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Macro Markets Podcast Episode 80: Fixed-Income Outlook: Sunny with a Chance of Tail Risks

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Jay Diamond: Hi everybody, and welcome to Macro Markets with Guggenheim Investments, where we invite leaders from our investment team to offer their analysis of the investment landscape and the economic outlook. I'm Jay Diamond, head of thought leadership for Guggenheim Investments, and I'll be hosting today. Now here's where we are: Bonds have regained their negative correlation with stocks, economic growth remains resilient, and the markets are pricing more Fed easing in later this year. That creates a constructive backdrop for fixed income. Yet there is uncertainty. Here to help us make sense of the crosscurrents, where we might be going, and how our portfolios are positioned for this climate, is Steve Brown, our chief investment officer for fixed income.

Welcome back to the podcast, Steve, and thanks for taking the time to chat with us today.

Steve Brown: Thank you for having me. I appreciate it.

Jay Diamond: Now, Steve, the future is all that matters to investors and we will talk about our outlook and strategy for the future in a bit. But I want to start by asking you to set the scene for that discussion. Where are we right now in markets and how did we get here?

Steve Brown: Yeah, I think that's a great place to start, Jay, and thanks again for having me and for everyone who's listening. It has been quite an eventful start to the year and, frankly, last year was equally eventful. So I think maybe it makes sense to compare and contrast, if you will, the themes in the backdrop from last year versus this year and how we're thinking that that might influence markets.

So in a couple broad categories, one on the macro geopolitical-slash-fiscal front. Obviously we're now in year two of the Trump administration. You know, last year was more about disruption, particularly with trade and the global realignment of interest into this, you know, new or evolving,

multipolar world. And it was quite clear that, this U.S. centric agenda that the president was elected on, was going to be enacted.

And so, , this year, we're starting to see potentially more of the benefits of those changes, in particular from the OBBA, further deregulation push, and the potential for consumer stimulus in what is now, a midterm election year, which is hard to believe already. So, broadly speaking, we have a constructive backdrop from the fiscal side, particularly here in the U.S.

And then more broadly and globally, we have an environment where there's still elevated, government deficit, deficit spending, and really no fiscal restraint, if you will, or limited fiscal restraint. So that's supportive and more of a positive this year versus last year.

When you think about monetary policy, that's a little bit different. You know, last year was about central banks getting back to near neutral, right? They were lowering their policy rates as inflation, was falling last year. Most central banks were still affirmatively in restrictive territory. But then were taking their time throughout the year to lower the policy rate as inflation came down. And now, when you look, globally and here in the U.S. as well, you have, policy rates that are much closer to neutral.

Now, we would say they're still mildly restrictive. And we'll talk about that more. I know here in the U.S. (and later in this podcast) so there is still room for interest rates to fall. But we're now more of in an equilibrium state, if you will, with regards to monetary policy. So last year, maybe a little bit more tailwind. This year, certainly not a headwind, but not as much of a tailwind to think leads to a more kind of stabilized market environment, and one where we're going to continue to see rangebound yields, lower volatility, and other themes that we'll talk about later.

And so finally, what does that mean for markets? You know, last year, obviously, as a result of the turbulence from a policy perspective, but at the same time the tailwind for monetary policy, we saw really strong performance across everything.

You know, the equity markets, fixed income markets, credit markets. Absent a few periods of significant volatility, basically the year was defined by tighter and tighter risk premia or higher and higher valuations, as volatility continued to compress. And so coming into this year we had a view and we still have a view that performance would look like last year, although maybe not as strong in most categories, but that there would be more dispersion and more volatility, particularly in the tails, which I know is one of the themes of this podcast. And so you're already starting to see that. You know, six weeks into the year, we're starting to see more of a questioning, in particular of the AI theme, build out the winners and losers, and we think that's only going to continue. It's going to be a rolling theme and one that has so much change associated with it, it's both hard to forecast other than to say that continue to expect dispersion and pockets of volatility.

So what that means is, is broadly a constructive environment for risk, especially for fixed income and credit. But no narrative is likely to last, or be persistent throughout the year. So you need to be active and, and ready for change.

Jay Diamond: Well, thanks for that great scene setting. Steve. So let's dive into the outlook, starting with the economic backdrop. What's your outlook for U.S. economic growth?

Steve Brown: It's a relatively strong outlook, particularly for the first half of the year. As I briefly mentioned, the kind of pains of last year, if you will, are gains this year. And so, in particular, you'll see, a boost on the tax side for both households and corporations, as you get some of the expensing that was allowed in OBBBA and also the potential for consumer stimulus.

