



# Short Duration

Q2 2025  
Portfolio Actions & Outlook

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## Q2 2025 Sector Takeaways

### Investment Grade Credit

- Corporate issuers' credit fundamentals have been resilient, though earnings outlooks are clouded, mainly by elevated policy uncertainty and economic deceleration.
- Our positioning reflects an up-in-quality bias based on valuations and concerns that heightened macro risk and economic growth headwinds fail to be adequately reflected in current spread levels, which moved further below longer-term U.S. corporate bond indices' spread averages.
- We favor the Banking and Finance/Aircraft Leasing subsectors, as well as short-dated, less cyclically exposed subsectors like Insurance, Communications, Consumer Non-cyclicals and Electric Utilities.

### Treasuries / Agencies

- A decline in global business sentiment tied to uncertainty around U.S. trade policy, as well as concerns regarding the inflationary impact of new tariffs on households and businesses, will continue to put downward pressure on U.S. growth.
- While the Fed remains cautious amid a stagflationary backdrop, it is expected to respond swiftly to signs of labor market weakness. We anticipate two quarter-point fed-funds rate cuts before year-end.
- Portfolio positioning remains focused on a steeper yield curve, with a slightly long duration bias. We maintain patience, adding to duration tactically as interest rates form defined ranges.

### ABS

- We expect further deterioration in certain asset-backed securities (ABS) collateral performance, as labor market growth slows, and consumers come under more stress; however, we continue to be comfortable with our top-of-the-stack, AAA- and AA-rated holdings.
- Primary ABS market issuance is below last year's record levels, although there is a broad range of ABS subsector issuance, which offer select opportunities.
- The resumption of student loan payments creates a headwind for ABS performance in that subsector.

### CMBS

- Commercial mortgage-backed securities (CMBS) spreads generally tightened, but the CMBS market faces additional headwinds, as collateral metrics continue to deteriorate.
- Single asset, single borrower (SASB) deals continued to dominate non-agency new issue supply — a subsector where we remain selective regarding our purchase activity.
- We avoided adding agency CMBS and instead opportunistically added higher-quality, conduit tranches as spread levels are more compelling, in our view.

### RMBS

- Mortgages posted positive excess returns in the second quarter, with non-agency collateralized mortgage obligations (CMOs) representing the top performing subsector.
- The possibility of the privatization of Fannie Mae and Freddie Mac and other potential housing market policy changes by the Trump administration continue to be topical, but we do not expect material changes in the near term.
- We find non-agency spreads attractive versus other sectors but are cautious about adding deals with significant exposure to investor properties, due to early signs of worsening credit performance.

### Municipals

- Despite slightly wider credit spreads, the ICE BofA 1-5 Year U.S. Taxable Municipal Securities Index outperformed the ICE BofA 1-5 Year Treasury index over the second quarter.
- States face slower revenue and economic growth, rising tariffs, and policy changes that may reduce federal support, leading to more conservative budgets and increased reliance on reserves.
- Federal policy changes are creating financial challenges for smaller private colleges, while well-funded public and large universities are better equipped to navigate these shifts.

## Investment-Grade Credit

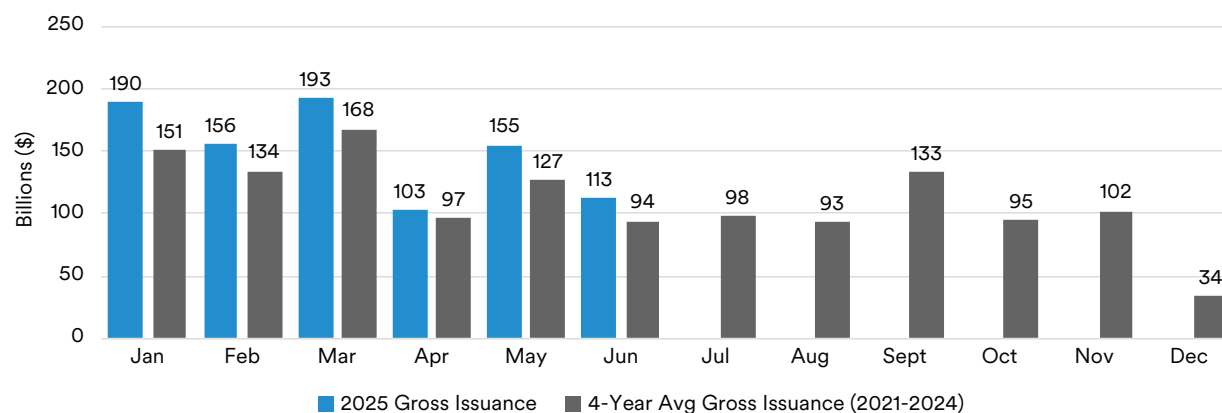
**Recap:** We began the second quarter with President Trump's April 2 Liberation Day announcement detailing reciprocal tariffs on goods imported into the U.S. from most of its trading partner countries, which immediately created a tizzy in global risk markets and even U.S. Treasuries. The announcement, which saw tariffs imposed or moved to levels much higher than investors had been anticipating, produced a precipitous drop in equities and a gap wider in credit spreads. Over the ensuing handful of days, the president backtracked and put the tariff hikes on hold for 90 days, except for China. That enabled markets to regain their footing over the rest of April with front-end corporate credit spreads retracing about half their initial post-announcement spread widening by month-end, even as economic data showed tentative signs of weakness.

The positive market momentum carried over into May, as markets were further buoyed by the May 11 temporary agreement between the U.S. and China to roll back their tariff rates and walk back some other trade restrictions, which served to dial down the temperature around their confrontation. That backdrop set front-end credit, as gauged by the benchmark ICE BofA 1-5 Year U.S. Corporate Index, on a course to produce its best month for excess return since November 2023, with its option-adjusted spread (OAS) ending May at 70 basis points (bps), 2 bps tighter than where it stood on March 31 before the Liberation Day announcement, and 16 bps tighter on the month.

In June — despite further noise around geopolitical developments — most worrisome was the major escalation in hostilities between Israel and Iran, with U.S. forces ultimately inserting themselves in an attempt to eliminate or significantly degrade Iran's uranium enrichment capabilities. However, the corporate bond market did not waver much and remained resilient. That strength was driven by the prevailing strong technical backdrop, favorable economic data (especially on the inflation front) relative to expectations, and benefits from the sharp reversal in oil prices, which can be expected to support U.S. consumer spending if sustained. As a result, front-end credit spreads crept 4 bps lower in terms of the benchmark's OAS, while equity prices reached new record highs. Spread tightening over the quarter was helped by the return of robust technical conditions, with corporate bond net issuance turning negative, as higher coupon payments and increased debt maturities outstripped new issues volume coming to market. New issue concessions stayed modest throughout the quarter, as investors readily absorbed corporate issuance. In addition, April's post-Liberation Day fund outflows reversed course in May and June, seeing a return of strong high-grade bond fund inflows with the highest weekly total since the second week of January 2024, to close out June (\$10 billion).

## High Grade Bond Issuance

(as of June 30, 2025)



Source: J.P. Morgan

First-quarter earnings reports that arrived throughout the second quarter showed evidence of enduring earnings strength and continued sound balance sheets with no signs of any broad meaningful deterioration in debt leverage and interest coverage metrics. First-quarter, year-over-year earnings growth was a heady 12.7% for the S&P 500 Index's constituents, according to Bloomberg.

**Portfolio Actions:** After the significant gapping out in credit spreads in the wake of the Liberation Day announcement on reciprocal tariffs proved rather fleeting, our efforts to selectively add exposure across our strategies in its aftermath at much wider spreads was met with mixed success. We did add exposure across all our strategies in secondaries as well as new issues, but we found trading conditions somewhat difficult and disappointing in secondaries, especially in the first half of April when we saw some of the best opportunities to add risk. Dealer bids, during the period of more pronounced market turbulence in early April, lacked the breadth and depth we would have hoped to see, indicative of the ephemeral nature of liquidity conditions in the investment-grade credit market. Nevertheless, a sizable portion of our trading activity over the quarter entailed opportunistically executing sales and purchases to maintain or extend portfolio durations across all strategies.

