Market Update

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July's data sent mixed signals for the U.S. economy, but Friday's jobs report has shifted the economic narrative and market outlook. The Bureau of Labor Statistics reported that employers added just 73k jobs, below the expected 104k, with significant downward revisions revealing the economy created only 33k jobs combined in May and June, marking the weakest three-month stretch since the pandemic recovery. Although the employment picture is weakening, consumer spending remained relatively strong.

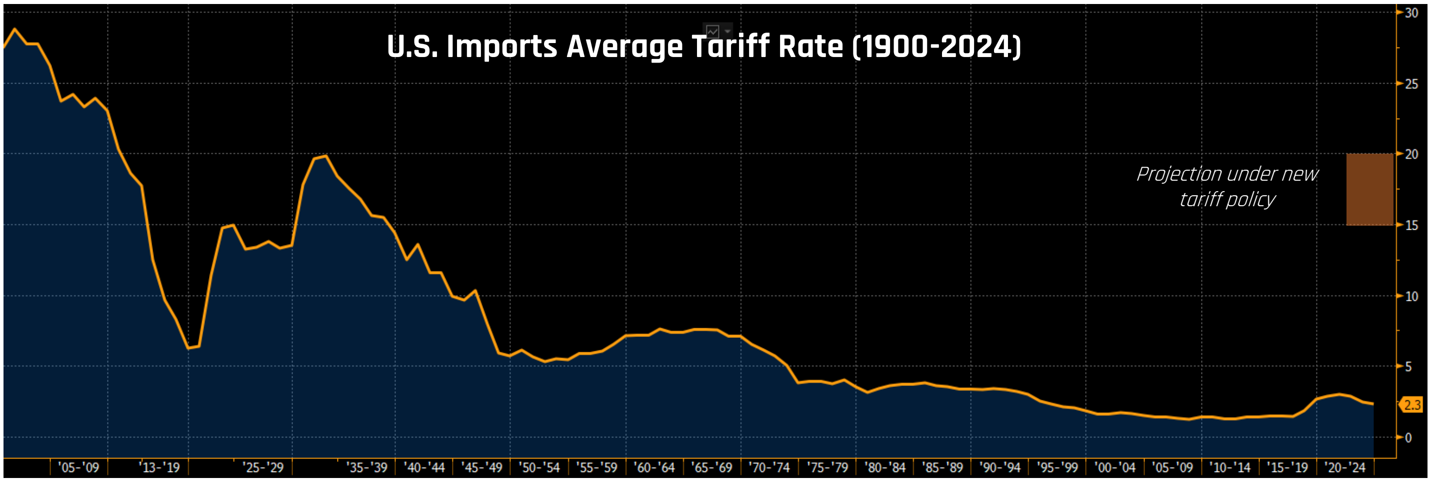
In July, President Trump signed an executive order imposing new tariffs ranging from 10% to 41% on dozens of countries, effective August 7. The U.S. now faces an average effective tariff rate of 18.4%, the highest since 1933, with consumers bearing an estimated $2,500 annual burden per household. Tariff uncertainty has impeded business investment decisions, with corporate earnings calls increasingly focused on supply chain disruptions and margin pressures. Manufacturing, the sector most affected by import costs, lost an average of 5k jobs monthly during the second quarter. As noted in previous updates, we see this forcing companies to accelerate AI adoption to offset rising costs. China and India are the only two major trading partners who have yet to resolve trade deals. When its all completed. we continue to expect the average tariff rate to settle between 15-20%.

The Federal Reserve faces intensified challenges as tariff-driven inflation competes with weakening growth dynamics. Core PCE inflation remains elevated at 2.7%. We are monitoring whether the weakening employment situation will introduce disinflationary forces. Truflation, an alternative real-time inflation measure not acknowledged by the Fed, reported a PCE index reading of 2.16%, which has also been trending lower.

Regional banks face increasing challenges as the economic outlook weakens. Higher funding costs, potential credit deterioration, and compressed net interest margins are weighing on sector performance. Many regional banks reported mixed Q2 results, with some increasing provisions for potential loan losses due to rising commercial real estate stress.

A positive development in July was the temporary de-escalation of Middle East tensions following the June Israeli-Iranian conflict. The 12-day war ended with a ceasefire that has held through early August, reducing energy market volatility and providing relief for risk assets. However, underlying structural tensions persist, and the durability of current arrangements remains uncertain.

In July, the FOMC revealed growing internal pressure for rate cuts, with two governors dissenting in favor of immediate easing. Chair Powell's assessment of the labor market as "solid" now appears outdated given the latest employment report. Markets are pricing in 2-3 25-basis-point cuts through year-end, with September as the likely starting point. Adding to this dynamic, Fed Governor Adriana Kugler, considered the most hawkish FOMC member, announced her resignation. This allows President Trump to shift the FOMC toward a more dovish committee, with the nomination to replace Kugler potentially becoming the eventual successor to Powell when his term expires in May 2026. We maintain our view of the first rate cut in October, with 150 basis points of cuts through 2026, though the probability is increasing for a September cut given aforementioned dynamics.



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Product Views

Rates: Last Friday's payroll report pushed rates lower across the curve, as market expectations for a Fed rate cut shifted more firmly toward September. As a result, we have moved from an overweight to neutral view on the front and intermediate parts of the yield curve. Through 2026, we anticipate approximately 150 basis points of rate cuts, which is largely in line with current market pricing. We have shifted from an overweight duration stance to neutral.

Looking ahead, we believe the curve may steepen if markets begin to price in a new Fed Chair who is perceived to favor more aggressive easing than the dual mandate would typically justify. For that reason, we remain cautious on the long end of the curve.

Credit: Credit spreads widened following Friday's softer-than-expected payroll report. If the economy is indeed slowing, we believe spreads have further room to widen, even in the face of currently strong fundamentals. Given this backdrop, we continue to maintain an up-in-quality bias within credit, which should provide a degree of resilience in the event of a broader economic downturn.

Securitized: Year-to-date, MBS indices have outperformed credit, and we continue to favor this sector. In the event of an economic downturn, we believe MBS spreads are well-positioned to outperform, particularly when exposures are concentrated in the right segments of the coupon stack.

Within CMBS, we remain cautious. Given recent commentary and signs of credit deterioration within the banking sector, we are closely monitoring these credits.