So the first half of the year, we're likely to see those benefits that could boost growth by anywhere from 50 to 75 basis points. Of course, there's the continued theme around productivity growth. You know, this low hire or low fire environment. And one where productivity is likely to be aided by advances in AI and technology more broadly.

You know, as we get to the middle of the year and into the second half of the year is where things start to potentially change a little bit more. One, on the inflation side, you're likely to see the base effects be more positive in the second half of the year. So while the first half of the year, there's the chance for a little bit higher levels of inflation, particularly from goods passed through and tariffs that started in the back half of last year.

You're still going to see housing disinflation, we think throughout the year. But as you get into the second half of the year, the base effects from the goods side will start to depress and inflation should continue to fall. We also think though that the administration, of course, is looking for strong economic growth and is very mindful of where we are in the political cycle.

So the chance of, as I've mentioned a few times, consumer stimulus, something out of the ordinary, whether it's, you know, tariff dividends, the continued talk about housing reform, caps on mortgage rates, caps on credit card interest rates, there's going to be the kitchen sink, if you will, thrown at the economy with the objective of strong growth and relief for the consumer.

So while our initial take is that growth could taper off from these above-potential levels the first half of the year, we think the administration is likely to be ready to try to combat that. So overall, it's a strong backdrop for growth.

Jay Diamond: Were you surprised by the jobs number that came out for January? The market's reaction was fairly negative, but it seems to have bounced back today. I'm talking about the bond market, of course.

Steve Brown: We continue to see lower and lower market reaction to economic releases. Part of it, we think, is, frankly, the changes, particularly in these survey measures in the maybe the lower reliance on them, or a belief in them from the markets. So while we did see an initial sell off in the bond market and a kind of tepid recovery in the equity market, frankly, given the point I made earlier on markets being more in equilibrium, we don't think markets are as volatile or susceptible to significant sell offs from economic data, either on the jobs number or on the inflation side, particularly when they're relatively positive.

So, I think you're in this environment where it's going to be more about what's under the surface and may be less macro driven. Now, if you saw a meaningfully negative jobs number, because that's what markets more worried about, you know, that would have manifested in lower Treasury yields and the degree with which they would have been lower versus higher in this upside surprise, we think would have been a magnitude of, say, one-and-a-half or two-to-one.

So put another way, bonds and fixed income yields are going to react more to negative news, which is a positive for returns than they are going to react poorly to let's just say positive news.

Jay Diamond: Interesting. In your previous answer you highlighted the AI phenomenon as a driver of economic growth. Can you elaborate on the economic impact of AI?

Steve Brown: Obviously this is the narrative that's dominating markets, dominating thoughts around the economy, both the contribution from the AI build out as well as the future benefits or costs to the economy. And so when we think about the first part of your question, which is what is it doing for growth? We just put out a paper on our longer-term themes with regards to AI. And so one of them is that, yes, it is contributing meaningfully to growth, mostly from CapEx, and the build out of this new digital infrastructure. We think it's contributing anywhere to from, you know, 75 basis points to almost a full percentage point of growth last year and even more this year.

But as a firm, you know, we can speak firsthand. We're making very significant investments. in how we're using this technology and implementing it. You know, it's going to be game changing. One for the broader economy and for every sector. But two, that the build out is going to be clunky, right. We're going to see these rolling themes across the markets of winners and losers.

Now, there's an open question as to whether there are more winners or losers, how much this changes the trajectory of the k-shaped economy, whether that's for consumers or corporations. And so the narrative, we think is going to be less about how much this CapEx build is adding to the economy, and it's going to be less about rewarding, particularly the hyperscalers for CapEx investment.

And it's going to start to turn into where is the return on that investment coming from? How is everyone in the ecosystem monetizing it? And then really importantly, particularly for credit investors like ourselves or active investors across markets, how is this changing sectors and industries? How is this changing specific company trajectories? And then, of course, the broader impact on the economy.

So there are a lot of unknowns. And, frankly, we're spending a ton of time trying to digest everything, as, as new things come about.

Jay Diamond: You characterize your growth outlook as relatively positive and solid, but what are the biggest risks to that outlook?

Steve Brown: It's almost kind of similar to the to the risks of the AI build out. You know, there's a this this kind of circular reference and phenomenon for the economic growth, particularly here in

the U.S. And a lot of it's related to the AI and tech build out. So frankly, you know, growth is impacted and being fed by very large corporations with large CapEx at relatively high multiples.