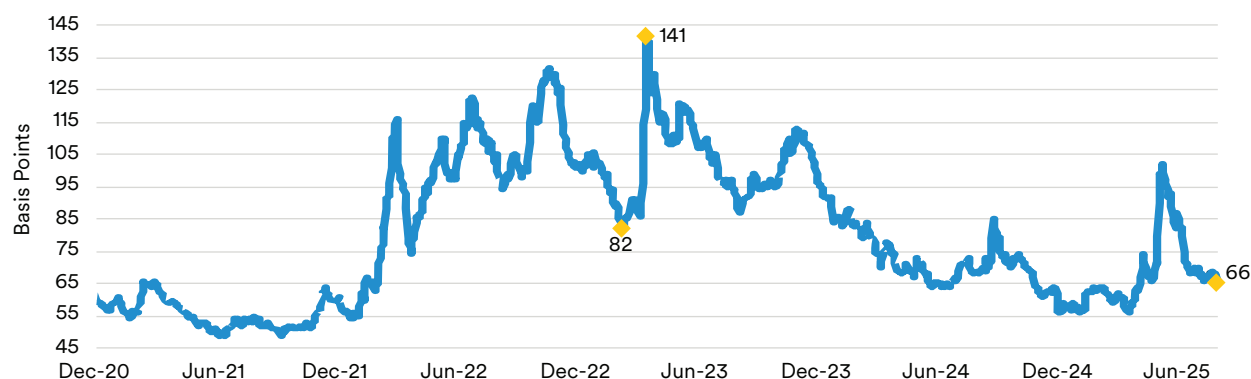
In our Cash Plus strategy, we raised our sector weighting meaningfully by adding 1-1.5-year duration bonds in financials and industrials in some of our favored subsectors, including Banking, Consumer Non-cyclicals and Energy-Midstream, to lock in attractive all-in yields. In our Enhanced Cash strategy, we also increased our portfolio weightings in credit through chiefly purchasing 1-1.5-year duration corporates in the Banking sector, funded by selling our shorter-duration positions inside half a year. In our 1-3-year strategy portfolios, we reduced our credit weighting slightly over the quarter by selling roughly one-year duration corporates and selectively adding 2-3-year duration bonds in secondaries and via the new issue market. Secondary buys included a U.S. airline's senior secured bonds and several money center bank extensions. New issue purchases were a U.S. custodian bank's four-year/non-call, three-year tranche, an insurance company's secured funding agreement-backed, three-year, Canadian midstream pipeline three-year, and a South Korean automotive manufacturer's U.S. captive finance issuer's two-year bonds. We also trimmed our credit weighting over the quarter in the 1-5-year strategy portfolios, mainly by selling our approximately 1.25-year duration holdings, while selectively utilizing the new issue calendar to purchase a money center bank's and the aforementioned U.S. custodian bank's four-year/non-call, three-year tranches, an insurance company's secured funding agreement-backed five-year, a midwestern U.S. life insurance company's secured funding agreement-backed three-year, and a Canadian midstream pipeline company's three-year. Of note, in the 1-3-year and 1-5-year strategy portfolios, we sold selective foreign automotive manufacturer's bonds to reduce exposure to some of the risks around forthcoming tariffs and to avoid potential spread widening.

**Outlook:** Our outlook for the credit sector and its attractiveness is mainly colored by what we deem as unappealing valuations at current levels, broadly speaking. This fits with our modest reduction in overall exposure to the investment-grade sector, in the second quarter, in our longer-dated 1-3-year and 1-5-year strategy portfolios. While some events and crises broke relatively favorably from a macro and geopolitical risk standpoint over the quarter, we see some clouds on the horizon in terms of slowing economic growth, finalizing of tariff announcements and trade agreements between the U.S. and its trading counterparts that may prove disappointing and once again, be at odds with market consensus. Current spread levels are reapproaching cyclical tightness, setting up less constructively for sector excess returns. As such, we find ourselves situated, once again, with a backdrop characterized by elevated macro and policy uncertainty and a market seemingly failing to price in adequately the appropriate degree of compensation for risk, in our view. Simply stated, credit markets are implicitly pricing in a very sanguine, low-volatility scenario unfolding over the medium term that is somewhat at odds with some of the identified risks we have outlined. Nonetheless, U.S. consumer balance sheets and income have held up reasonably well so far, but

we have seen cracks forming in the labor market, as job creation has narrowed, and upwards of ten million delinquent U.S. student loan borrowers may soon be facing diminished credit availability or forced to redirect spending to bring their loans current. Likewise, corporate credit fundamentals have remained resilient, but companies' ability to plan and invest for the future has become challenged, given the overhang of policy uncertainty around tariffs and supply chain disruptions, which have yet to be fully felt in higher prices and reduced profit margins. Accordingly, we ended the second quarter holding a preference for investing in up-in-quality, lower-beta subsectors and issuers within the investment-grade credit universe, awaiting a better entry point to increase our sector weighting and spread duration positioning at wider spread levels.

#### ICE BofA 1-5 Year U.S. Corporate Index OAS

(as of June 30, 2025)



Source: ICE Data Services

**Performance:** The investment-grade credit sector contributed positively to relative performance across all strategies in the second quarter vs. Treasury benchmark indices. Positive excess returns were driven by the tightening in credit spreads over the quarter, in addition to security selection. Credit spreads gapped wider, after President Trump's April 2 Liberation Day announcement detailing reciprocal tariffs on goods imported into the U.S. from most of its trading partner countries, threw risk markets for a loop — before beginning to retrace the move higher during the remainder of the quarter to finish tighter, quarter over quarter. The ICE BofA 1-5 Year U.S. Corporate Index, our bellwether front-end credit index, tightened 6 bps, in terms of its OAS over the quarter, to close June at 66 bps. The index's quarterly total and excess returns were 1.78% and 0.45%, respectively. Strongly performing, investment-grade credit subsectors that drove positive excess returns across our strategies included Banking, Finance Company, Insurance, Wireless, Automotive, Food and Beverage, Health Care, Tobacco, Technology, Transportation, and Electric Utilities.

## Treasuries/Agencies

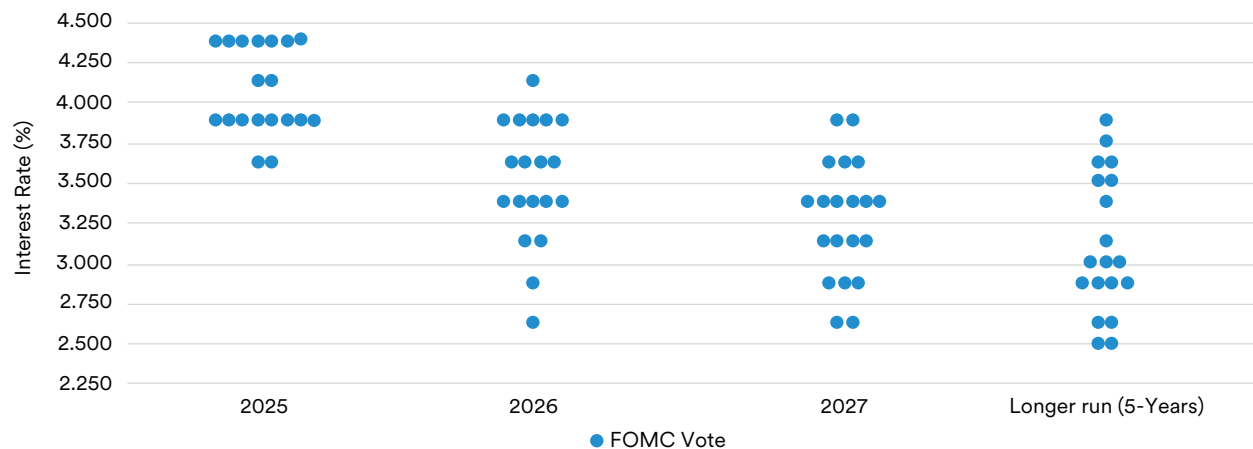
**Recap:** In the second quarter, the U.S. Federal Reserve (Fed) maintained its patient stance, leaving its federal funds policy rate unchanged in a target range of 4.25% to 4.50% during both the May and June Federal Open Market Committee (FOMC) meetings. This marks the fourth-consecutive pause, reflecting the Fed's wait-and-see approach as it balances persistent inflation pressures, a softening growth outlook and evolving risks from trade policy. Tariffs were an evident central focus in both the updated economic projections and Chair Powell's post-meeting remarks. Fed policymakers raised their inflation outlook and projected unemployment rate, while revising downward their expectations for economic growth in the Summary of Economic Projections, signaling concern that the full impact of new import duties has yet to materialize. The Fed now anticipates U.S. inflation to end 2025 at 3.0%, up from 2.7% in its March forecast, while real GDP growth is projected to slow to 1.4%, down



