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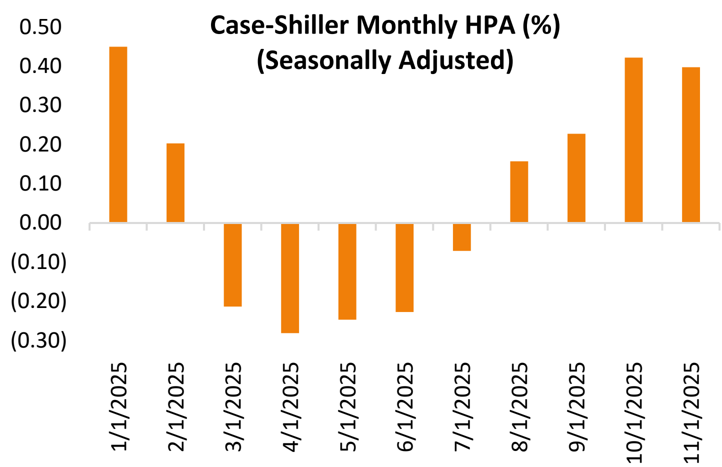
CCS – Q4 2025 Commentary

Macro & Sector Themes

Throughout 2025 there were many concerns and potential threats to the continued strength in economic growth and risk assets—labor market deterioration, tariffs, persistent inflation, geopolitical shifts, AI bubble fears, and noteworthy credit defaults. Ultimately, the overall economy remained remarkably resilient to close out the year. Across asset classes, equities, bonds, and credit all performed in 2025 with continued strength in growth, ongoing AI capex spending, and further central bank cuts. Though economic data was significantly clouded in the fourth quarter with the government shutdown, the data we did get, appended with private measures, showed that meaningful labor market stress has simply yet to show up—while the unemployment rate increased, participation rates did too, suggesting higher unemployment since July is due to higher supply rather than lower demand. This is consistent with the overall health of the consumer with sustained spending and inline credit metrics for most cohorts.

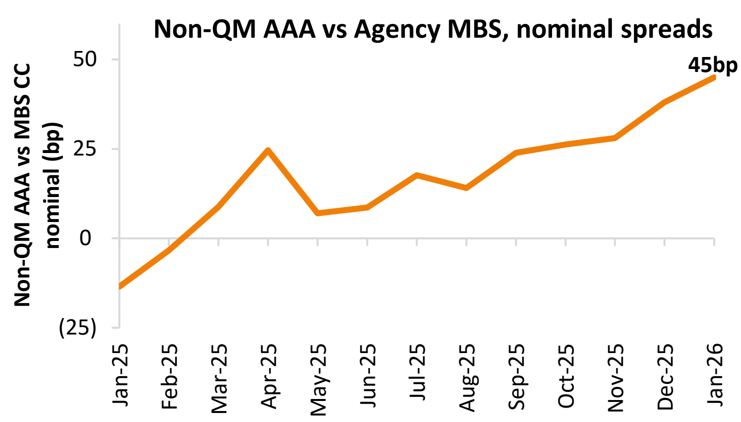
The election cycle with the upcoming midterms in 2026 adds evermore incentive to add fuel to the fire. Significantly, upcoming income tax refunds are expected to be 20% higher relative to the prior year largely due to the OBBBA, which would bring refunds to $350bn by the end of May, with an average check size around $3,500.[1] Consumers typically report paying off debt as a main use of refunds, which contributes to consumer credit seasonality and the delinquency improvement we expect to see in the first few months of the new year.

Though 2025 ended with strength, the general tone of optimism makes the market vulnerable to exogenous shocks in our view, including political announcements or AI developments. Political headlines are likely to increasingly be in focus ahead of the midterms, resulting in "winners and losers" or volatility for certain sectors, beyond broader market volatility. This has been playing out already in the structured credit space with SFR operators, banks or finance companies with credit card programs, Visa and Mastercard, and GSE purchases and agency MBS spreads all as a result of the latest post from the Administration.



