AGG underweight narrows

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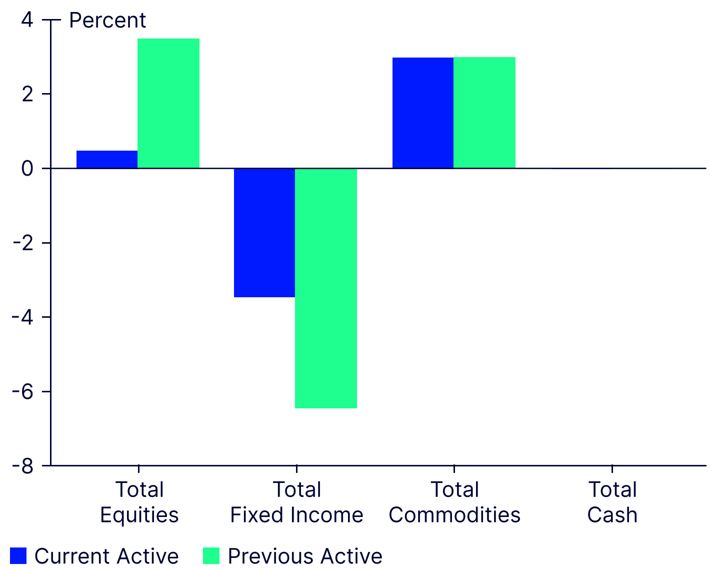
Each month, the State Street Investment Management Investment Solutions Group (ISG) meets to debate and ultimately determine a Tactical Asset Allocation (TAA) to guide near-term investment decisions for client portfolios. Here we report on the team's most recent discussion.

Macro backdrop

Despite heightened geopolitical tensions in the Middle East, our core outlook remains unchanged. We continue to expect solid economic growth, persistent inflationary pressures, and a Federal Reserve that remains patient on further policy adjustments. While geopolitical developments may trigger periodic market volatility, we believe neither the US nor Iran has a strong incentive to pursue a significant escalation, making continued negotiations and intermittent flare-ups the more likely path forward.

Although pockets of stress persist across the US economy, including elevated consumer delinquencies and low savings rates, the broader growth backdrop remains resilient. Economic activity continues to be supported by healthy consumer spending, ongoing business investment, and government expenditures.

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 benenmarks (represented as 0%), comparing the current and previous month.

Source: State Street Investment Management, as of August 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.

Strong corporate earnings, sustained capital spending, federal outlays such as defense spending, and a more business-friendly regulatory environment should provide additional support for growth. Credit conditions have eased somewhat as bank lending to consumers has moderated, but lending activity remains sufficient to support spending.