So valuations are supporting growth and supporting investment, which supports valuations, which supports growth and investment. And so when you think about it at the corporate and the consumer level, you know, market valuations being still relatively elevated, particularly in the equity markets, you know, are susceptible to a breaking of that linkage, and then that leading to lower CapEx, lower consumer spending, etc.

So, it's almost like as long as the markets continue to do well, most of those themes in that linkage will not be broken. And then, two would be, you know, the labor market I briefly mentioned low-hire/low-fire environment, the jobs release you cited from the other day was relatively strong, but again, was concentrated in, in one or two sectors.

So you are not seeing broad-based hiring in any industry or sector. The AI impact on labor is certainly up for debate. You have relatively high unemployment rate amongst recent college graduates. So there's a bit of this shaking out process in the labor market that has more downside risk, frankly, than upside risk.

And so those are a couple the potential challenges that would go against the thesis that we have, which is, a relatively sanguine environment, but with volatility.

Jay Diamond: We can't talk about an outlook without noting the expected change in the composition and leadership at the Federal Reserve. It looks like Kevin Warsh can be nominated to be the next Fed chair and probably sail through the Senate. So, what could that mean for fixed income markets?

Steve Brown: The nomination is really a very measured, calculated and relatively strong one. You know, this is someone who, of course, has prior Fed experience, is well known and respected in the industry and has had experience through the financial crisis in a leadership role at the Fed, and knows how it works and all the parties at play. So while the market reaction was, I guess, a little bit focused on his potential hawkish-leaning history, you know, he's also shown to be pretty flexible and change his thinking on certain things.

So, we also know he was very well vetted, clearly by the Treasury secretary, by the president. And you know, they have their policy agenda. So, we're not expecting significant disruption. We think the challenge to independence, we think that's been overblown. We think that the structure of how they decide policy is relatively insulated from too much outside influence.

And so we're expecting kind of, a little bit more of the same. Obviously, the bias will be potentially for a lower policy rate, as you stated, potentially for a lower balance sheet. But at the same time, that would require a significant change in how reserves are met and, and how banking sector is regulated.

So for now, we think the Fed is going to be on hold. They're likely to continue easing again once the new chairman is in place. But as I said to lead off the call, you know, interest rates are still

mildly restrictive. And so there is room to ease, even just in a base case where inflation falls, let alone a case where they need to stimulate the economy. So that's all generally a tailwind for fixed income, and for the level of interest rates.

Jay Diamond: So let's go right there. What's your outlook for Treasury yields and the shape of the yield curve?

Steve Brown: Our outlook is that the spot curve will likely steepen a bit further, you know, in line with what's priced in the forwards. So, if you look at the forward curve, you've got a fed funds rate by the end of this year closer to 3%, which would be two 25 basis point cuts from, from where we are today.

We think that's reasonable as I just ended that last question with, there is policy room, should, you know, the economic trajectory change or the inflation trajectory change, there's room for the policy rate to move lower. And as I led off the call with, you know, that's that's good because that as, as you said, you have now a negative correlation again between bond returns and equity returns, for example.

So fixed income again, is a risk off ballast if you want to think about it that way. Because, while we're closer to a neutral, we're not quite there yet. And usually we go well through neutral when needed to stimulate the economy.

But we've been in this kind of micro trading range, particularly when you look at, say, the ten-year Treasury yield. You know, the average yield is right around where we are today. You know, for 4.15 or so the last year, you know, as you test 4.25 or 4.30 these days, you tend to, to retrace, as you get closer to 4.0, you tend to have yields increase a bit. So this is manifesting in lower and lower realized volatility over time, which is also bringing implied volatility lower.

We're now at levels in implied volatility back to where we were pre-2022. This is a stabilizing factor. You know the more you have stability in interest rates, the easier it is to make asset allocation decisions. The easier it is for for CapEx decisions for consumers and corporates to think about borrowing needs.

So our view is a continuation of this theme of a rangebound environment. And that's unlikely to be knocked off course. And if it is, you know, our bet would be that it'd be a little bit lower in rates rather than a little bit higher.

Jay Diamond: Well, given this, rate outlook, how are you positioning the portfolio from a duration perspective?

Steve Brown: You know, I think high quality duration is a good risk off ballast and is a good way to generate relatively high, nominal yields and, in certain cases, significant real yield too. So, we have a pretty, balanced allocation across the curve. And we're kind of in a slightly above average levels of overall duration.