Source: Federal Reserve Bank of St. Louis

As noted last quarter, data center spending is increasingly moving into the credit markets. The scale of capital is tremendous, with forecasts pointing to more than $2.7tn of cumulative AI-related spending from 2025 to 2029. In the fourth quarter, Oracle, Meta, Google, and Amazon issued roughly $90bn in bonds alone—as the shift into debt markets continues, the composition of credit markets, beginning with investment-grade and segments of securitized, will notably evolve, impacting the technical environment as the market works to digest this bloated supply.

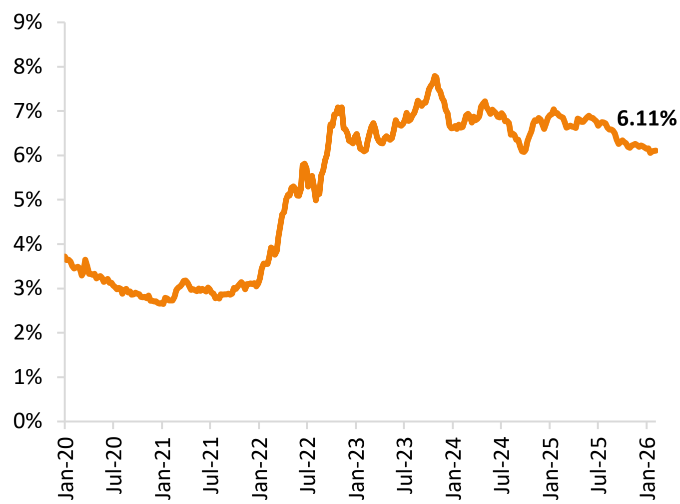


Source: Nomura, Yield Book

1. Morgan Stanley US Economics Weekly – Tax Refunds

The transformative impact of AI has started making its mark on another segment of corporate credit—the leveraged loan market—as software business models become existentially threatened. This is a continuation of a trend that developed through 2025 where the bifurcation in the loan market became increasingly amplified, as mentioned last quarter. Typically, as credit problems in the loan market pick up, prepayment speeds slow down, but the better-performing segment of the market has continued to prepay quickly. These two forces combined create a challenging environment for CLO equity, which outperforms when both defaults and prepayments are low. Further tailwinds from 2025 have now become headwinds, with net supply in the loan and CLO markets turning from negative to positive. For the most part, however, our comment last quarter that unlike recent cycles, we may continue to see credit problems materialize without broader systemic financial stress, has thus far rung true.

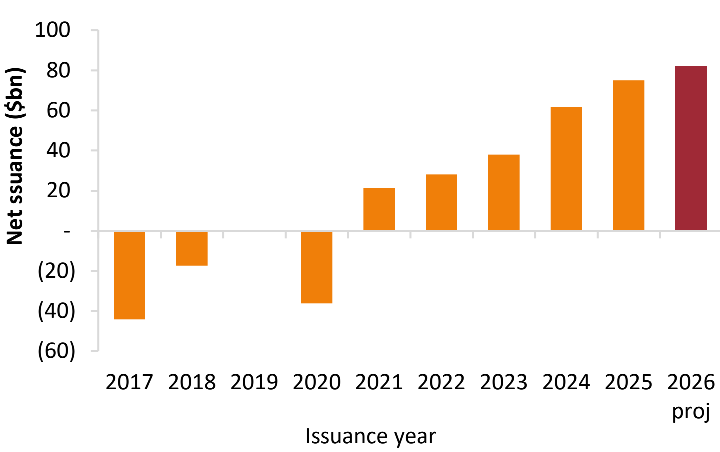
Mortgage rates declining through year-end 2025



