Reams Asset Management

Market Thoughts and Opportunities Post-Tariffs

Market Overview

Tariffs have been front and center in the news this year. Until last week, most thought they would be small and just a negotiating tool. Instead, last week brought tariffs at levels that were much higher than expected. This created uncertainty, both for investors and any corporation trying to plan on spending. Although a backtrack has been announced, there is still a 10% baseline tariff, and a high-stakes game that has isolated China. Risks certainly remain and growth will be impacted, although not as severely as the initial worst case suggested.

Tail risk is again elevated. The tariffs brought extreme tail risk to the outcome distribution. Why? The tariffs as advertised would have translated to a very sharp contraction in global economic activity as consumers and businesses responded to prices and adjusted supply chains. The market came to realize that President Trump was looking to use this event to correct what he viewed as multiple decades' worth of structural imbalance to the U.S. economy in terms of trade deficits.

Inflation could be temporarily boosted, perhaps significantly, but the demand destruction associated with high prices would almost certainly mean the tariff-related impact would be short-lived as inflation succumbs to slower growth. The market for U.S. Treasury Inflation-Protected Securities reflected exactly this, with breakeven inflation rates implying pain over the next two years, but a sharp decline to 2.1% to 2.2% in the outyears.

What does this mean for the spread sectors? Both investment grade and high yield corporate spreads increased sharply, following the sharp drawdown in equities. Investment grade widened by 0.31% year to date, going from 0.77% to 1.08%. High yield widened by 1.60%, from 2.60% to 4.20%. Was this enough? It's tough to tell. As we noted before, tail risk remains elevated, which can bring wide opinions on the adequacy of spread compensation.

What is a concern is that one could argue that credit outperformed the move in equities relative to historical drawdowns. We have three instances – 2011, 2015 and 2022 – when the move in investment grade was 0.50% to 1.00%. High yield widened 2.00% to 3.00% during those instances. One could make a case that the tariff program as advertised would have been a worse event than those three.

So, we know that credit can behave like a "hot knife through butter" on a risk-off move, coupled with the notion that the tail risk in this situation is formidable, credit must be added judiciously and with discipline, staggering entry points to plan on severe downside. As a result, adding to these asset classes should be measured and with multiple entry points rather than backing up the figurative truck at one time.

This has been an exciting time to be an active manager.

We believe the Reams playbook is situated well for environments like this. As you may recall about our process, we believe that predicting the future with accuracy is very difficult and arguably a fool's errand. What we do instead is sit in our perch of discipline and observe market levels and surmise what forecast is implied by market prices, and then adjust the portfolio as we agree or disagree with those inputs. Those managers who try to predict most certainly were caught off guard with the turmoil of this year as those predictions failed to materialize.

What have we done in our portfolios?

We went into the year underweight credit across portfolios, noting the tight levels of spreads and high spread duration made our belief that the asset class was unlikely to deliver strong performance. In the weakness, we increased investment grade exposure using a basket of high-quality 10-year names. Our investment grade contribution to duration is now just above the benchmark in the benchmarked portfolios, having been increased in absolute terms in all portfolios. In terms of high yield, we added in multiple small increments where guidelines allowed.

Overall, we added what we felt to be appropriate levels of risk, but we are also very cognizant of the levels and where they could go. We feel that the move in credit didn't make it particularly attractive by historical standards but is closer to fair value. High yield seems more attractive of the two, in our opinion, given the relative gapping out of each asset class. Some of this was funded

as a sector rotation from securitized, where we have held an overweight for some time. In securitized, we also extended interest rate sensitivity with a swap to bonds with different characteristics to take advantage of wider option-adjusted spread levels.

For more information regarding Reams Asset Management, please contact us at 463.777.3900.

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Investing involves risk, including risk of loss. Diversification does not ensure a profit or guarantee against loss. Past performance does not guarantee future results.

Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration). The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody's and Standard & Poor's. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities (see below for a discussion of the risk associated with convertible securities). However, the overall return on Government bonds tends to be less than these other types of fixed-income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk, and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

Investment grade refers to fixed income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

High-yield (below investment-grade) bonds are not appropriate for all investors. The lower rating of high-yield bonds reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to make income and principal payments. To the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Securitized products, such as asset-backed securities (ABS) and mortgage-backed securities (MBS), are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

Definitions

Breakeven inflation rates reflect what market participants expect inflation to be over a specified period of time, on average. For example, the 10-year breakeven inflation rate reflects what market participants expect inflation to be in the next 10 years, on average. It is calculated using 10-Year U.S. Treasury Constant Maturity Securities and 10-Year Treasury Inflation-Indexed Constant Maturity Securities. The five-year breakeven inflation rate is derived from 5-Year Treasury Constant Maturity Securities and 5-Year Treasury Inflation-Indexed Constant Maturity Securities.

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

A drawdown is a decline in the returns of a security or group of securities, as measured over a period from the peak of returns to their trough.

Duration incorporates a bond's yield, coupon, final maturity, and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

An option-adjusted spread (OAS) measures the spread of a fixed-income security rate and the risk-free rate of return, which is typically calculated using U.S. Treasury yields for the risk-free rate. The spread represents the incremental yield above the risk-free rate that compensates investors for bearing the risk of defaults or downgrades of the underlying security.

A risk-off scenario is typically one where sentiment is driven by a weakening growth environment, bad news that fuels a bearish outlook, and/or investor expectations of unfavorable risk/reward ratios.

Rotation describes the movement of investments in securities from one industry, sector, factor, or asset class to another as market participants react to or try to anticipate the next stage of the economic cycle.

Spread sector is a term used in fixed income investing to describe nongovernmental fixed-income securities, such as corporate bonds or mortgage bonds, whether investment grade or high yield, that provide an additional yield, or "spread," over the yield of a risk-free government bond. Spread sector widening refers to the expansion of the spread between the securities in question and the risk-free government bond.

Tail risk describes a form of portfolio risk associated with the increased possibility that an investment will move more than three standard deviations from the mean in a normal distribution. Left tail risks refer to unusually large losses. Right tail risks refer to unusually large gains.

Underweight describes a portfolio position in an industry sector or some other category that is less than the corresponding weight level in a benchmark portfolio.

U.S. Treasury Inflation-Protected Securities (TIPS) provide protection against inflation. The principal of a TIPS instrument increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, investors are paid the adjusted principal or original principal, whichever is greater.

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Additional information is available at www.reamsasset.com.

720291 | Exp. 12/31/2025 | FL-RM-TARIFF

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