Quarterly portfolio manager commentary

Cash Management Portfolios

What market conditions had a direct impact on the bond market this quarter?

The second quarter of 2026 began with heightened concerns surrounding the conflict in the Middle East, rising energy prices, and the inflationary consequences of supply disruptions. As the quarter progressed, easing geopolitical tensions and a pullback in oil prices improved investor sentiment, allowing markets to refocus on economic fundamentals and monetary policy.

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Economic Activity – Labor market conditions continued to normalize throughout the quarter, with payroll growth slowing and wage gains continuing to moderate, particularly among lower-income households. Despite this cooling, job openings remained elevated and layoffs historically low, reinforcing a "low-hire, low-fire" environment. While conditions are softening, we view the labor market as normalizing rather than deteriorating.

Economic growth remained supported by business investment, while consumer spending made its weakest contribution to Gross Domestic Product (GDP) in several years. Declining savings rates and slowing wage gains suggest continued moderation in consumption. Business investment remains a notable bright spot, particularly in technology, software, and AI-related capital expenditures, which continue to support business activity and productivity expectations. At the same time, strong demand for computing infrastructure has contributed to inflationary pressures in select technology segments. We expect economic growth to remain near current trends, with business investment offsetting signs of moderating consumer demand.

Inflation remained above the Federal Reserve's (Fed) target throughout the quarter with headline inflation accelerating, driven primarily by higher energy prices. Core measures remained elevated as services inflation showed limited signs of improvement. Importantly, long-run inflation expectations stayed relatively well anchored despite higher headline readings. We believe headline inflation may be at or near its peak as energy prices retreat, but persistently elevated core inflation remains a concern for the Fed as it determines the near-term path of policy rates.

Monetary Policy – The quarter marked a significant transition at the Fed. The Federal Open Market Committee (FOMC) held its target range unchanged at 3.50% to 3.75% at Kevin Warsh's first meeting as Fed Chair. As expected, the Fed removed all forward guidance, signaling a more data-dependent approach. The June "dot plot" also shifted more hawkish, with nine policymakers projecting at least one rate hike in 2026. Given current market pricing, we see value in the front-end of the yield curve.

usbancorp
Asset Management

What were the major factors influencing investment-grade fixed income this quarter?

U.S. Treasury yields rose across the curve during the second quarter as markets repriced the Federal Reserve's policy path amid energy-induced inflation concerns and a more hawkish policy outlook. The increase was most pronounced in shorter maturities, with the 2-year Treasury yield leading the move higher as markets priced in a reduced likelihood of policy easing and a growing probability of additional rate hikes.

The 3-month U.S. Treasury ended the quarter at 3.81%, 14 basis points (bps) higher. The 2-year, 5-year and 10-year U.S. Treasuries ended the quarter at 4.17%, 4.23%, and 4.47%, representing increases of +38 bps, +28 bps, and +28 bps, respectively.

Bond indices delivered mixed performance during the quarter as rising yields weighed on valuations, while elevated income supported returns. The ICE BofA 3-month and 2-year U.S. Treasury indices returned 0.88% and 0.27%, respectively. The 5-year U.S. Treasury index declined 0.17%, while the 10-year U.S. Treasury index returned 0.13%. The divergence in performance reflects the greater income available in longer maturities, which offset the larger valuation headwinds associated with rising yields.

Excess returns were generally positive during the quarter as improving sentiment surrounding Middle East negotiations supported spread products. Despite robust issuance volumes, corporate bonds were the strongest performing sector, outperforming both asset-backed and mortgage-backed securities.

Investment-grade corporate bonds benefited from strong investor demand and generally healthy corporate fundamentals. Credit spreads tightened back toward historically rich valuations, supporting excess returns during the quarter. Federal agency and supranational securities also benefited from limited issuance, which helped keep spreads near historically tight levels. Meanwhile, AAA-rated asset-backed securities continued to benefit from resilient collateral performance and strong demand, while agency-backed mortgage-backed securities (MBS) and Agency commercial MBS generated positive excess returns as demand remained strong and interest rate volatility moderated.

What near-term considerations will affect portfolio management?

Given our expectation that the Fed will remain on hold into 2027, we continue to view all-in yields as attractive across fixed income sectors. However, historically rich valuations across many spread sectors are likely to limit future excess return opportunities.

For investment-grade corporates, we believe the scope for additional spread tightening is limited, making income generation and carry the primary drivers of future returns. Similarly, limited federal agency and supranational issuance is expected to constrain excess return opportunities going forward.

Within securitized markets, ABS fundamentals remain favorable, but tighter spreads and below-average valuations increase the importance of security selection. Agency-backed mortgage-backed securities (MBS) and commercial MBS continue to benefit from favorable technical conditions, though valuations appear rich relative to historical levels, which may limit future performance.

As a result, portfolio management will seek to maximize income and carry while maintaining disciplined security selection. With spreads across many sectors near historically tight levels, we expect security selection, relative value analysis, and yield capture to be the most important drivers of returns going forward.

Sources
Bloomberg

[Please see important disclosures on the following page.]

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