from 1.7% previously. These adjustments reflect expectations that rising tariffs will eventually filter through to consumer prices and constrain business activity. Although the Fed's median projection still points to two quarter-point rate cuts by the end of 2025, unchanged from the March forecast, Powell made clear that the committee holds those views with less-than-high conviction. He avoided committing to any specific timetable for future moves, emphasizing that policy remains entirely data dependent. The tone of his remarks suggests policymakers are prepared to maintain restrictive rates for longer if inflation proves more persistent. Powell also noted that many businesses, consistent with recent survey data, expect to pass along at least some of the new tariff costs down the supply chain, ultimately reaching consumers. He acknowledged that the effects of tariffs on inflation and the economy would ultimately depend on several factors, including their final scope and duration, but affirmed that a price impact is expected at some stage. For now, the Fed remains focused on inflation dynamics while monitoring signs of slowing demand. With limited clarity on how long tariff pressures will persist and a wide range of views among officials, rate policy is likely to remain in a holding pattern until there is more definitive progress on inflation.

### Fed Dot Plot

(as of June 18, 2025)



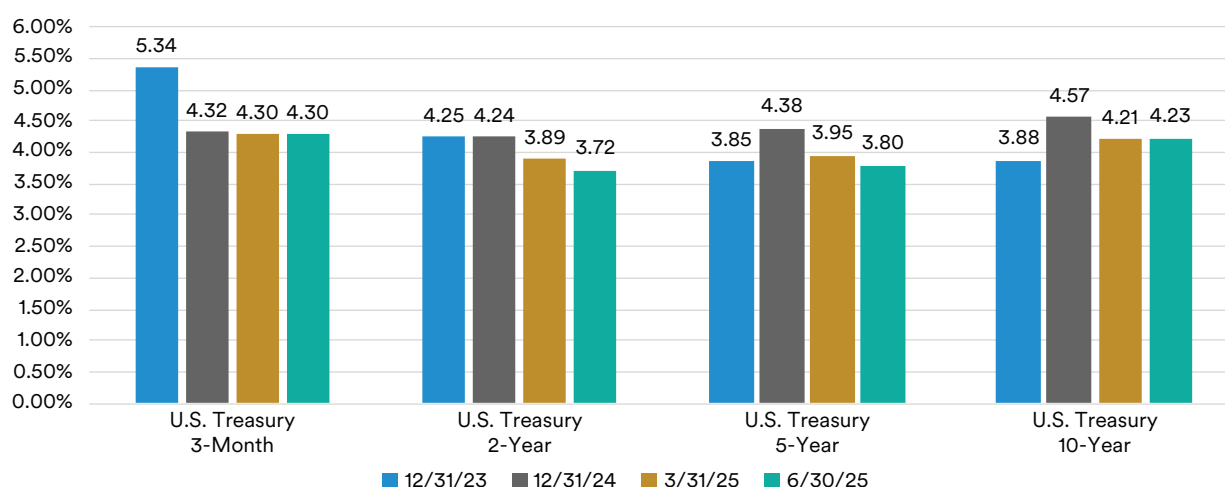
Source: FOMC



In the front end of the maturity spectrum where we operate, short Treasury bill yields were again somewhat mixed over the second quarter. One-month bill yields were 9 bps lower, while three-month bill yields were unchanged, and six-month bill yields rose slightly, increasing by 3 bps. Further out the curve, yields moved noticeably lower, as we saw the two-year Treasury yield decline 16 bps, ending the quarter at 3.72%. The five-year Treasury yield also fell, dropping 15 bps and closed the quarter at 3.80%. The 10-year Treasury was an exception, rising modestly by 2 bps to finish the quarter at 4.23%. This dynamic resulted in a meaningful steepening of the yield curve. The spread between the 10-year Treasury and the two-year Treasury increased 18 bps to 51 bps over the quarter. The move reflects growing expectations that short-term yields will eventually come down further as long-term yields hold firm.

## U.S. Treasury Yields

(as of June 30, 2025)



Source: Bloomberg

Treasury Inflation-Protected Securities' (TIPS) breakeven spreads decreased during the quarter. Five-year TIPS breakeven spreads moved lower to 231 bps from 263 bps at the start of the quarter, while the 10-year TIPS breakevens moved down to 228 bps from 237 bps over the same period. The five-year real yield increased from 131 bps at the beginning of the quarter to 148 bps at the end of the quarter. The 10-year real yield also rose from 184 bps to 193 bps over the quarter.

Front-end Government-Sponsored Enterprise (GSE) agency spreads slightly widened over the second quarter, as the OAS of the ICE BofA 1-5 Year U.S. Bullet (fixed maturity) Agency Index ended the quarter at 6 bps, 1 basis point wider from the start of the quarter. Conversely, in the SSA (Sovereigns, Supranationals & Agencies) subsector, U.S. dollar-denominated, fixed-maturity security spreads were 4 bps tighter and finished the quarter on average at 26 bps over comparable-maturity Treasuries. Agency callable spreads continued to widen as two- and three-year maturity "Bermudan" callables, which feature quarterly calls with lockout periods of three months, saw their spread over Treasuries widen from 47 and 68 bps at the start of the quarter to 70 and 84 bps at the end of the quarter, respectively.

**Portfolio Actions:** During the second quarter, across all our strategies, we further increased our allocation to Treasuries. This shift was funded in part by reducing positions in spread product, particularly shorter-duration securities where spreads had tightened considerably. Concurrently, we continued to implement extension trades across our portfolios, adding duration to maintain a modestly long bias relative to benchmark indices. This position reflects our outlook for a lower rate environment in the front end of the maturity spectrum and our preference for higher-quality duration at this stage of the cycle.

**Outlook:** The U.S. currently exhibits the most pronounced stagflationary tilt among the major economies. Inflation remains persistently above the Fed's 2% target, even as early signs of labor market softening begin to emerge. In effect, elevated inflation still serves as a constraint on immediate policy easing, particularly if labor markets remain resilient. However, the Fed has also made clear that any material deterioration in employment conditions would prompt a relatively swift policy response, even if inflation data remain uncomfortably firm. Underlying this reaction function are several key convictions held by the Fed. First, officials continue to believe their inflation fighting credibility remains intact. They have placed greater weight on market-based inflation expectations, which have stayed relatively well anchored, rather than on more volatile household survey data. This reinforces their confidence that inflation expectations are not becoming unbound, affording them greater flexibility in responding to economic weakness. Second, the Fed is acutely aware of historical patterns in which even modest labor market deterioration has often preceded more significant downturns. In particular, U.S. job growth falling below a 1% annualized pace has historically signaled heightened recession risk. The Fed is therefore likely to act preemptively to avoid a more entrenched slowdown, especially given the lags in monetary policy transmission. Finally, the Fed sees recessions as inherently disinflationary. With rising downside risk to economic growth and increasing likelihood of demand weakness, the Fed appears willing to look through near-term inflation pressures, such as those related to tariffs, under the assumption that they will not become entrenched. Together, these dynamics support our expectation that the Fed will cut rates twice in the second half of 2025, bringing the target range to 3.75%–4.00%. In the U.S., the timeline for a tariff-related inflation passthrough remains a key variable. A gradual increase in consumer prices would cushion the impact on household purchasing power, helping sustain consumer spending. However, it would also squeeze corporate margins, likely amplifying the pullback in capital investment plans. So far, these pressures have not triggered a broad tightening in financial conditions, but risks remain. Beyond the U.S., the global outlook remains clouded by uncertainty, both in terms of policy direction and the economic picture. The impact of major policy shifts already in place, including trade restrictions, fiscal realignment and central bank recalibrations, will likely define the trajectory of global markets through year-end. We expect a synchronized downshift in global growth and a gradual rotation in inflation trends, but the pace and magnitude of these shifts remain difficult to predict. At the same time, the U.S. Treasury markets are grappling with rising term premia, reflecting growing concerns over the long-run fiscal outlook. The broader fiscal impulse for 2025–2026 is likely to be slightly contractionary. When adjusted for higher tariff revenues and slower federal spending growth, fiscal policy is shifting from supportive to neutral at best, notwithstanding a federal deficit approaching \$2 trillion. Despite efforts to generate revenues from tariffs and rein in costs, the budget outlook remains structurally challenging. Consequently, investor appetite for long-duration Treasuries has waned, contributing to higher term premia and a softer U.S. dollar.