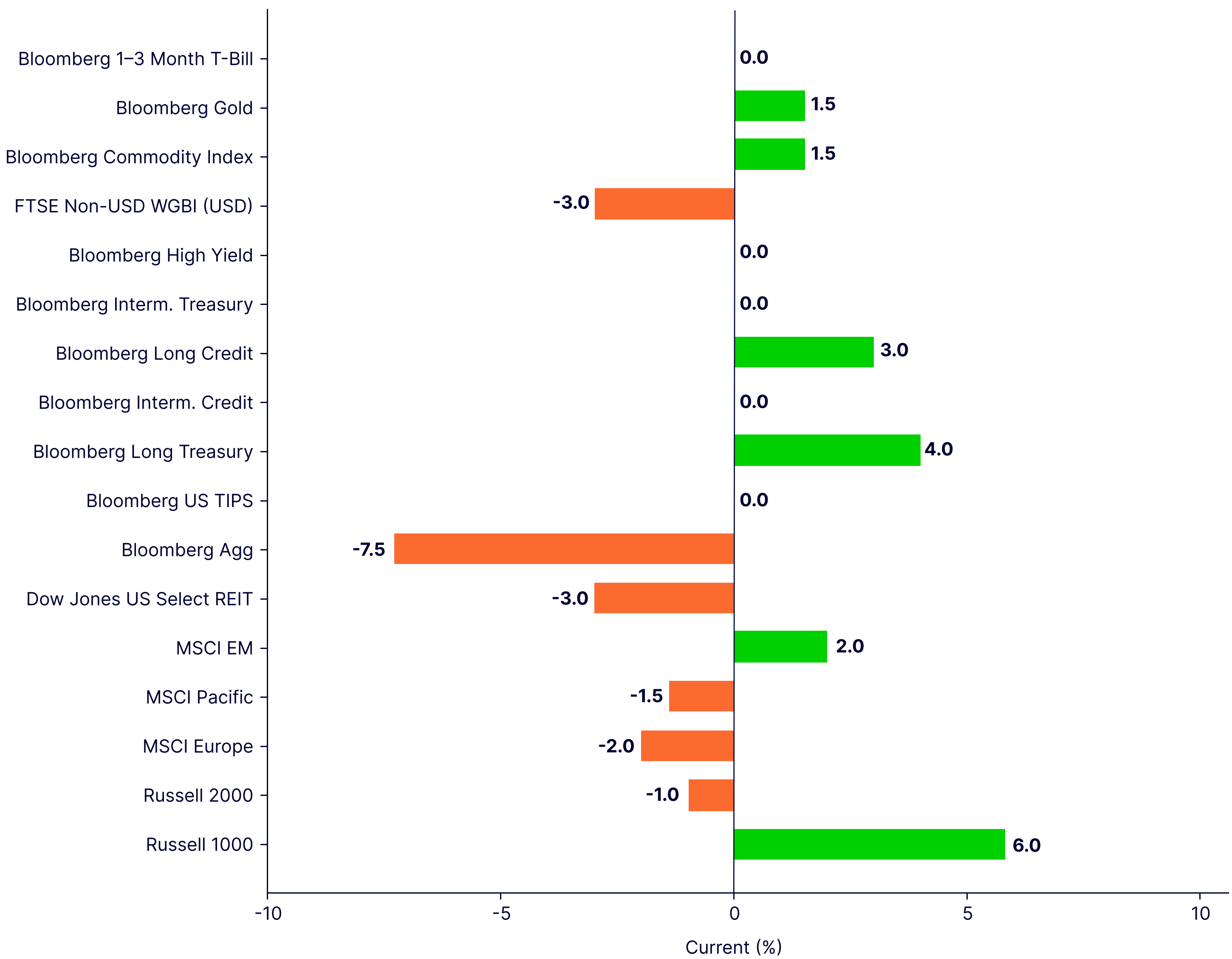
Meanwhile, manufacturing activity has improved meaningfully, with survey data firmly in expansionary territory and new orders continuing to strengthen. The services sector, while cooler than earlier in the year, also remains in expansion and continues to support overall economic growth.

The labor market has come under increased scrutiny following a weaker July payrolls report and downward revisions to prior months. While these developments warrant close monitoring, we believe the broader labor market remains more stable than the headline figures suggest. Demographic trends, including an aging population and slower immigration, mean the economy requires fewer new jobs than in the past to maintain a stable unemployment rate.

Encouragingly, several leading indicators continue to paint a constructive picture. Small business hiring intentions have improved meaningfully and are now more consistent with pre-pandemic norms, while manufacturing employment surveys have strengthened and remain in expansionary territory. Jobless claims remain low by historical standards, continued claims have declined this year, and measures of layoffs remain broadly contained.

At the same time, worker confidence appears to have stabilized, as reflected in steadier quit rates, while the number of positions small businesses report being unable to fill has leveled off at healthy levels. Taken together, these indicators suggest the labor market has cooled from exceptionally tight conditions but remains fundamentally resilient and supportive of continued economic expansion.

Figure 2: Benchmark asset classes and their weightage



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

With labor market conditions appearing broadly stable, the Federal Reserve can place greater emphasis on the inflation side of its dual mandate. Recent Fed commentary has taken on a more hawkish tone, reflecting ongoing concerns that inflation remains above target and highlighting a growing divide among policymakers over the appropriate path for interest rates.

Our outlook continues to call for sticky inflation, with core PCE ending the year near current levels and remaining well above the Fed's long-run objective. We expect several disinflationary forces to persist, including moderating shelter inflation, slower wage growth, and increasingly price-sensitive consumers. At the same time, pockets of inflationary pressure remain, ranging from firmer import and producer prices to AI-related investment demand and business pricing intentions that, while easing, remain elevated relative to pre-pandemic norms.

On balance, we believe the Fed is likely to remain patient as it assesses incoming inflation data and navigates heightened geopolitical uncertainty. While our base case continues to be for no change in policy rates, we acknowledge that the risks have shifted modestly toward an additional rate hike should inflation prove more persistent than expected.

