DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Fourth Quarter 2025

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US Economy

Summary

The fourth quarter of 2025 confirmed that the U.S. economy has transitioned from late-cycle tightening risk to mid-cycle recalibration. The dominant macro question has shifted from “Will restrictive policy induce recession?” to “What is the appropriate neutral policy rate in a structurally higher nominal growth regime?”

Real GDP growth moderated through 2025 but remained firmly positive. Final domestic demand held up, supported by real income gains as inflation decelerated and nominal wage growth normalized. Corporate investment continued to concentrate in productivity-enhancing sectors — artificial intelligence infrastructure, semiconductor fabrication, energy development, automation, and supply-chain reshoring — reflecting a secular reallocation of capital rather than cyclical excess.

The consumer sector demonstrated late-cycle resilience rather than exhaustion. While excess savings have largely normalized, aggregate household net worth remains elevated relative to pre-pandemic levels, and debt service ratios remain manageable despite higher absolute borrowing costs. Credit normalization has been orderly rather than disorderly.

Labor markets softened at the margin but did not fracture. Unemployment drifted modestly higher toward levels consistent with a late-cycle cooling phase rather than recessionary stress. Importantly, wage growth decelerated without collapsing, allowing services inflation to ease gradually while preserving aggregate purchasing power.

Inflation dynamics improved meaningfully over the course of 2025. Core goods disinflation persisted, shelter inflation rolled over as lease resets filtered through official data, and supercore services inflation decelerated as labor cost pressures eased. While inflation has not yet converged fully to the Federal Reserve’s long-run target, the trajectory has been consistent with a sustained disinflation process.

Financial conditions have loosened modestly relative to peak restrictiveness. Equity markets discounted a soft-landing scenario, credit spreads remained contained, and rate volatility (as measured by the MOVE Index) declined materially from prior cycle highs. Markets have increasingly internalized the view that policy is restrictive relative to neutral and that the next meaningful adjustment is more likely to be downward than upward.

Outlook

Our 2026 baseline is characterized by continued expansion and a policy bias toward accommodation, not as a response to contraction but as a recalibration toward neutral.

The Federal Reserve’s reaction function has evolved from front-loaded inflation suppression to symmetric risk management. With inflation trending lower and labor markets cooling in an orderly fashion, the cost of maintaining policy rates meaningfully above neutral increasingly outweighs the risk of incremental easing. Absent a renewed inflation impulse, we believe the policy bias in 2026 is toward gradual rate cuts.

We do not anticipate an aggressive easing cycle. Instead, we expect a measured glide path lower in policy rates as real rates remain restrictive relative to estimated neutral levels. The easing dynamic is likely to be framed around sustaining the expansion rather than counteracting recession.

We expect real GDP growth in 2026 to remain positive and potentially reaccelerate modestly as financial conditions ease. Lower funding costs should support housing stabilization, corporate refinancing activity, and incremental risk appetite. The secular investment cycle in technology, energy, and domestic industrial capacity remains intact and should provide a structural growth tailwind.

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Risks to this outlook include:

- A reacceleration of inflation driven by energy or wage shocks
- Persistent fiscal deficits contributing to upward pressure on long-term yields
- Geopolitical disruptions affecting trade flows or commodity markets
- An adverse repricing of term premium

However, our base case remains one of steady nominal growth, declining inflation volatility, and incremental policy normalization.

Sector Analysis

US Interest Rates

The rates market in 2025 reflected the intersection of three structural forces: disinflation, resilient growth, and historically elevated Treasury issuance.

Although the Federal Reserve held policy in restrictive territory for much of the year, forward guidance increasingly acknowledged progress on inflation. The Fed's reaction function has transitioned from singularly inflation-focused to dual-mandate balancing. With inflation expectations anchored and labor market conditions normalizing, the hurdle for further tightening has increased materially.

At the same time, long-duration yields remained elevated relative to pre-2022 norms. This has not been solely a function of growth expectations but rather a repricing of term premium. Structural fiscal deficits — driven by entitlement growth, defense spending, and industrial policy initiatives — imply sustained elevated Treasury issuance. As a result, the market has demanded incremental compensation for duration risk.

The fiscal arithmetic is increasingly relevant. With debt-to-GDP elevated and interest expense consuming a larger share of federal revenues, the marginal cost of capital for the sovereign has risen. While the Federal Reserve does not target fiscal outcomes, the interaction between monetary policy and Treasury supply influences term structure dynamics.

The yield curve continued its normalization process in 2025. Front-end yields reflected restrictive real rates, while intermediate and long maturities priced a combination of term premium and nominal growth expectations.

Looking to 2026, we believe the directional bias favors lower front-end and intermediate yields as policy rates gradually decline. The magnitude of long-end yield compression will depend on the behavior of term premium. If inflation volatility continues to decline and fiscal credibility stabilizes, long yields could grind lower. If fiscal issuance accelerates or inflation expectations become less anchored, long-end yields may remain elevated even as policy rates fall.