## 10-Year Term Premiums

(as of June 30, 2025)



Source: FRED



In summary, while the global economy still shows signs of resilience, downside risks are building beneath the surface. We expect a broader moderation in growth, gradual disinflation and an eventual Fed policy pivot shaped more by labor market developments than by short-term inflation noise or pressure from the president. The balance of risks continues to tilt toward slower growth, with markets increasingly sensitive to any signs that the Fed's tolerance for labor market weakness is lower than previously assumed.

From a portfolio positioning perspective, we view defined yield levels in the front of the Treasury curve as attractive entry points for adding duration tactically. Specifically, two-year Treasury yields in the 3.90% to 4.05% range and five-year yields above 4.10% are attractive within the context of our macro outlook and expectations for Fed easing later this year. In parallel, evolving trade policy dynamics, particularly the inflationary implications of new tariffs, could contribute to wider breakeven rates in the TIPS market. We are evaluating opportunities to express this view through selective inflation-linked exposure. Within spread markets, we expect agency (GSE) and Supranational/Sovereign (SSA) to remain broadly range-bound over the near term. However, SSAs may experience modest widening pressure amid increased supply expectations and persistent trade-related uncertainty. European SSA issuers continue to benefit from a meaningful funding advantage when issuing in U.S. dollars and swapping proceeds back into euros, a dynamic that has persisted since late last year. The USD/EUR cross-currency basis remains deeply negative and is likely to remain supportive of this strategy in the near term, making USD-denominated issuance an efficient and cost-effective option for euro-based supnationals and sovereigns. We remain highly engaged in navigating this complex and shifting environment. Across all portfolios, we continue to manage risk with discipline while seeking to identify relative value and tactical opportunities as they emerge.

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The balance of risks continues to tilt toward slower growth, with markets increasingly sensitive to any signs that the Fed's tolerance for labor market weakness is lower than previously assumed.

**Performance:** During the second quarter, a decline in interest rates created a constructive backdrop for portfolio positioning. Our modest overweight to duration, coupled with strategic curve positioning, contributed positively to excess returns for all strategies. Performance within the agency sector was broadly neutral, with sector allocation and security selection having a limited impact on relative performance during the period.

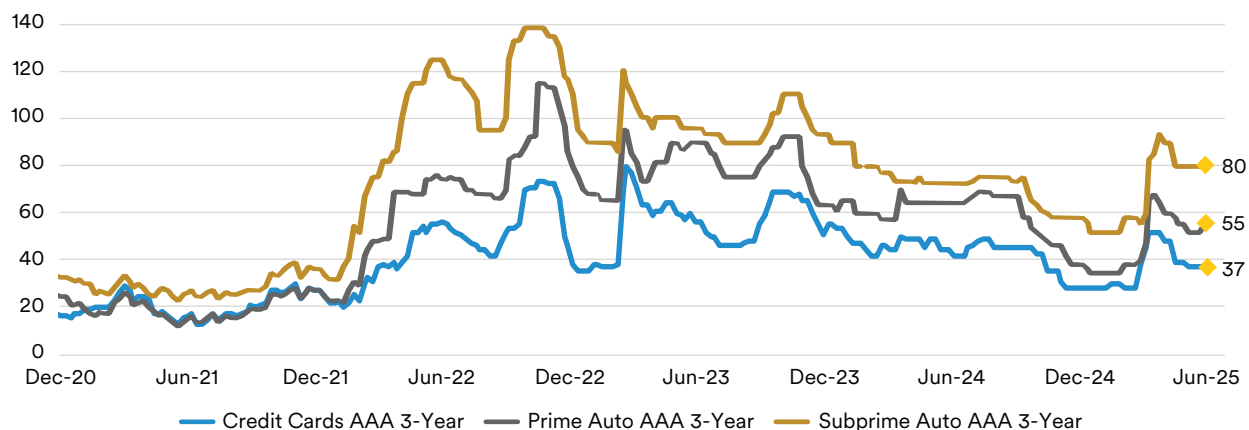
## ABS

**Recap:** The impact of tariffs, geopolitical risk and consumer credit concerns made for an interesting second quarter. Short-tenor ABS spreads ended the quarter mixed, mostly widening out across the board. Benchmark three-year, AAA-rated credit card and prime auto tranches ended the quarter at spreads of 37 and 55 bps over Treasuries, 8 bps tighter and 8 bps wider, respectively. Following along, three-year, AAA, floating-rate private student loans ended the quarter 100 bps over SOFR and 15 bps wider. Similarly, three-year, AAA, fixed-rate, subprime auto tranches ended at 80 bps over Treasuries and 20 bps wider. There was \$75 billion in ABS issued this past quarter, bringing the year-to-date total to \$163.7 billion. Issuance continues to lag 2024's pace. Last year saw \$89.5 billion issued in the second quarter and \$178.6 billion, year-to-date 2024. Almost half of the quarter's

issuance, \$37.9 billion, came from the auto sector. This was followed by over \$15.1 billion of issuance in the Other ABS subsector, a “catch-all” category, which includes deals collateralized by cell phone payment plans, timeshare loans, mortgage servicer advances, insurance premiums, aircraft leases, etc. Of the year’s total issuance, 60% was Rule 144A, and 6% was floating rate.

### Short Tenor AAA ABS Spreads

(as of June 26, 2025)

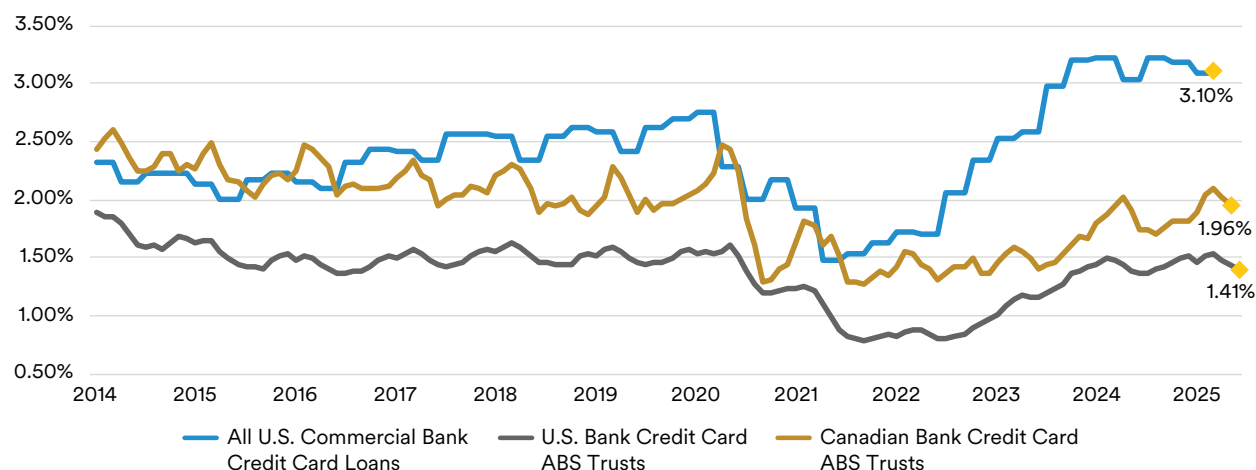


Source: Bloomberg, MIM

Credit card trust performance metrics showed signs of slight improvement over the quarter. Data from the J.P. Morgan credit card performance indices reflecting the June remittance reporting period showed charge-offs on bank credit card master trusts declined 13 bps during the quarter. The 60-plus-day delinquencies measure also fell 9 bps. Even if we do see signs of deterioration in the future, we do not anticipate a material impact on our credit card holdings, due to their robust levels of credit enhancement, as charge-offs and delinquencies remain well below historical norms. In addition, we believe that securitized ABS credit card trusts are likely to perform better than broader credit card portfolios due to their more seasoned collateral accounts.