Directional trades and risk positioning

Our quantitative assessment of markets has become more cautious, with expected returns declining across most asset classes. The largest reduction occurred in global equities, where forecasts remain positive but offer considerably less upside potential than before. Fixed income expectations have moderated but remain more attractive than equities. Against this backdrop of more limited return opportunities, we have reduced equity exposure, scaled back our high yield allocation, and increased our exposure to aggregate bonds.

Our proprietary Market Regime Indicator (MRI) has little changed during the month and continues to signal positive risk appetite, supporting a constructive view on risk assets. Strong corporate earnings, easing inflation pressures, and resilient economic growth helped offset concerns surrounding geopolitical tensions and hawkish Fed rhetoric. Within the model, there were few meaningful changes across the underlying indicators, with most continuing to point toward a risk-on environment.

Sentiment spreads, which measure the relative performance of risk-on versus risk-off assets, weakened slightly and now reside in more neutral territory. At the same time, equity momentum improved into an extremely risk-on regime. Elsewhere, volatility conditions were largely unchanged and remain moderately supportive.

While implied equity volatility declined slightly, it remains elevated relative to recent history, whereas currency volatility and credit spreads continue to reflect a benign environment. Overall, the MRI remains supportive of risk-taking and continues to indicate a constructive backdrop for risk assets.

Our equity forecast deteriorated this month for several reasons. One driver was a weaker long-term equity risk premium signal, which compares the risk-adjusted return available from equities with that of high-quality bonds.

Rising bond yields increased the attractiveness of fixed income, while equity earnings yields remained largely unchanged, reducing the compensation investors receive for taking equity risk. Macroeconomic factors also became a more meaningful headwind to the forecast. While price momentum and quality metrics remain supportive, both softened during the month. Valuations continue to appear elevated, although robust sales and earnings expectations remain a source of support.

Our fixed income forecast moderated this month but remains constructive across most bond sectors. The model continues to anticipate lower yields, although the expected decline is smaller than last month. Softer equity momentum and largely unchanged risk sentiment provide greater support for falling yields, while valuations remain attractive as yields continue to sit above long-term norms, suggesting scope for mean reversion.

We also expect further Treasury curve flattening, as persistent inflation and resilient growth keep pressure on shorter-term rates. Within credit, attractive carry continues to support returns, though modest spread widening is expected as higher rates and slowing equity momentum weigh on spreads.

Relative value trades and positioning

Within equities, we observed notable shifts in our regional rankings this month. Forecasts improved for Europe and emerging markets, while the outlook for the US and Pacific markets softened. As a result, the dispersion across regional equity forecasts narrowed, reflecting a more balanced set of opportunities globally.

In Europe, the improved outlook was driven by a significant strengthening in analyst expectations for both sales and earnings growth, which have shifted from a headwind to a meaningful tailwind for equities. Valuations remain attractive, while quality indicators continue to provide support. By contrast, our Pacific forecast weakened as analyst sentiment deteriorated, with sales expectations turning negative and earnings expectations moderating.

The softer US outlook was also driven by weaker sentiment measures. While earnings and sales expectations remain strong in absolute terms, improving opportunities elsewhere, particularly in Europe, have reduced the relative attractiveness of US equities. The US continues to score favorably across most factors, with valuations remaining the primary area of concern. Within the US, our preference shifted further toward large caps as the outlook for small caps deteriorated amid weaker macroeconomic conditions and a diminished valuation advantage.

Emerging markets moved higher in our rankings, supported by improving macroeconomic conditions alongside still-favorable price momentum and sentiment indicators.

These changes led to several portfolio adjustments during the month. We reduced our US small-cap and Pacific equity exposures back to underweight positions and redeployed capital to Europe and emerging markets. While Europe remains an underweight allocation, the increase in emerging markets restored the portfolio's overweight position in the asset class.

With our model forecasting lower yields but wider credit spreads, we reduced our allocation to high yield and increased our exposure to aggregate bonds. The reduction in high yield brought the position back to benchmark weight, while the increase in aggregate bonds reduced a significant underweight. Overall, we maintain a preference for longer-duration bonds, particularly investment-grade credit and Treasuries.

Within equity sectors, communication services, industrials, and health care remain our preferred exposures, while technology moved lower in our rankings. Communication services continues to score highly across most factors, supported by strong sentiment, attractive valuations, and solid quality characteristics. Industrials remain well supported by robust price momentum, favorable sentiment, and positive macroeconomic signals. Health care does not stand out on any single factor but benefits from broad-based support across the model, including attractive valuations and steady momentum. Technology moved lower in our rankings as sentiment and macroeconomic indicators became less supportive than in prior months.

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.

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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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