Source: Bloomberg, Freddie Mac

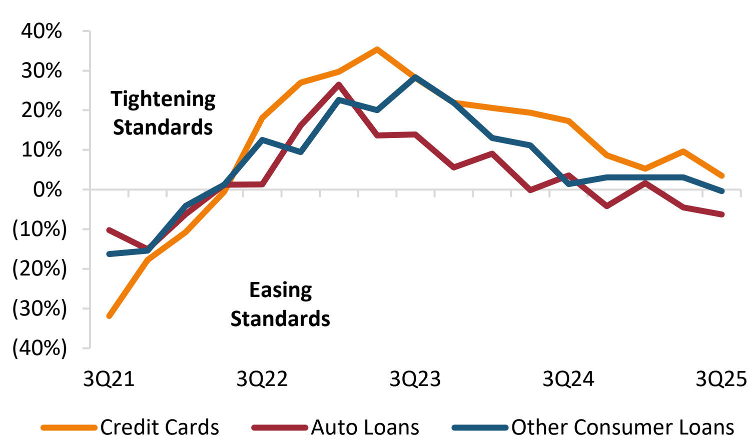
Another force that had been a positive tailwind for demand of floating rate loans and CLOs—higher interest rates—also began to abate in 2025. The FOMC cut rates twice more in the fourth quarter, for a total of 75bp for the year. Perhaps more significantly for the broader economy, U.S. 10-year Treasury yields saw their first annual decline since 2020, decreasing 40bp. In the fourth quarter specifically, the long-end basically ended where it started, but remained lower throughout the quarter, even dipping below 4% in October. While still well above post-financial-crisis averages, mortgage rates ending the year just a touch above 6% provided some relief for the housing market. On the national level, signs of stabilization that we noted last quarter continued into year-end. While dispersion persists across geographies, the latest Case-Shiller print shows national home prices up 1.4% year-over-year with a 40bp seasonally adjusted increase month-over-month, marking the fourth consecutive month with a sequential increase following five consecutive months of sequential decline. Forecasts for 2026 generally expect more of the same, with annual growth projected around 0-2% as the current supply-demand dynamics are expected to persist.

Non-Agency RMBS Net Issuance



Source: Nomura estimates

Net Respondents Tightening Lending Standards



Source: NY Fed Senior Loan Office Opinion Survey, Morgan Stanley

While these rate and housing market supply-demand dynamics have eased some of the extreme tightness in the housing market, they in no way organically support the mortgage volumes experienced in 2021 when mortgage rates were sub-3%, both from a purchase and refinance standpoint. Non-agency RMBS gross issuance in 2025 nonetheless reached 2021 levels—net issuance was around $75bn, by far the highest the sector has experienced since before the financial crisis. This trend is likely to continue, with 2026 expected to surpass these record volumes at over $80bn of net issuance as the non-QM and closed-end second sectors continue to expand meaningfully. As with all meaningful market growth, there have been and we expect there to continue to be some growing pains in the market as both the buyer base and the capital markets functions evolve to absorb the heavier volumes. The RMBS asset class remains highly attractive given the stability in the housing market and borrower credit metrics—improvements in lending standards have continued to broadly filter through to improving delinquencies by vintage.

On the consumer side, aggregate delinquencies in subprime auto continue to print markedly higher year-over-year. That said, decomposing the index, some issuers have demonstrated notable performance improvement. The higher-delinquency-shelves have increased in weight, however, worsening the overall credit quality composition of the index, and again reflecting how critical underwriting is when examining consumer credit performance beyond general consumer health. To that point, while the consumer has generally remained resilient, we are cognizant that the credit pendulum is always swinging. Just as lenders tightened standards significantly when credit performance was deteriorating, we are watching for any signs that standards are easing as performance stabilizes—at this point there is only the slightest indication. According to the NY Fed Senior Loan Office Opinion Survey, lending standards for credit cards are still tightening, but at a slower pace than they had been. Lending standards for auto loans began to ease slightly over the past two quarters, while lending standards for consumer loans have been unchanged.

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