### Credit Card Delinquencies

(as of June 30, 2025)

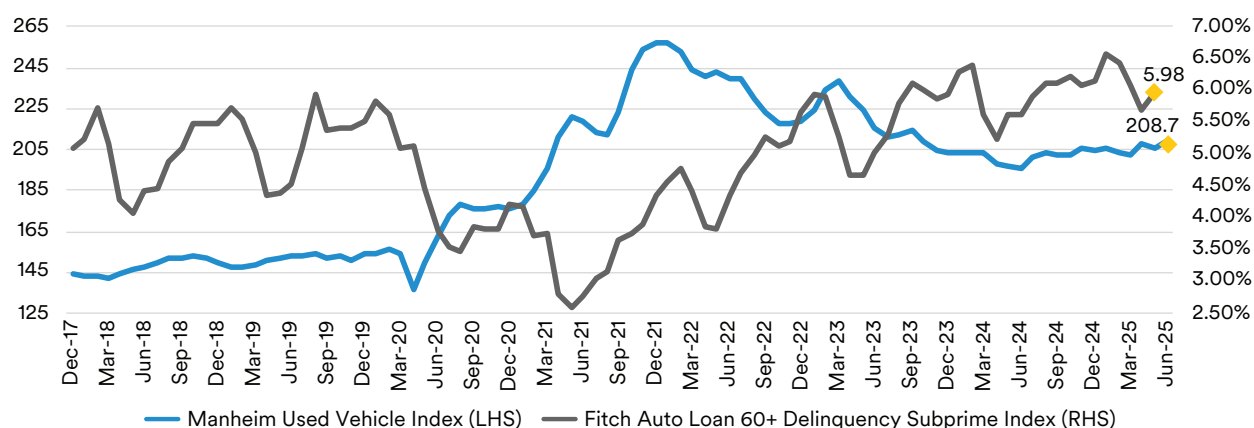


Source: Bloomberg, J.P. Morgan

Due in part to strong results in April and May, second-quarter new vehicle sales were up 2%, year over year. The first half will end with a 4% gain over last year, and the June sales pace, or seasonally adjusted annual rate (SAAR) suggests the market is on course to hit 16.3 million units for the year. However, Manheim/Cox Automotive research expects the sales pace to slow in the second half as fewer summer buyers remain after a frenzied spring, and higher prices and tighter inventory will create headwinds for sales in the fall. General Motors led the first half with sales up 12%, thanks to robust growth across all brands. Hyundai also performed well, as did Ford and Toyota, suggesting the largest, most diverse auto companies are gaining market share in this challenging market.

### Manheim Used Vehicle Index & Fitch Auto Loan 60+ Delinquency Subprime Index

(as of June 30, 2025)



Source: Bloomberg

The most recent Fed Senior Loan Officer Opinion Survey, reflecting sentiment as of April, showed banks generally tightening lending standards for credit card loans, while keeping standards mostly unchanged for auto and other consumer loans. Banks also reported that demand weakened for credit card and other consumer loans and remained basically unchanged for auto loans.

**Portfolio Actions:** At the beginning of the quarter, our ABS exposure stood at very high levels compared to historical averages. With spreads moving tighter over the course of the quarter, we took the opportunity to reduce our ABS weightings across all strategies. We continued to opportunistically add liquid, defensive tranches, but our sales and paydowns outweighed our purchases. We chose to reinvest most of the cash from paydowns and sales into other spread sectors. This past quarter, we did, however, participate in both primary and secondary deals. Like our activity in prior quarters, we purchased front-pay “CP” tranches of various auto deals in our shorter strategies (these tranches stand at the top of the payment waterfall and carry short-term commercial paper ratings equivalent to AAA). Since they are structured to receive the priority principal payments, we believe they are among the safest tranches in ABS deal structures from a credit perspective. We also remained focused on one-year through three-year, AAA-rated senior tranches. For example, we purchased multiple tranches of a large U.S. super-regional bank’s inaugural prime auto deal. One of these purchases was the 2.5-year, AAA-rated tranche, which priced at a spread of 55 bps over U.S. Treasuries.

**Outlook:** As tariff-related volatility creates an environment of extreme uncertainty, we maintain our previous outlook. We expect weakening economic conditions and continued easing from the Fed. Accordingly, we anticipate deterioration in ABS credit metrics, so we continue to prefer liquid, defensive tranches and more resilient subsectors of the market. As in the prior quarters, ABS spreads remain relatively attractive compared to other spread sectors, but we remain mindful of the prominent levels of ABS exposure within the portfolios, so are unlikely to materially increase our weightings. Instead, we are likely to use sales of existing ABS holdings to fund new purchases. We reiterate our preference for prime borrowers over subprime. While we still believe that, in

an economic deterioration, leveraged loans will suffer heightened downgrades, we are open to adding CLOs at an opportunistic level given the ample levels of credit enhancement and structural protections for the AAA- and AA-rated attachment points where we invest.

Tariff concerns have receded from last quarter but remain topical. We continue to expect that our ABS auto holdings will evidence the greatest impact, since targeted tariffs on different metals have the potential to increase the cost of manufacturing new vehicles. GM and Ford appear to be the American original equipment manufacturers (OEMs) that are most vulnerable to tariffs, and while they are expected to absorb some of the higher costs, substantial portions will be passed along to consumers via higher vehicle prices, which is bound to further stretch consumer affordability. Higher new vehicle prices should support used vehicle prices, which are expected to remain stable this year. Overall, we anticipate lower auto ABS issuance volumes, as new vehicle sales numbers decline due to tariff concerns, rising prices and supply constraints. However, the impact on ABS auto trust deal performance is likely to be mixed. We expect improving collateral recoveries (bolstered by higher used car values) to offset the impact of a worsening economy and rising default rates.

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## We anticipate deterioration in ABS credit metrics, so we continue to prefer liquid, defensive tranches...

About 45.2 million borrowers, accounting for approximately a quarter of U.S. households, carry student loan debt. Federal loan student payments restarted as early as October 2023, but a year-long “on-ramp” period blocked missing payments from hurting borrowers’ credit score. Since the on-ramp period ended in September 2024, student loan delinquencies have been on the rise, as many consumers struggle to make their monthly payments. For context, on an average \$35,000 student loan, a \$400 monthly payment accounts for 6.5% of the take-home pay of someone making \$100,000 in annual income. The June TransUnion student loan analysis showed that the delinquency rate, made up of borrowers who are more than 90 days delinquent on their federal student loan payments, increased from 20.5% in February to 30.6% in March and then to 31.0% in April. We expect private student loans to see slower prepayment speeds, as some borrowers resume paying federal direct loans. Collateral performance will likely weaken for sectors that are most exposed to non-prime borrowers, as cash becomes tight and credit scores move lower.

**Performance:** After adjusting for duration and yield curve repositioning, ABS outperformed across all strategies. Much of the outperformance can be attributed to the Auto and “Other” ABS sectors. The weakest-performing sector was student loans, where our minimal holdings were generally flat to slightly negative across strategies.

