

Seeks total return, balancing income and diversification potential

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Strategy overview

Total return approach, investing in below-investment grade corporate securities with a bias towards higher quality and a concentrated posture.

Key takeaways

- The first quarter of 2026 unfolded as a period where artificial intelligence-driven disruption and mounting geopolitical risk combined to reshape the balance of risks across financial markets.
- The SMA performed inline the Index on a gross-of-fees basis and underperformed the Index on a net-of-fees basis during the quarter.
- The escalation of the conflict involving Iran meaningfully alters the balance of risks around this otherwise constructive backdrop.

Market review

The first quarter of 2026 unfolded as a period where AI-driven disruption and mounting geopolitical risk combined to reshape the balance of risks across financial markets. Early in the quarter, investor attention was increasingly drawn to the accelerating impact of AI within the software sector. Rapid adoption of agentic AI tools began to challenge incumbent business models, which had often been underwritten on assumptions of high recurring revenue and low competitive risk, raising questions around the durability of cash flows that had historically supported leveraged balance sheets. These pressures were particularly relevant for senior loans, private credit and BDC portfolios, where the software industry comprises a relatively large portion of these sectors.

At the same time, AI-related capital spending plans contributed to a record pace of new issuance in the investment grade corporate bond market. Heavy supply weighed on spreads, which began to drift wider early in the quarter despite still-resilient economic data, highlighting how technical factors and valuation concerns were already testing investor risk appetite. For fixed income markets, the combination of these factors proved to be an early signal that credit conditions were becoming less forgiving.

Geopolitical risk moved decisively to the forefront as the quarter progressed. Following the early-January U.S. military operation in Venezuela, tensions escalated sharply in late February when the United States and Israel entered into a direct military conflict with Iran. Initial market reactions were muted, as investors appeared to assume the conflict would be short-lived and geographically contained. That assumption gradually proved too optimistic. As Iran asserted effective control over traffic through the Strait of Hormuz, one of the world's most critical energy chokepoints, the risk of prolonged disruption to global oil supply became increasingly apparent. Shipping volumes collapsed, oil prices surged, and inflation expectations moved meaningfully higher. Once markets recognized that the conflict—and its impact on the Strait—was likely to be extended, the sell-off in risk assets gained momentum, reinforcing a broad repricing across credit markets.

Macroeconomic data during the quarter added to the sense of uncertainty. Labor market reports were volatile, with January payroll gains of 130,000 (later revised to 126,000) coming in well above expectations, followed by a 92,000 decline (later revised to –133,000) in the subsequent report. The latter fueled debate about whether the economy may be approaching the end of its cycle, particularly against the backdrop of emerging stress in private credit and the inflationary impulse from supply disruptions. Inflation dynamics echoed this mixed picture. Shelter inflation continued to ease, but services ex-shelter ("super core") and certain tariff sensitive goods categories showed modest acceleration, reinforcing the view that disinflation would remain uneven.

By quarter-end, these crosscurrents were clearly reflected in fixed income markets. Credit spreads finished the quarter broadly wider, and interest rates ended higher after significant volatility. The yield curve flattened materially, driven by a more aggressive selloff in front-end rates relative to longer maturities (2-year Treasury Yield rose 35 bp), signaling expectations that higher policy rates would remain in place for longer than previously anticipated.

Portfolio review

For the quarter, the SMA performed inline the Index on a gross-of-fees basis and underperformed the Index on a net-of-fees basis. Security selection within BB and B rating bonds detracted during the quarter, but this was offset by the SMA's overweight exposure to BBB rated bonds and underweight in CCC rated bonds, which were both additive to results given the risk-off environment.

Outlook

Broadly speaking, economic fundamental factors entering this year have been generally constructive. U.S. growth has been supported by easing financial conditions, strong household balance sheets, and resilient consumer spending—contributing to a “rolling recovery” rather than a sharp reacceleration.

The escalation of the conflict involving Iran meaningfully alters the balance of risks around this otherwise constructive backdrop. Most notably, downside risks to growth have increased, while inflation risks have become more asymmetric to the upside. The Strait of Hormuz remains the key focal point for markets. As long as this shipping route remains a binding constraint, supply chain disruptions are likely to persist, biasing growth lower and inflation higher. While energy markets are the most visible transmission channel, the implications are more broad based. Restrictions on oil flows place upward pressure on fertilizer costs, increasing the risk of higher food prices. Elevated petrochemical prices could feed through to household goods and apparel, while disruptions to the transport of industrial metals could weigh on automobile production and homebuilding activity. Collectively, these channels reinforce the stagflationary tilt associated with a prolonged disruption scenario.

In this environment, the policy response function becomes more constrained. The U.S. Federal Reserve, already wary of declaring victory over inflation, would be reluctant to ease policy aggressively in the face of renewed price pressures—even if growth were to soften. Importantly, rate cuts would do little to resolve supply-driven inflation stemming from commodity and logistical bottlenecks, limiting the effectiveness of monetary policy as a countercyclical tool.

Despite recent widening, financial markets continue to underprice the left-tail risk of a prolonged conflict with significant, lasting supply disruptions from an extended conflict. In response, we are remaining patient and maintaining flexibility across portfolios while selectively identifying opportunities in markets and sectors that have reacted more acutely to heightened geopolitical risk.

Outside of these geopolitical considerations, underlying economic fundamental factors remain supportive of risk-taking over the medium term—especially if the conflict were to resolve more quickly. We have seen early signs of recovery in housing market activity, which had been at very low levels due to higher rates, and our expectation is that a more complete recovery will materialize over time and become another factor supporting economic growth. We also view the labor market as being supportive of consumer spending, particularly as it relates to wage gains. Although some might interpret recent jobs data—such as higher unemployment and slower job growth—as signs of weakness, we view these changes as evidence that the labor market is continuing to return to normal after a long stretch of unusually tight labor conditions. Additionally, as the labor force continues to stagnate, the “floor” for wage growth remains higher. And while the AI disruption in software poses new risks, we believe the ultimate impact should be limited and sector-specific rather than systemic, reflecting a broad investor base that, importantly, is not concentrated in the banking system.

In summary, our outlook is path dependent. If the war in Iran ends soon and the Strait of Hormuz reopens, we would expect growth to reaccelerate and the rolling recovery to continue. But if the conflict drags on and disruptions persist, the hit to growth is likely to be meaningful, the damage to fundamental factors more lasting, and recession concerns will likely remain—and continue to be priced into markets.

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