Frankly, as short term interest rates fall, and particularly the overnight rate that starts to make carry trades a little bit more appealing, make some levered trades more appealing. You can generate excess return from roll down, you know, as a bond gets closer and closer to maturity. So we think that's creating opportunities in the Treasury market, the agency mortgage market, and the corporate credit markets to generate some active returns.

Jay Diamond: Well, let's talk about the corporate credit markets. How do you characterize credit quality and the dynamics of the markets in general right now?

Steve Brown So we've talked a lot about disruption and risk and what's being priced in the market, you know, in our conversation so far. And one thing I haven't mentioned is that, you know, while we've talked about relatively high multiples and or tight valuations, you know, most of what's manifesting and flowing through into the markets is an equity story, right?

So we're seeing a lot of volatility under the surface in the equity markets now, particularly around this AI theme and winners and losers. And while we are finally starting to see a little bit of it in the credit markets, it's still mostly an equity story. So, the credit markets are pretty well insulated broadly from this disruption because fundamentals are pretty strong.

And LTVs and essentially what you're advancing against the enterprise value of a company is still relatively low. So while spreads, you know, the excess risk premium you get over Treasurys, remain relatively tight, particularly in the corporate credit markets and particularly in IG, we think it's for the right reasons.

Now, this year, we're gonna have more supply than we had last year. So the last couple of years, we've had relatively muted net supply. It finally started to grow last year, particularly with the AI build out and hyperscalers coming to market and other parts of that ecosystem using debt rather than cash flow to fund CapEx. So that will increase this year.

So the technical backdrop is a little bit worse this year with more supply. But you continue to see really strong demand. I mean, we're seeing across our franchise with inflows, you know, both on the corporate and public side as well as on the retail side. And so, it's been expected that would manifest in slightly wider spreads. That would be our base case expectation. But so far on the year, spreads have been tight and staying tight. The benefit of fixed income markets continues to be this relatively high level of yields. And where you're seeing more of the dispersion is in the levered credit markets, you know, as I said in the equity markets. That dispersion's picked up more recently in the last couple of weeks in tech and software, you know, that's been under the limelight again. It first happened in the fall and now it's again a focus for the markets to start the year, particularly in the loan market, which tends to have more exposure to software than, say, the high yield market or the IG market. So, you're going to see pockets of volatility as I led off with, which frankly for us creates a lot of opportunity.

Jay Diamond: So without asking for CUSIP numbers or tickers, what are your picks to click right now? Where, where are you finding opportunities? Which industries and sectors?

Steve Brown: We're as diversified as we've ever been from a sector allocation standpoint. Because while, as I said, there are tight spreads for the most part in corporate credit, you can still generate relatively wider spreads from an active sector and industry allocation. And then when you think about different asset classes, securitized products for us continue to be one of the cheapest ways to insulate your portfolio from downside risk, while monetizing rate volatility or call optionality that you're short to your issuer.

So, agency MBS remains one of the largest allocations for us. You know, basically current coupon allocation. So it's effectively having a covered call allocation on Treasurys. We like certain parts of the IG market, particularly in insurance. We think that that sector is, is perpetually mispriced. Within ABS, commercial ABS is seeing a renaissance, if you will, of issuance. We've had a number of aircraft lease securitization deals to start the year. We've seen some data center securitizations where we're much more selective than we would say the market is, and we're allocating a little bit there.

Non agency mortgages, so, non-QM securitizations—that's a similar play to what we're doing on the agency mortgage side. We think that's a very defensive trade and it's structures where you have a relatively intermediate duration instrument that has a high carry and a high yield, and then you have downside protection from coupon step ups, and ways that the structure locks out equity capital over time should the transaction not be called.

And finally, on the real asset side, you know, we're seeing, as I've said, growing issuance in infrastructure. So there's, there's some ways to play, not just the AI build out, but the power build out, associated with the AI. And we can do that a little bit more globally in the infrastructure sector.

So where we're being the most cautious and careful, you know, is in tech, is in software, is in the levered credit markets. You know, you've seen BDCs take a hit, for example. We've, rarely had exposure to BDCs, at least on an unsecured basis. We tend to like lending on credit better through the CLO market, and you've seen very limited spread widening there.

So really it's about prioritizing a defensive overall positioning, being senior in the capital structure in most places, and then having some dry powder and capital to put to work. When you get these bouts of volatility, which for now we think will still be sector specific or industry specific, but, you know, should broaden out to a broader beta opportunity, we want to have the flexibility to invest.