## CMBS

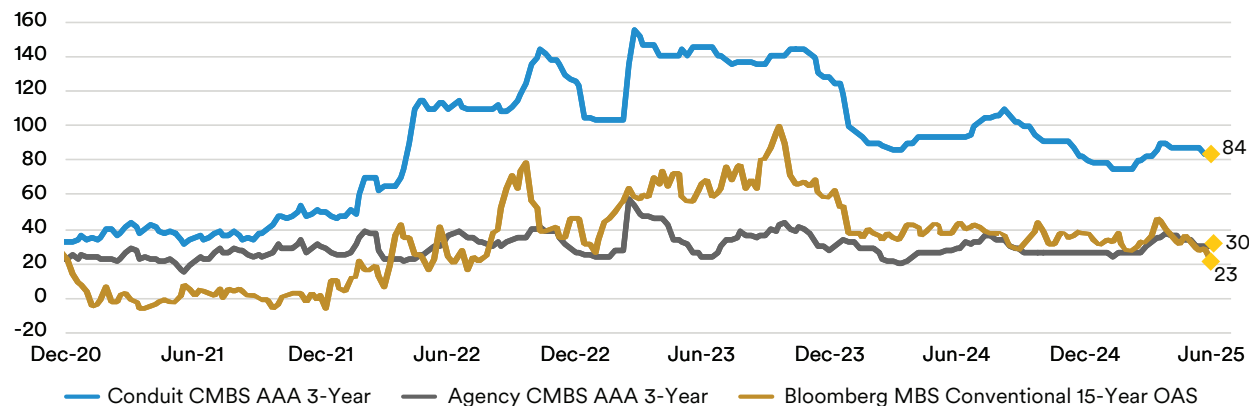
**Recap:** We are now halfway through the year, and CMBS new issuance stands at \$131.8 billion, 52% higher than 2024’s comparable total of \$86.7 billion. Private-label CMBS issuance has amounted to \$75.4 billion so far this year, while agency CMBS stands at \$56.4 billion, 70% and 33% higher than this time last year, respectively. Fannie Mae DUS bonds saw the largest amount of issuance in agencies with \$14.5 billion of new deals coming to market in the quarter. In non-agencies, the single asset, single borrower (SASB) subsector saw the largest volume with \$16.7 billion of new issuance. Apart from three-year and five-year, AAA-rated conduit tranches, which widened 2 and 7 bps, respectively, short-tenor CMBS spreads generally tightened across the board this quarter. Three-year Freddie Mac “K-bond” agency CMBS tranches ended the quarter at a spread of 30 bps over



Treasuries, 3 bps tighter. Three-year, AAA-rated, floating-rate single asset, single borrower (SASB) tranches ended the quarter at a spread of 127 bps over SOFR and 11 bps tighter.

### Short Tenor AAA CMBS Spreads

(as of June 26, 2025)

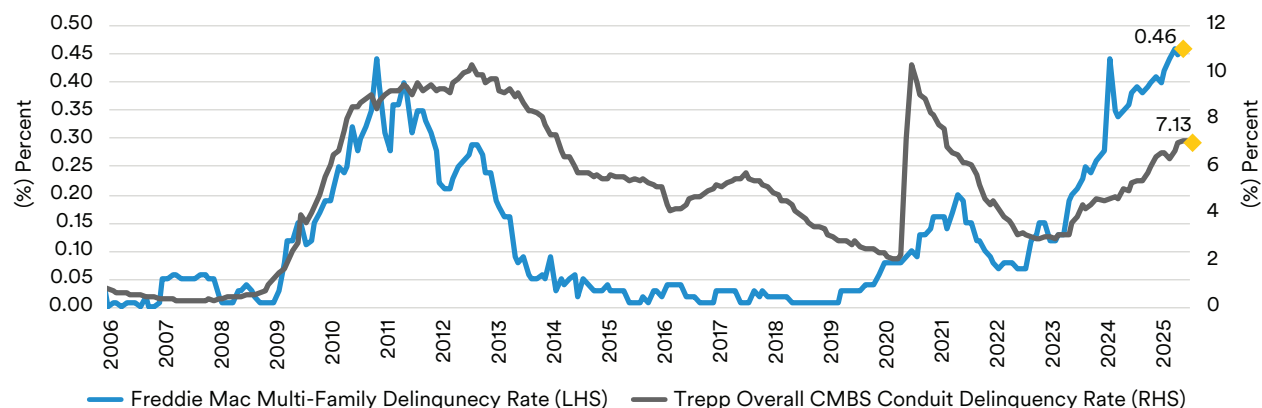


Source: Bloomberg, MIM

Continuing to trend higher over the quarter, CMBS delinquencies (as measured by the Trepp 30-plus-day delinquency rate) rose 58 bps to 7.13% in June. The delinquency rate rose steadily throughout the quarter to 7.03% in April and 7.08% in May. In May, four of the five main property type delinquency rates decreased, but the opposite happened in June. The delinquency rates for four of the five rose, with only the multifamily rate pulling back by 20 bps. The sector that had the highest rate increase was, not surprisingly, the office sector, climbing 49 bps to 11.08% and reaching another record high, surpassing its previous peaks of 11.01% in December 2024 and 10.70% in July 2012. Lodging delinquency has been quite volatile in recent months, rising 42 bps to 6.81% in June, after shedding nearly 150 bps in May. In June, the main contributor to the rise in the headline rate was the reduction in the overall balance, with the overall delinquent balance minimally changed. At the loan level, \$4.2 billion in loans cured, while \$4.1 billion became newly delinquent, which resulted in a net improvement of \$0.1 billion. However, this overall stability masked some sector-level differences in office and mixed-use. The office sector saw a net deterioration of \$0.8 billion, as \$1.8 billion in loans went delinquent, while only \$1.0 billion cured.

### CMBS Delinquencies

(as of June 30, 2025)



Source: Trepp, Bloomberg

Commercial property prices declined in May, with the RCA CPPI National All-Property Index down 1.0%, year over year, extending a trend of mild annual decreases over the last year. The index has posted five-consecutive monthly declines, and in May, prices fell 0.2% from April, suggesting a faster annualized pace of deterioration of 2.8%. The retail index led all property types in May, posting a 4.0% year-over-year gain. The retail index climbed 0.2% from April, an increase that, when annualized, implies a weaker growth rate of 1.9%. Retail prices have risen for 12 straight months, rebounding after a two-year slide. Apartment prices dropped 1.1%, year over year — a more moderate pace of annual loss than seen over the previous two and a half years. On a monthly basis, the apartment index slipped 0.4%, a change that annualizes to a more pronounced decline of 4.6%. Central business district (“CBD”) offices remained the weakest-performing sector in May, but the pace of decline continued to ease. Prices fell 6.2%, year over year, a substantial improvement from the drop of nearly 30% recorded in May of 2024. Suburban office properties outperformed their CBD counterparts, recording a modest 1.1% year-over-year increase.

The most recent Fed Senior Loan Officer Opinion Survey, reflecting sentiment as of the first quarter, showed that banks reported mixed standards changes across bank size categories. Among large banks, most reported having eased standards for multifamily and construction and land development loans, while leaving standards for non-farm non-residential loans unchanged. In contrast, most other banks reported having tightened standards for all commercial real estate (CRE) loan categories. Large banks reported stronger demand for all CRE loan categories, while other banks reported weaker demand in the first quarter. Our interpretation is that the difference in pressure that local and regional banks are facing from their exposure to commercial real estate loans, relative to larger banks, caused them to tighten lending standards earlier in the cycle. Historically, tightening lending standards precede periods of rising delinquencies and charge-offs for CRE loans.

**Portfolio Actions:** During the quarter, we decreased our CMBS exposure across all strategies. We used both the outright sale of agency CMBS tranches and the reinvestment of CMBS paydowns into other spread product sectors to accomplish the reduction. Within the sector, we continued to favor short-tenor investments in agency, more stable conduit ASB and select SASB tranches. In our view, spreads for securities further out the maturity spectrum remain relatively unappealing, compared to other spread product. We participated in one primary deal this quarter, purchasing the two-year, AAA-rated tranche of a floating-rate SASB hotel deal at SOFR+160.

**Outlook:** With CMBS spreads generally tightening across the board in the second quarter, we expect to continue to maintain our current portfolio weighting and only add exposure if an appealing opportunity appears. As we have stated in previous commentaries, we believe that the CMBS market will face headwinds for the foreseeable future and expect continued worsening collateral metrics driven by weakness in office properties. Although a sustained move lower in interest rates should help refinancing on the margin, we are not anticipating any dramatic improvement for that troubled subsector. We are also closely monitoring increasing delinquency rates for multi-family properties in some markets. We expect the impact of tariffs to continue to have a more muted impact on CMBS than the more consumer-focused ABS and RMBS sectors. Nonetheless, a deteriorating economy and market volatility are not positive for CMBS performance and create headwinds for borrowers seeking to refinance their properties. We continue to monitor the situation with the view that tariff uncertainty further supports our bias toward a defensive posture in CMBS.

