

Quarterly portfolio manager commentary

Cash Management Portfolios

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

The third quarter brought a meaningful shift in the rate environment as resilient economic activity, higher energy prices, and escalating geopolitical risks kept inflation concerns elevated. Oil prices rose sharply in July, while renewed conflict-related uncertainty contributed to higher bond-market volatility. Despite these risks, domestic demand remained firm, supported by consumer spending and continued investment in technology, software, and artificial intelligence infrastructure.

Economic Activity – Economic growth remained resilient and was increasingly supported by business investment. Second-quarter real GDP growth was revised higher to 2.2%, with technology investment contributing approximately 0.4 percentage points as firms continued to invest in information-processing equipment, software, and related infrastructure. This spending supported domestic demand and potential productivity growth, although related financing and infrastructure needs also contributed to heavier corporate issuance and inflationary pressures in select areas.

Consumer spending remained strong, although its durability became less certain. Slower job creation and moderating wage and income growth may weigh on purchasing power, particularly as consumer spending continues to outpace income growth and the savings rate declines. Higher energy costs represent another potential constraint. The labor market nevertheless remained stable as the “low-hire, low-fire” environment continued. The unemployment rate ended the quarter at 4.2%, while the three-month average of 51,000 new jobs remained broadly consistent with the pace needed to keep unemployment stable.

Inflation remained the central economic challenge, with limited progress toward the Federal Reserve’s 2% target. Higher energy prices continued to affect headline inflation, while elevated core measures and rising business costs increased the risk that price pressures could broaden. Resilient growth and a labor market broadly consistent with full employment gave policymakers confidence that the economy could withstand tighter policy, allowing the Fed to remain focused on restoring price stability.

Monetary Policy – The quarter marked an important shift in Federal Reserve policy. The Federal Open Market Committee held rates unchanged in July amid divided views among policymakers, but limited progress on inflation strengthened the case for additional tightening. At its September 16 meeting, the FOMC unanimously raised the federal funds target range by 25 basis points (bps) to 3.75% to 4.00%, its first increase since July 2023. Federal funds futures subsequently reflected expectations for at least one additional rate increase in 2026.

Although views differ regarding the timing and pace of future policy actions, inflation remains above the Fed’s preferred target and monetary policy appears likely to retain a tightening bias. The precise path will depend on how inflation, labor-market conditions, economic growth, and geopolitical developments affect the yield curve and the Fed’s assessment of the appropriate policy stance.



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

A more hawkish Federal Reserve and resilient economic activity prompted markets to reprice the expected policy path, driving U.S. Treasury yields higher across the curve. The September rate increase accelerated that move, with intermediate- and longer-term Treasury yields reaching their highest levels in decades.

The 3-month Treasury ended the quarter at 4.11%, an increase of 30 bps. The 2-, 5-, 10-, and 30-year Treasury yields ended the quarter at 4.89%, 5.09%, 5.28%, and 5.63%, representing quarterly increases of 72, 86, 81, and 68 bps, respectively.

Rising yields weighed most heavily on longer-duration securities. The ICE BofA 3-month and 2-year U.S. Treasury indices returned 0.89% and -0.24%, respectively, while the 5- and 10-year Treasury indices returned -2.70% and -5.17%. Income helped cushion the effect of higher yields, but shorter-maturity securities outperformed as the yield curve shifted higher.

Spread-sector performance was mixed as strong fundamentals and investor demand competed with higher rates, increased volatility, heavy issuance, and rich valuations. Federal agency and supranational issuance remained limited, keeping spreads near historically tight levels and constraining excess-return opportunities.

Investment-grade corporate bonds continued to benefit from healthy fundamentals and strong investor demand. However, elevated issuance and rich valuations limited the potential for additional spread compression. Wider spreads in September improved potential entry points, but a cautious and selective approach remained warranted.

AAA-rated asset-backed securities benefited from resilient consumer fundamentals and favorable collateral performance. However, stretched valuations reinforced the importance of security selection and supported allowing portfolio allocations to decline through natural paydowns where relative value was less compelling.

Agency mortgage-backed securities came under pressure as higher mortgage rates and elevated interest-rate volatility weighed on the sector, particularly in September. Although valuations improved, near-term risks remained skewed to the downside. Agency commercial mortgage-backed securities were more resilient earlier in the quarter but weakened as rates and volatility rose toward quarter-end. Favorable structures and limited extension risk continued to provide support, although rate uncertainty warranted a selective approach.

What near-term considerations will affect portfolio management?

Market pricing appears to reflect a more aggressive path of Federal Reserve tightening than our base-case expectations, creating attractive opportunities in shorter-duration securities. Higher all-in yields have improved fixed income's prospective return profile, but elevated policy uncertainty continues to favor disciplined duration positioning rather than large directional interest-rate exposures. We remain neutral on the long end of the yield curve, where heavy Treasury issuance, expanding fiscal deficits, and higher term premiums present additional risks.

Within money market portfolios, managers are emphasizing front-end value while preserving the flexibility to reinvest at potentially higher rates. A measured barbell approach remains appropriate, emphasizing one- to four-month securities offering favorable breakeven value relative to overnight repurchase agreements, complemented by selective investments in the 12- to 13-month sector when market volatility creates attractive opportunities. Fund yields should benefit as higher policy rates and term premiums are increasingly reflected in market yields.

A more normalized repurchase agreement and Secured Overnight Financing Rate environment has made short-term Treasury bills and government-sponsored enterprise discount notes increasingly effective substitutes for repo. Supply dislocations and broader market dynamics should continue to create opportunities to add these securities when relative value becomes attractive. Floating-rate securities will also remain an important component of the investment strategy, contributing incremental yield, diversification, and price stability.

Prime money market fund yields should continue to benefit from modest spread widening relative to government securities amid ongoing market uncertainty and volatility. Front-end corporate yields should remain supported by ample supply, term-risk premiums, and a steepening front-end yield curve.

Portfolio management will continue to prioritize liquidity and credit quality while selectively pursuing opportunities to enhance yield through fixed- and floating-rate securities consistent with the economic, credit, and interest-rate outlook.

Municipal variable-rate demand note yields may remain sensitive to seasonal cash flows, new-issue supply, and changing Federal Reserve expectations. The significant third-quarter repricing left short-term municipal yields at higher levels and improved relative value across much of the tax-exempt money market universe heading into the fourth quarter.

Across portfolios, management will remain focused on liquidity, disciplined security selection, relative-value analysis, and flexibility. The principal near-term challenge will be balancing attractive current income against uncertainty surrounding inflation, monetary policy, economic growth, labor-market conditions, and geopolitical developments.

Sources

Bloomberg Finance L.P.
ICE BofA Indices

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