SMITH AFFILIATED CAPITAL

RESEARCH COMMENTARY

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The Quiet Transformation of Fixed Income

Recent market action offers an important reminder that markets are constantly repricing new information. Treasury yields have moved higher in a largely parallel shift, with the front end experiencing the greatest pressure as inflation expectations have firmed following renewed geopolitical tensions in the Middle East. At the same time, volatility has increased beneath the surface of the equity market, even as the major indices remain near historically elevated levels.

While these developments have attracted investors' attention, an equally important story may be unfolding in the credit markets.

PIMCO recently observed that "the credit loss cycle is upon us." Their point is not that another financial crisis is imminent, but rather that the unusually benign credit environment of the past several years is beginning to normalize.

What does "normalizing" mean? In fixed income, it simply means markets are beginning to behave more as they have over longer periods of history. For much of the past decade, abundant liquidity, extraordinarily low interest rates, and central bank support compressed credit spreads and kept default rates unusually low. Investors were often rewarded simply for taking additional credit risk. As conditions normalize, lenders become more selective, weaker borrowers face higher refinancing costs, credit spreads begin to reflect differences in credit quality, and investors are once again compensated for careful security selection rather than simply reaching for yield.

Historically, this is how credit cycles begin—not with a sudden market event, but through a gradual repricing of risk. Credit spreads widen modestly, lending standards tighten, and investors become increasingly focused on balance sheet strength and predictable cash flow. These adjustments are a normal part of the economic cycle and often occur while broader equity markets continue to perform reasonably well.

What makes today's environment particularly interesting is the relationship between credit and interest rates. Over the past several years, investors have favored short-duration investments, attracted by higher cash yields and uncertainty surrounding inflation. However, if credit conditions continue to normalize and economic growth moderates over time, longer-duration, high-quality fixed income may once again provide an important source of portfolio diversification and total return.

Higher Treasury yields, while uncomfortable in the short run, have historically improved long-term return expectations for fixed income investors. They also enhance the return potential associated with duration—not because rates must decline, but because investors are being compensated more appropriately for assuming interest-rate risk. Whether yields ultimately move higher, lower, or remain range-bound, today's starting yields provide a stronger foundation for long-term total return than they have for much of the past decade.

At the same time, the role of U.S. Treasuries is evolving. Beyond providing income and serving as a traditional safe haven, Treasuries are increasingly becoming the preferred form of collateral supporting global financing markets. As tokenization develops, the ability to transfer, finance, and settle Treasury securities almost instantaneously could further increase their utility throughout the financial system. While this evolution is still in its early stages, it highlights that the value of Treasury securities may increasingly extend beyond their coupon and principal repayment.

Markets evolve gradually before they change dramatically. Today, investors are navigating a market shaped by geopolitical uncertainty, shifting inflation expectations, and the early signs of a more discerning credit environment. At the same time, the role of U.S. Treasuries continues to expand—from a traditional defensive investment to the foundational collateral supporting an increasingly digital and interconnected financial system.

Whether this transition unfolds over months or years, we believe investors should think beyond today's headlines. The objective is not to predict the next move in interest rates or equity markets, but to build portfolios that are resilient across a range of outcomes. In our view, that continues to support an emphasis on high-quality fixed income, disciplined duration management, and the flexibility to adapt as the next market cycle takes shape.