**Performance:** CMBS had positive performance across strategies except for the 1-3-year strategy. The underperformance in the 1-3-year strategy was the result of weakness in one of our AAA-rated conduit tranches. This position saw its price decline as modification activity on its underlying collateral loans caused the bond’s average life to extend, but we do not have any credit concerns

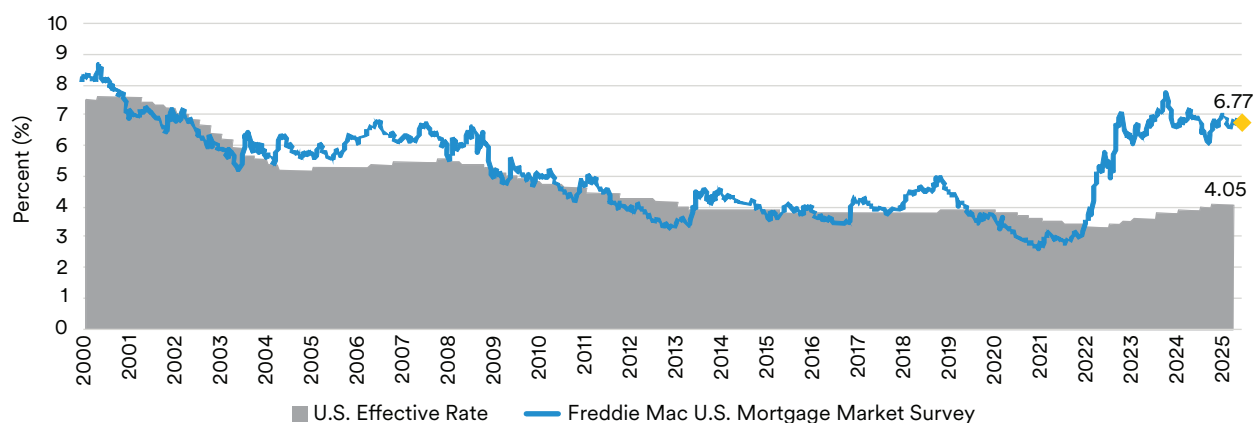
about the bond. In the other strategies, our AAA-rated and AA-rated, floating-rate SASB tranches accounted for most of the outperformance. Our agency holding returns, although more muted than non-agency, were also positive contributors, mostly led by Freddie Mac “K-bonds.”

## RMBS

**Recap:** Overall, generic 30-year MBS collateral ended the quarter at a spread of 145 bps over 10-year Treasuries (2 bps tighter), while 15-year collateral ended the quarter at a spread of 87 bps over five-year Treasuries (1 bp tighter). Non-agency RMBS issuance has exceeded \$77 billion so far this year. Non-agency MBS spreads were flat to slightly tighter over the quarter with prime front cashflows ending the quarter at 165 bps over Treasuries, 5 bps tighter.

### Outstanding Mortgage Average Rate vs. Current Rate

(as of June 30, 2025)



Source: Bloomberg

The Fed’s mortgage portfolio ended the quarter at \$2.14 trillion, following paydowns of \$17.9 billion in June, \$17.7 billion in May and \$ 16.8 billion in April. July’s prepayment report showed 30-year Fannie Mae mortgages paying 7.0 conditional prepayment rate (CPR) in June, 4% lower than the previous month. Fifteen-year mortgages prepaid at 7.2 CPR, unchanged from May. We expect prepayments to drift lower over the next few months, as the market adjusts to higher mortgage rates and increased market volatility.

As we discussed last quarter, privatization of government sponsored enterprises (GSEs) continues to be a topic of market speculation. While it does not seem to be a primary focus for the Trump administration, it is a subject that has been brought up on multiple occasions, going back to Trump’s first term. To recap, in response to the Global Financial Crisis, the U.S. Treasury placed Fannie Mae and Freddie Mac into conservatorship in September 2008. This action was intended to stabilize the mortgage market and restore confidence in the GSEs. There is a draft bill that calls for the U.S. Treasury Department to relinquish its senior preferred equity stake in the GSEs, exercise its warrants on the common stock, sell off that equity and then release the GSEs from conservatorship within two years. Fitch currently rates GSE debt AA+, the same credit rating as the U.S. government, due to the implicit government guarantee of the GSEs. Fitch noted that “ending GSE conservatorship would have a direct, negative rating effect on GSEs, which in turn would have an adverse impact on a substantial number of affordable housing debt ratings that have direct linkages to Fannie Mae and Freddie Mac, based on guarantees provided by these GSEs.” In our view, privatization of the GSEs continues to be unlikely in the near term, as the administration is likely to continue to prioritize other matters such as immigration reform and tariff policy.



**Portfolio Actions:** We marginally increased our RMBS exposure in certain strategies this past quarter. We opportunistically added exposure to several non-agency prime, closed-end, second-lien deals. Collateralized by full-documentation, owner-occupied loans to high FICO borrowers, these deals offer attractive spreads and benefit from the positive credit fundamentals supporting the residential housing market. We also added exposure to agency hybrid ARM tranches in 1-3-year and longer strategies, as agency hybrid spreads, in our view, looked attractive versus similar-duration alternatives. While the adjustable rate mortgage (ARM) market has been relatively stagnant for the past few years with mortgage rates rising, issuance activity has picked up. May total ARM issuance surpassed \$1.5 billion, the highest total since August 2021.

**Outlook:** Going forward, we are content to hold our current RMBS allocation across our strategies. Increases in sector exposure will be dependent upon mortgage spread levels relative to other spread product. Within RMBS, we favor agency specified pools, as we believe that maximizing portfolio liquidity is paramount for the near term, and the superior liquidity profile of agency tranches outweighs the spread advantage found in non-agencies. However, we may selectively increase our exposure to non-agency, second-lien deals and single-family rental (SFR) tranches if spreads widen further. We maintain our preference for deals collateralized by full-documentation loans to high FICO borrowers at modest loan-to-value (LTV) ratios. We will continue to avoid non-agency deals with significant exposure to investor properties, due to early signs of worsening credit performance in that subsector.

We expect prepayments to slow over the near term, given continued interest rate volatility. While a deteriorating economy is a negative headwind for residential real estate performance, we believe our portfolio holdings of senior non-agency tranches are well protected and do not anticipate any meaningful credit deterioration. That said, we remain mindful of spread volatility and challenged liquidity in non-agency tranches.

**Performance:** Our RMBS tranches contributed positive excess performance across strategies after adjusting for their duration and yield curve positioning. Non-agency CMOs were the biggest outperformer over the quarter.

