fed easing cycle. It requires the market to absorb duration supply at a time when fiscal dynamics remain challenging.

Our rates view is disciplined. We favor intermediate duration. We are selective on the long end. We do not assume Fed cuts automatically translate into a full-curve rally.

Securitized Products

Securitized credit remains one of the more attractive areas of fixed income because the risk is more directly underwritable.

Corporate credit largely compensates investors through carry. Securitized credit can still compensate investors through structure, collateral, cash-flow priority, and complexity. In a market with less room for valuation error, that distinction matters.

Agency MBS remain attractive relative to Treasuries. The sector offers spread without direct corporate balance sheet exposure. Mortgage spreads remain meaningful, prepayment risk is contained by the lock-in effect, and lower rate volatility would be supportive.

But this is not a generic mortgage allocation. Coupon selection, convexity exposure, specified pool characteristics, and cash-flow profile matter. If rates decline gradually, MBS can perform well. If rates decline sharply, prepayment risk can re-emerge quickly. The opportunity is in owning the right mortgage cash flows at the right price, not simply increasing mortgage exposure.

Consumer ABS remains investable, but selectivity is required. We prefer senior consumer ABS backed by prime or seasoned collateral, where structural enhancement and payment priority provide identifiable downside protection. Lower-quality consumer exposure requires more caution. Lower-income borrowers are more sensitive to higher financing costs, slower wage growth, and reduced savings. That risk can be acceptable, but only where credit enhancement, seasoning, and collateral performance justify the spread.

CMBS remains highly differentiated. It should not be treated as broad index exposure. Office remains structurally challenged. Lower rates may reduce refinancing pressure, but they do not solve obsolete buildings, weak demand, poor leasing economics, or impaired capital structures.

At the same time, office is not the entire CMBS market. Industrial, logistics, data infrastructure, multifamily, and select high-quality retail have different fundamentals. There is value in CMBS, but only through collateral-level underwriting, sponsor analysis, debt-service coverage discipline, and careful capital-structure selection.

Our securitized view is constructive. We favor agency MBS with disciplined convexity exposure, senior consumer ABS with real structural protection, and high-quality collateral-backed cash flows where downside protection is identifiable.

We remain cautious on weak office exposure, lower-quality consumer collateral, and structures that require easy refinancing to work.

The objective is to own structure and collateral quality, not embedded leverage disguised as yield.

Investment Grade Credit

Investment grade credit remains fundamentally sound, but valuations are no longer compelling on a broad basis.

Large companies retain market access. Liquidity is adequate. Earnings are slowing, but not collapsing. Balance sheets are broadly stable. This is not a corporate solvency problem.

The issue is compensation. Spreads already reflect a favorable outcome. Investors are being paid to collect carry, not to absorb a meaningful growth shock.

That makes issuer selection more important than broad exposure.

The mistake in investment grade credit is reaching for incremental spread in issuers that do not warrant the risk. Late in a cycle, portfolios often accumulate hidden beta through credits that appear safe in stable markets but deteriorate quickly when liquidity, margins, or refinancing conditions tighten.

We favor issuers with pricing power, conservative leverage, recurring free cash flow, and manageable maturity profiles. We prefer companies that can fund themselves even if markets become less generous. The preference is for durable business models, strong liquidity, and balance sheets that do not require a perfect capital-market window.

We are cautious on businesses that require strong margins, resilient demand, lower rates, and open capital markets for the balance sheet to remain comfortable. Those are not defensive credits. They are cyclical exposures with less margin for error.

Financials remain investable, but dispersion matters. Large, diversified, well-capitalized institutions are materially different from weaker lenders with deposit pressure, commercial real estate exposure, or concentrated funding models.

Industrials require the same discipline. Strong franchises with pricing power can withstand a slower economy. Levered cyclicals with margin pressure should not be treated as quality simply because they are included in the index.

Our investment grade view is straightforward: own quality, avoid spread-chasing, and do not confuse market liquidity with balance sheet strength.

Investment grade credit can perform in 2026, but the easy spread compression is likely behind us. From here, returns should come from carry, rates, and issuer selection rather than broad beta.

High Yield

High yield is where underwriting discipline matters most.

The market is not broken. New issuance remains open. Refinancing remains possible. Default risk is contained for now. That argues against broad panic.

It does not justify broad exposure to weak balance sheets.

The weakest issuers remain dependent on favorable capital markets. Many refinanced at higher coupons, extended maturities, and relied on continued growth to stabilize leverage. That works when markets are open and earnings hold. It becomes much more fragile if growth slows, rates remain elevated, or investors reduce risk appetite.

The key distinction is between yield and value.

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Yield is value only when the borrower can service the debt, refinance it, or reduce leverage through cash flow. Otherwise, the yield is compensation for credit risk that may not be fully reflected in the price.

We favor BBs and select Bs where the business model is durable, free cash flow is visible, maturities are manageable, and the capital structure does not require immediate rate relief. The better opportunities are in issuers with improving leverage trajectories, identifiable asset coverage, and enough liquidity to withstand a less favorable refinancing market.

We are cautious on CCCs that require rate cuts, levered cyclicals that require a strong economy, and companies whose capital structure depends on capital markets remaining open.

There will be opportunities in high yield, but they will come from underwriting, not broad market exposure. The market is not distressed enough to justify buying indiscriminately, and it is not cheap enough to forgive weak credit work.

High yield can still contribute in 2026, but the opportunity is selective. Balance sheet quality, cash flow, liquidity, and maturity structure matter more than headline yield.

Conclusion

The first quarter did not invalidate the soft-landing thesis. It showed how much of that outcome was already embedded in market pricing.

The economy is still growing. Labor is cooling, not collapsing. Credit markets are functioning. Corporate balance sheets remain broadly stable. Those facts argue against panic.

They do not justify complacency.

The market entered the year priced for a clean landing. That leaves less room for disappointment if inflation proves sticky, oil remains elevated, the Fed delays easing, or term premium remains firm.

We are not bearish on the economy. We are cautious toward assets priced with limited margin for error.

In rates, we favor intermediate duration because policy asymmetry is improving and the long end carries more fiscal and term-premium risk.

In securitized products, we favor agency MBS with disciplined convexity exposure, senior consumer ABS, and collateral-backed cash flows where downside protection is identifiable.

In investment grade credit, we prefer durable balance sheets, recurring free cash flow, and strong liquidity over marginal spread.

In high yield, we favor companies that can withstand a less favorable financing environment without relying on immediate rate cuts or aggressive refinancing assumptions.

The portfolio answer is not to sit in cash and wait for a recession. It is also not to buy every asset with yield attached to it.

The appropriate posture is to own risk where compensation is clear, underwriting is defensible, and downside protection is real — and to avoid risk priced for a cleaner macro environment than the one in front of us.

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The MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate passthroughs), ABS and CMBS (agency and non-agency).

The Bloomberg US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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