In sum, we view duration as increasingly constructive on a risk-adjusted basis, particularly in the 2- to 7-year sector, where policy transmission is most direct.

Securitized Products

Securitized markets in 2025 benefited from declining rate volatility, stable macro fundamentals, and improving technical conditions. As the probability of recession diminished and volatility subsided, investor demand for structured credit strengthened across the spectrum.

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Agency mortgage-backed securities continued to offer compelling carry relative to Treasuries. While spreads tightened modestly during the year, they remained attractive versus long-term averages for much of the period. Elevated mortgage rate levels suppressed prepayment risk, reducing convexity-driven volatility and improving the stability of cash flows. In a gradual easing environment in 2026, the sector stands to benefit from declining rate volatility without immediately triggering a refinancing surge, given the significant gap between outstanding mortgage coupons and prevailing market rates.

Consumer-backed ABS demonstrated resilient collateral performance. Delinquency trends normalized but did not deteriorate meaningfully beyond manageable levels. Structural protections remained robust, and spread tightening reflected improved liquidity conditions and strong institutional demand. In a scenario of continued economic expansion and incremental rate cuts, structured consumer credit should benefit from stable income dynamics and reduced refinancing pressure.

Commercial mortgage-backed securities exhibited selective stabilization. Structural challenges remain in office and certain legacy assets, but industrial, multifamily, data infrastructure, and high-quality retail properties demonstrated resilience. Easing financial conditions in 2026 should improve refinancing optionality in performing segments, though dispersion remains high across property types and capital structures.

Across securitized sectors, declining volatility, stable growth, and incremental policy accommodation create a supportive technical backdrop. We emphasize structural quality, cash flow durability, and convexity management rather than pure spread beta.

Investment Grade Credit

Investment grade credit performance in 2025 was driven primarily by carry and modest spread compression. Corporate balance sheets remain broadly stable, with leverage ratios flattening and liquidity cushions intact. While refinancing costs remain above pre-2022 norms, anticipated rate cuts in 2026 should gradually reduce funding pressures.

Earnings growth moderated but remained positive, supported by disciplined capital allocation and operational efficiencies. Sector dispersion increased as investors differentiated between issuers with durable pricing power and those facing margin compression.

In a gradual easing, soft-landing environment, investment grade credit stands to benefit from both declining rate volatility and incremental spread tightening. While valuations appear fair rather than distressed, default risk remains low absent a significant growth shock.

We favor issuers with conservative financial policy, durable free cash flow generation, and limited near-term refinancing exposure.

High Yield

High yield markets demonstrated resilience in 2025. Default rates rose modestly but remained below long-term averages. The refinancing wall, while visible, has been manageable in an environment of functioning capital markets.

In 2026, a gradual easing cycle should support refinancing capacity and reduce interest burden pressure. As long as nominal GDP growth remains positive, high yield issuers should be able to manage leverage trajectories.

However, dispersion remains elevated. Lower-quality issuers with aggressive capital structures remain vulnerable to idiosyncratic shocks. We continue to emphasize bottom-up selection and avoidance of structurally impaired business models.

Carry remains the dominant driver of expected returns, with selective opportunities for spread compression should growth remain stable and policy normalization proceed as expected.

Conclusion

The macro landscape exiting 2025 reflects a transition from restrictive stabilization to calibrated normalization. The U.S. economy has absorbed one of the most aggressive tightening cycles in decades without systemic stress, and the focus has shifted from recession risk to the appropriate neutral rate in a structurally higher nominal growth regime. Disinflation has progressed, labor markets have cooled in an orderly fashion, and financial conditions have stabilized. Policy remains restrictive relative to neutral, but the directional bias is increasingly toward accommodation.

Our 2026 base case is defined by continued expansion and gradual policy recalibration. We do not view prospective rate cuts as recession-driven, but rather as a measured adjustment toward neutral as inflation trends lower. The Federal Reserve’s reaction function has evolved toward risk symmetry — preserving the expansion while maintaining inflation credibility.

In rates, front-end yields remain restrictive while the long end embeds fiscal-driven term premium. As policy rates move lower, the intermediate sector should respond most directly, while long-duration performance will hinge on inflation credibility and Treasury supply dynamics. On balance, duration — particularly in the 2- to 7-year sector — offers improving asymmetry in a declining volatility environment.

Across spread sectors, fundamentals remain intact. Securitized products benefit from stable collateral and moderating volatility. Investment grade issuers maintain manageable leverage, and high yield markets continue to function within an orderly refinancing backdrop. Carry remains a meaningful return driver, though dispersion reinforces the importance of security selection over broad beta exposure.

Risks remain — including fiscal imbalances, energy-driven inflation shocks, and term premium repricing — but absent a material disruption, the macro configuration supports a constructive stance toward high-quality duration and selective credit risk.

Entering 2026, the opportunity set is defined not by crisis response, but by disciplined positioning within a late-cycle normalization framework.

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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.

The Credit Suisse Leveraged Loan Index tracks the investable market of the US dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's / S&P ratings of Baa1 / BB+ or Ba1 / BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

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