

Adding bonds, trimming risk

Insights
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Each month, the State Street Investment Management Investment Solutions Group (ISG) meets to debate and ultimately determine a Tactical Asset Allocation (TAA) to guide near-term investment decisions for client portfolios. Here we report on the team's most recent discussion.

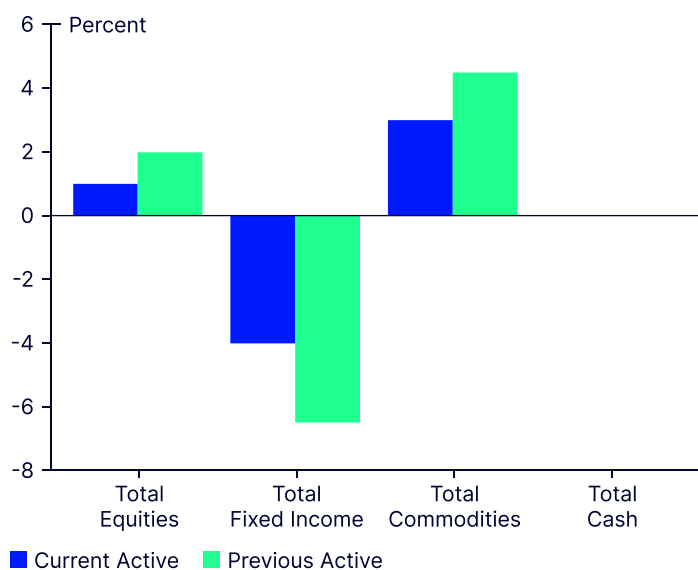
Macro backdrop

Economic growth remains resilient, and we see evidence of this in both manufacturing and services activity, which remains positive. Economic growth remains uneven, with strength concentrated in artificial intelligence-related investment and technology-driven capital spending, while housing and other interest-rate-sensitive sectors continue to face headwinds. This creates a risk, as higher rates are likely to weigh on residential investment in 2027, but so far, companies are signaling that capital expenditure plans should continue.

Higher yields are likely to weigh on consumption as well, especially since wage growth has continued to slow. Easing inflationary pressures next year would go a long way toward supporting growth.

Labor market conditions remain broadly stable despite recent signs of moderation. September's non-farm payrolls report disappointed expectations, and prior months were revised lower, while the Conference Board's jobs plentiful minus jobs hard to get measure continues to trend lower, pointing to some softening in labor demand.

Figure 1: Model portfolio tactical positions for the US



Note: The benchmark allocation is equities: 57%, fixed income: 40%, commodities: 3%, and cash: 0%. The tactical positioning chart shows the active positioning of these asset classes relative to their respective benchmarks (represented as 0%), comparing the current and previous month.