Jay Diamond: So earlier you referenced a recent research paper on the economic and market impact of AI. And we have some investment themes that we included as part of this. So I was wondering if you could take a minute to review your investment framework for the opportunities now that you're seeing in artificial intelligence.

Steve Brown: I think we have to acknowledge what we think we can predict and what we can't. And then one, define where we have a view, you know, do we have an edge on that view? And then two, try to quantify what we think the markets are pricing. Essentially what risk are you taking. So, what risk do we like to take? We'd ideally like to tie the risk to a high quality off-taker,

you know, with very limited ability for that off-taker to essentially tear up the contract or lease or whatever is tying the cash flows back to the investment. But that that's increasingly getting a little bit harder, you know, as frankly, the issuers still retain a lot of flexibility and leverage from a negotiation standpoint in these transactions.

So you really want to be disciplined and conservative in where you're lending, because the last thing you want is to tie an investment thesis to a long-term theme that is likely to change. Our ability, the market's ability to forecast, the needs for compute and data centers and power, three years out, five years out, ten years out is extremely low. And we're likely to be off by magnitudes. So limiting your residual value risk. And really trying to tie your investment thesis back to cash flows that you can project, and limiting the asset value risk that you have, that you're likely to be secured by over the long run is, is what we're spending a lot of time on. And that doesn't even get into the topic of, you know, the broader disruption in the markets, the obsolescence risk at the company, industry, sector level that we're spending a lot of time on. But I just wanted to mention that briefly because it's such an evolving topic and something every one of our credit committees is focused on as are the portfolio managers.

But, to summarize the piece, which I thought was great, you know, done by our macro research team, you know, there are a couple broad themes. One would be that, you know, the equity investments in AI companies are optimistically priced. So, you're having valuations challenged and as I said earlier, it's turning potentially into a ROI-driven market rather than one that's just focused on how much CapEx and money you can put into it. Two, y that there's, going to be real winners, AI adopters, and we consider ourselves one of them. We think that there's real, very concrete, efficiency gains, and that will lead to better output for those who adopt. Basically, if you don't adopt, we think you're going to be left behind.

Another theme is in that physical infrastructure space. So we mentioned a few times the ability to finance to build out. But as I said, you don't want to be financing all types of build out. And you want to be very careful in what you finance and really tied back to cash flows.

And then finally, you know what it does, what does it mean for the broader economy? You know, our team tried to make parallels to prior build outs and technology, whether it was tech and the internet in that late 90s, early 2000s and other historical parallels. And they found that, you know, typically there's a meaningful contribution to growth. And so over the long run, we would say this is disinflationary. It is going to be a meaningfully positive impact on productivity. But between here and there, there are going to be a lot of winners and losers, and our job is to, you know, avoid the losers at a minimum, and try to pick the winners.

Jay Diamond: Steve, we've covered a lot of ground today. What are some of the main takeaways that you would like to leave for our listeners, based on everything that we've talked about.

Steve Brown: We're in an environment that is very constructive for fixed income and for high grade fixed income, frankly, in particular. While we have tighter risk premia, more broadly, the all-in yields are very attractive. All-in yields historically are very highly correlated to your realized

returns. So in an environment with rangebound Treasury yields supportive fiscal policy, monetary policy that's likely to ease a bit but has room to ease significantly more, negative correlation between bonds and stocks again, and spread in certain sectors that looks pretty attractive. You know, this is a constructive time, as it has been the last couple of years. You know, last year was a very strong year for fixed income. We're likely to continue to see dispersion. And so that's a great time to be an active manager, particularly one that has the flexibility to invest across sectors and be relative-value focused, like we are ourselves here at Guggenheim.

Jay Diamond: Again, Steve, thanks again for your time. Please visit again soon with us. We look forward to hearing more of what you have to say. And thanks to all of you who have joined us for our podcast. If you like what you are hearing, please rate us five stars—that helps people find us—and if you have any questions for Steve Brown or any of our other podcast guests, please send them to MacroMarkets@Guggenheiminvestments.com and we will do our best to answer them on a future episode or offline.

I'm Jay Diamond. We look forward together again for the next episode of Macro Markets with Guggenheim Investments. In the meantime, for more of our thought leadership, including our just published in-depth paper on AI called "AI's Promise and History's Lessons," please visit Guggenheiminvestments.com/perspectives. You can also find our Ten Macro Themes for 2026. And with that, so long.

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