

Economic Outlook and Key Themes

U.S. Economic Outlook

Base case still sees solid U.S. growth, but war risks widen the tails

- ◆ The conflict in the Middle East represents a new shock to the U.S. economy. The impact to growth could be moderate if the conflict is resolved soon, but risks climb sharply if oil disruptions extend into summer.
- ◆ U.S. consumer and business fundamentals remain healthy in aggregate. Household balance sheets are in good shape given accumulated wealth gains and moderate debt levels. Corporate profitability remains strong and leverage metrics are in line with historical norms.
- ◆ Economic growth is supported by tailwinds from ongoing AI investment and fiscal stimulus, particularly in the first half of the year. Business provisions in the One Big Beautiful Bill Act should support investment beyond tech, while personal tax provisions should also boost consumer incomes by around \$100 billion.
- ◆ Our central case has a manageable hit to growth from higher energy prices, with real gross domestic product (GDP) growth this year a bit under 2 percent. The U.S. economy is more resilient to oil shocks than in the past, but higher fuel prices will pinch consumers and business profits, causing us to trim our growth forecast. Our baseline reflects flows through the Strait of Hormuz recovering in coming weeks, and oil prices trending toward \$80/b by fourth quarter 2026. A longer duration shock would risk nonlinear effects from tighter financial conditions and supply chain disruptions, raising recession risk.
- ◆ Smoothing through the noise, recent data suggests stabilization in the labor market. However, with hiring at low levels, it would only take a small rise in layoffs to see unemployment move up quickly. War impacts and artificial intelligence (AI) disruption present risks of layoffs.
- ◆ Recent core personal consumption expenditures (PCE) readings have been high, in part driven by some outliers and residual seasonality. Monthly headline inflation will be elevated from energy effects, and core could remain sticky due to some passthrough in areas like airfare. However, as tariff and energy effects fade in the second half, sequential inflation measures should return to a disinflationary path.

Fed rate cuts still seen as much more likely than hikes

- ◆ With some stickiness in inflation and concerns around energy prices, we expect the Fed will pause for the next few meetings to watch how the economy evolves.
- ◆ If pressures remain contained and inflation expectations well anchored, the Fed can look through elevated monthly readings. Rate cuts should be supported later this year by disinflation and labor market softness, taking the fed funds rate down to 3.125 percent.
- ◆ We don't expect incoming Fed Chair Kevin Warsh will materially alter the near-term dynamics for Fed policy. He will likely argue for an optimistic supply side rationale for further rate cuts, and over time will push for a smaller Fed balance sheet, though we see operational constraints on how quickly that can be achieved.

Investment Implications

Sector and bond selection essential as technical tailwinds ease this year.

- ◆ Demand for fixed income remains healthy given attractive all-in yields in Treasuries and credit.
- ◆ Corporate fundamentals continue to look strong and are supported by steady earnings growth, keeping rating migration balanced. While AI disruption is likely to lift defaults modestly in leveraged loans and private credit, we see pressures as concentrated in vulnerable segments and broadly contained.
- ◆ Supply technicals may challenge returns later this year as a re-leveraging cycle brings the strongest net supply of credit issuance seen in years. Recent geopolitical developments have added to spread volatility, making security selection vital with tight spreads posing risks to excess returns.
- ◆ Our positioning continues to be focused on diversification and income generation; however, recent spread volatility has created more total return opportunities. We have been utilizing our excess liquidity to take advantage of market opportunities but are keeping dry powder with the expectation that volatility will persist for some time.
- ◆ We maintain an overweight to Agency residential mortgage-backed securities (RMBS) where spreads remain relatively attractive and offer the potential for additional price upside from policy changes that could spur further buying both from the government sponsored enterprises (GSEs) and banks. Conversely, we have remained underweight investment-grade corporates where spreads remain very tight, even amid the recent war-induced widening.

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Global Economic Outlook

Energy disruptions a growing risk to global economy

- ◆ Prior to the conflict in the Middle East, the global economic growth outlook was solid. The collapse in Strait of Hormuz traffic has created a historically large oil flow disruption. If the war resolves in the next few weeks, the impact could be moderate. However, in an extended conflict scenario, physical shortages would lead to highly elevated oil prices and create downside risks to the global economy and markets.
- ◆ The Middle East conflict is weighing on global growth and pushing up inflation. The toll is heaviest in the conflict region from lost oil and non-oil revenue and damage to infrastructure. In other regions, Asia is feeling the most acute impact due to reliance on energy imports. Rationing and shortages are widespread, threatening global supply chains. Less developed economies are at risk given limited fiscal space, China is more insulated given high energy self-sufficiency.
- ◆ Europe, and in particular the U.K., is the most exposed developed economy region given its structural dependence on natural gas and liquified natural gas (LNG) imports transiting the Strait, creating stagflationary dynamics that complicate central bank policy.
- ◆ Disruptions extend beyond energy. Surging prices for industrial inputs are straining Asian manufacturers and risk bottlenecks in electronics, chemicals, and pharma supply chains. Tightening fertilizer markets threaten higher agricultural costs.

Bps (basis point): One basis point is equal to 0.01%. **Carry:** The difference between the cost of financing an asset and the interest received on that asset.

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