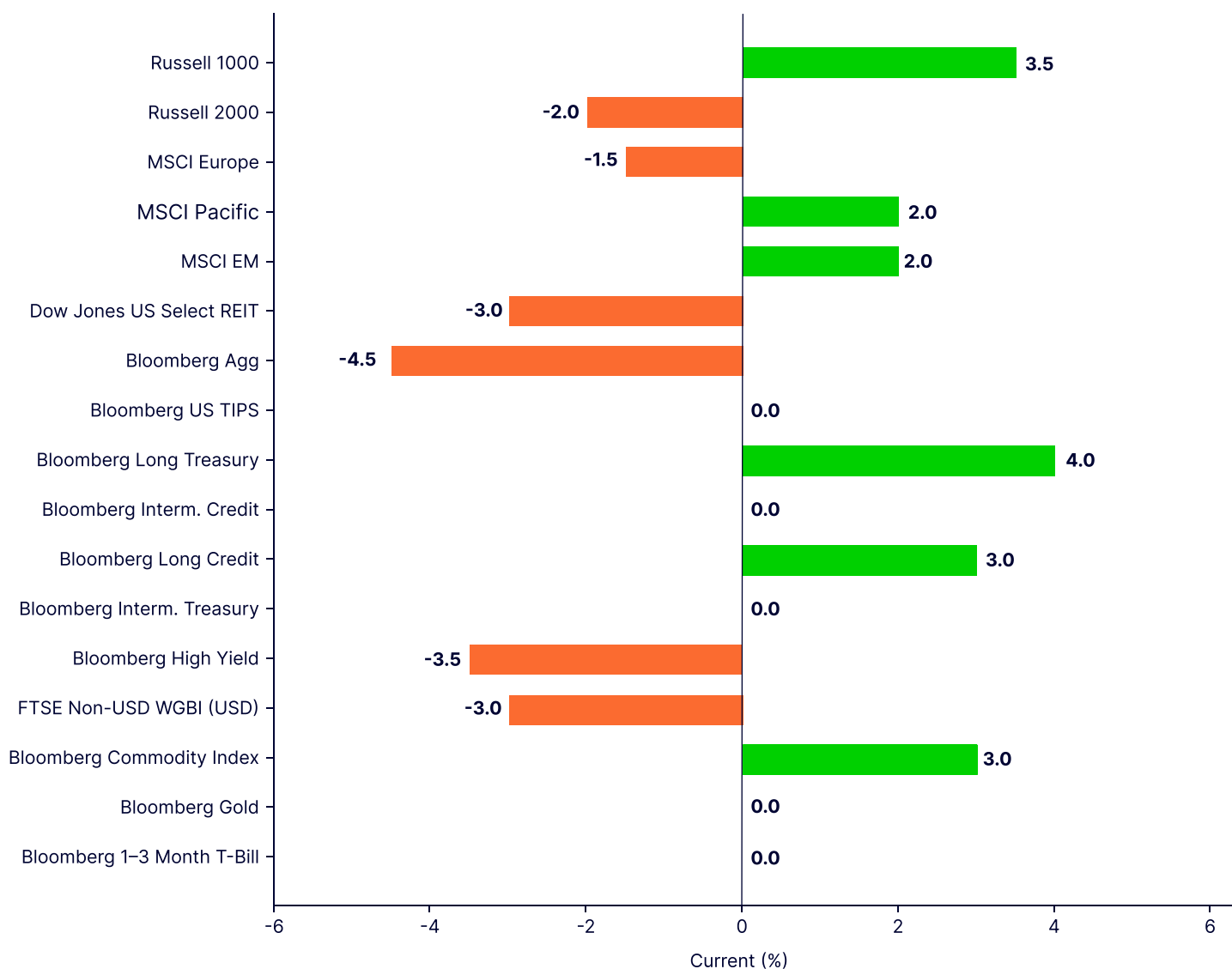
Source: State Street Investment Management, as of October 7, 2026. The model portfolio positions presented above are representative of ISGs market views and our positioning for our tactical portfolios as of the date given. The results shown were achieved by means of a mathematical formula and are not indicative of actual future results which could differ substantially. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

However, job openings remain at reasonable levels, layoffs are subdued and below pre-pandemic trends, employment measures within both manufacturing and services purchasing managers' indexes have moved into expansionary territory, and unemployment claims continue to signal a stable labor market. Overall, the data point to a low-hiring, low-firing environment that appears capable of withstanding current economic challenges.

Inflation has continued to moderate, but we expect progress toward the Federal Reserve's target to

remain gradual and uneven. While headline, core, and supercore inflation measures have cooled, several indicators suggest underlying price pressures remain elevated. Import prices, producer prices, and business surveys continue to point to persistent input cost pressures, while global supply chain stress, higher freight costs, energy market risks, and geopolitical uncertainty present potential upside risks. At the same time, structural investment trends tied to artificial intelligence, infrastructure, onshoring, and electrification may continue to support demand across parts of the economy.

Figure 2: Benchmark asset classes and their weightage



Source: State Street Investment Management, as of October 7, 2026. Investment grade bonds consist of investment grade credit, Treasuries and aggregate bonds.

Although moderating wage pressures and productivity gains could help contain inflation, we believe structural and supply-side factors will keep inflation above the Federal Reserve's target for some time, resulting in a longer and less predictable path back to price stability.

The Federal Reserve remains focused on inflation as underlying price pressures continue to exceed its target. The Committee raised rates by 25 basis points in September and revised several inflation projections higher, while increasingly hawkish Federal Reserve communications suggest concerns that inflation may prove more persistent than what recent headline data imply.

With labor markets stable and economic growth resilient, we believe the balance of risks has shifted toward additional tightening. Although higher rates are unlikely to materially alleviate supply-driven inflation or slow artificial intelligence-related investment spending, we expect one additional 25-basis-point rate hike this year, followed by an extended holding period.

Going forward, we anticipate that the combination of robust corporate profits, ongoing capital expenditures, supportive wealth effects, and stable labor markets will support consumer spending and overall economic growth.

Directional trades and risk positioning

Our quantitative framework remains broadly constructive, with positive outlooks across most asset classes. While our equity forecast remains modestly favorable, risk appetite has moderated recently. Meanwhile, our outlook for investment-grade bonds has improved, and commodities continue to offer attractive return potential, while our outlook for gold has deteriorated. As a result, we modestly reduced our equity overweight, sold high yield, and eliminated our allocation to gold while increasing exposure to commodities and bonds.

Based on our Market Regime Indicator (MRI), investor sentiment remains supportive of risk assets, though it has become more cautious over the past month. Resilient economic growth, moderating inflation, and robust corporate earnings continue to underpin risk appetite, but higher energy prices, rising yields,

and a more hawkish Federal Reserve have weighed on investor confidence. While our sentiment spread indicator improved, reflecting healthy risk appetite, forward-looking volatility measures weakened, and our equity trend factor became modestly less favorable. Overall, the MRI continues to signal positive risk-seeking behavior but supports a modest reduction in risk relative to last month.

Our equity forecast was largely unchanged during the month and continues to reflect a modestly positive outlook. Valuations remain the primary headwind, with both our long-term cross-asset valuation framework and fundamental valuation signal suggesting that equity risk-adjusted return potential remains insufficient, particularly following the recent rise in bond yields.

However, we continue to see reasons for optimism, as unfavorable long-term valuation signals are offset by stronger shorter-term dynamics, with our short-term signal improving to reasonably strong levels. Long- and short-term price momentum indicators remain supportive. Sentiment measures also continue to reflect constructive analyst expectations, while healthy corporate balance sheets, alongside robust profitability indicators, suggest a favorable backdrop for equities.

Our fixed income outlook became more constructive this month, with the model forecasting lower yields and a flatter yield curve. Softer equity momentum and weakening risk appetite have improved the backdrop for bonds, while longer-term signals continue to point toward lower rates.

The combination of resilient growth and sticky inflation supports a flatter curve, with short-term rates remaining more anchored than longer-term yields. Within credit, the model expects spreads to widen as higher volatility, elevated Treasury yields, and softer risk sentiment weigh on expectations. While carry and expectations for lower rates remain supportive of high yield, expectations for wider spreads reduce its relative attractiveness.

Our real asset outlook remains mixed, with weakness in gold but a constructive view on broad commodities. Gold faces headwinds from deteriorating technical indicators, including a variety of trend signals and curve structures. In contrast, we expect solid commodity

returns, supported by constructive outlooks for energy, industrial metals, and select agricultural markets. The main underpinnings of the positive commodity outlook remain an environment in which supplies are tight and demand is firm, with these dynamics reflected in favorable roll yields across many commodity markets.

Relative value trades and positioning

Changes to our regional forecasts were driven primarily by a significant upgrade to Europe and a smaller improvement in US large caps. By contrast, our outlook for Pacific equities weakened considerably but remains positive, while US small caps moved from a positive to a negative forecast. Emerging market expectations were essentially unchanged and remain modestly constructive. Against this backdrop, we have reduced exposure to US small-cap equities while modestly increasing our allocation to Europe.

For Europe, attractive valuations and strong profitability measures drove a more optimistic outlook. In the US, strong sentiment indicators and supportive macroeconomic factors continue to underpin our forecast, though valuations remain the key headwind. Within the US, small caps benefit from more

attractive valuations, but weak price momentum and less favorable profitability signals weigh on our outlook. For Pacific equities, both short- and longer-term price momentum indicators remain supportive, but relatively weak sentiment and profitability measures dampen our view of the region.

A weaker high-yield outlook relative to core bonds prompted us to rotate from high yield into aggregate bonds. As a result, high yield moved from neutral to underweight, while the sizable purchase of aggregate bonds significantly narrowed our underweight to core fixed income.

Health care and communication services remain our top-ranked sectors, supported by attractive valuations, firm macroeconomic factors, positive price momentum, and strong quality metrics. Energy's forecast is still positive, but weaker sentiment and persistently poor quality factors pushed it down our rankings. We replaced it with a split allocation to technology and financials. Technology benefits from robust sentiment despite artificial intelligence concerns, along with solid momentum and strong quality factors. Financials benefit from macroeconomic factors that turned positive and continued strong profitability.

To see sample Tactical Asset Allocations (TAA) and learn more about how TAA is used in portfolio construction, please contact your State Street relationship manager.

statestreet.com/investment-management

Marketing communication

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There are risks associated with investing in Real Assets and the Real Assets sector, including real estate, precious metals and natural resources. Investments can be significantly affected by events relating to these industries.

Bonds generally present less short-term risk and volatility than stocks but contain interest rate risk (as interest rates rise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

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Illiquid risk/Asset investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities.

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