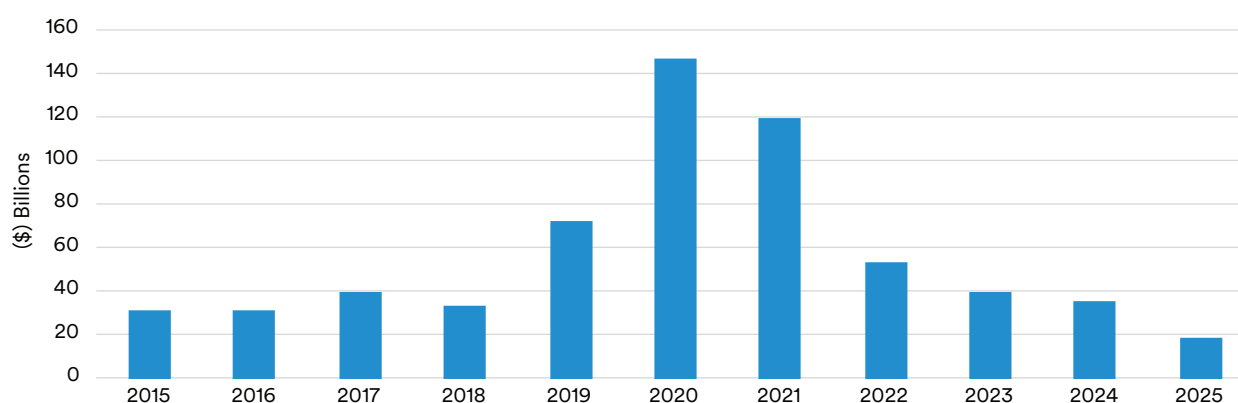


## Municipal

**Recap:** Total municipal new issue supply was \$160.6 billion in the second quarter, and as a component of total supply, taxable municipal issuance was \$11.3 billion, representing a 9% year-over-year decline for the quarter. While credit spreads modestly widened at the front end of the municipal market yield curve, the impact was offset by the decline in new issuance, which drove investor demand contributing to positive excess returns in the sector. The ICE BofA 1-5 Year U.S. Taxable Municipal Securities Index had a total return of 1.50%, outperforming the ICE BofA 1-5 Year U.S. Treasury Index, which posted a 1.36% total return. The option-adjusted spread on the taxable municipal index widened by 4 bps, ending the quarter at 47 bps.

### Taxable Municipal Issuance

(as of June 30, 2025)



Source: Bank of America

During the first two months of the quarter, the upgrade-to-downgrade ratio tracked by Standard & Poor's (S&P) was 1 to 1, indicative of a stable credit environment. Notable rating actions in the second quarter included an upgrade for the State of Rhode Island by Fitch to AA+ from AA. The upgrade reflected the state's declining long-term liabilities, disciplined fiscal management and controlled spending practices. In the transportation sector, Moody's upgraded the Metropolitan Transportation Authority of New York's (MTA) Transportation Revenue Bonds to A2 from A3, citing increased political and financial support from both the State of New York and New York City. The upgrade also recognized the MTA's role as an essential service provider to a large and economically diverse region. Conversely, a notable downgrade came from S&P, which lowered the City of Los Angeles' general obligation debt rating to AA- from AA. The downgrade was driven by concerns over the city's deteriorating financial condition and an emerging structural imbalance. S&P expects these pressures to reduce the city's reserve fund below its 5% policy target in 2025.

We continue to monitor pension funding levels, given their potential to materially affect state budgets. Lower funding ratios can increase pressure on state balance sheets and limit fiscal flexibility. A key metric we track is Milliman's Public Pension Funding Index, which aggregates data from the 100 largest U.S. public pension plans. Despite ongoing market volatility, the index has remained relatively stable, fluctuating within a narrow range around 80% during the first five months of the year. After dipping to 79.5% in March, down slightly from 80.0% at year-end 2024, the index improved to 81.1% by the end of May. While this marks a modest recovery, the index remains well below its peak of 85.5% at the end of 2021.

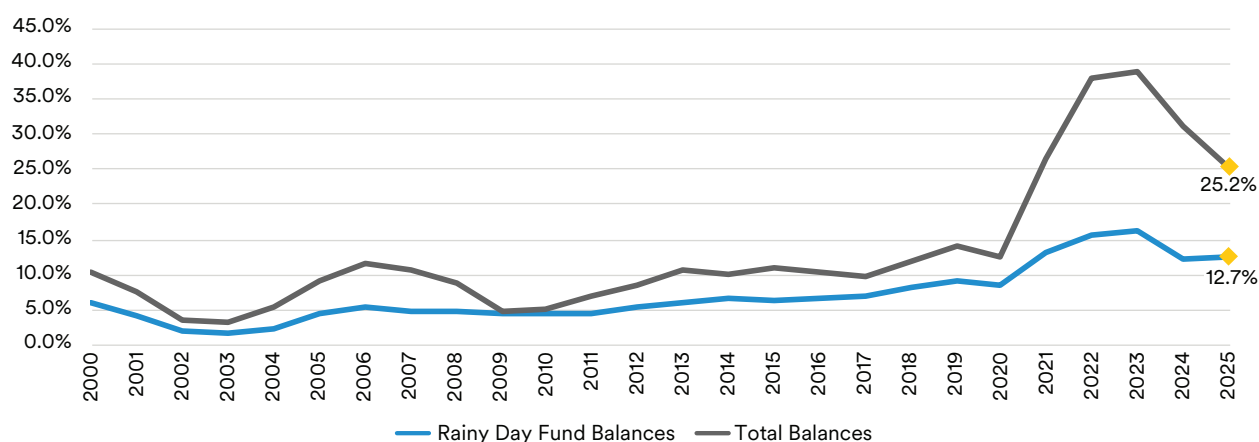
**Portfolio Actions:** Our allocation to taxable municipals increased in our Cash Plus and 1-5-year strategies and was maintained in our Enhanced Cash and 1-3-year strategies over the second quarter.

On the new issue front, we added to exposure in the Higher Education and State and Local Obligation sectors. In the secondary market, we were active in adding to high-quality issuers in the Airport, Healthcare and State Obligation sectors. Regarding our selling activity, our strategy continues to focus on reducing exposure of our shortest-duration bonds to capitalize on more attractive opportunities within the taxable municipal or other spread sectors further out the maturity spectrum.

**Outlook:** Public policy and tariffs are expected to increasingly affect credit quality in some sectors, including State and Higher Education. After two years of tax revenue declines, states entered fiscal 2025 with fewer resources, limiting their ability to fund tax cuts, public services and recession preparedness. The Pew Charitable Trusts noted that although revenues are stabilizing after pandemic volatility, collections remain sluggish. Overall, state tax revenues were 3.2% below long-term trends at the end of 2024, reflecting fading pandemic effects and widespread tax cuts, though early 2025 showed some improvement with half the states reporting revenue gains. According to the National Association of State Budget Officers, state governors' proposed budgets for fiscal 2026 project flat general fund spending amid a fourth-consecutive year of slower revenue growth, with strategies including targeted spending cuts, hiring freezes, fewer pay raises and mixed tax adjustments. Rainy day funds remain near historic highs, with most states expecting to maintain or grow these reserves through 2025 and 2026, even as total balances (rainy day funds plus general fund ending balances) are expected to decline for a third straight year due to spending down of prior year surpluses. Nevertheless, general fund balances remain well above historical averages, and total balances are more than double their highest pre-COVID levels. Rainy day fund balances as a percentage of general fund expenditures are expected to hold steady around 12%, close to the all-time high of 16.2% reached in fiscal 2023.

### Rainy Day Fund Balances vs. Total Balances

(as of June 30, 2025)



Source: National Association of State Budget Officers

Note: Fiscal 2025 represents projections in enacted budgets

An additional source of stress for state budgets is President Trump's proposal to restructure FEMA drastically after the 2025 hurricane season, limiting its role to catastrophic events and shifting disaster recovery costs to states. The plan includes replacing FEMA with state-to-state mutual aid and a federal advisory council for long-term disaster planning. Without FEMA, states prone to hurricanes, floods and wildfires would bear higher recovery costs. According to Barclays, FEMA has provided over \$300 billion in disaster relief over 20 years, easing state and local burdens. Reduced FEMA involvement may elevate municipal credit risk and complicate physical climate risk pricing due to the lack of standardized disclosures, potentially causing uneven market impacts. This represents

a significant federal/state shift, redefining disaster response as primarily a state responsibility. Switching to the revenue sector, the U.S. higher education sector faces growing pressure from federal policy shifts, with smaller private colleges most exposed due to reliance on endowments, federal aid and international tuition. The final version of President Trump's One Big Beautiful Bill Act introduced a sliding scale for taxing private college endowment income, with rates tied to endowment size and student enrollment, reaching a maximum of 8%. Separately, a Senate-backed earnings test will limit federal loan access for schools whose graduates earn less than the median income of high school graduates in their state, increasing financial pressure on institutions with weak post-graduate outcomes. New visa restrictions and delays in processing student visas threaten a key revenue stream for many higher educational institutions. Meanwhile, the U.S. Treasury Department is considering rules to revoke the tax-exempt status of private nonprofit colleges that consider race in admissions, scholarships, financial aid or use of facilities. While implementation may prove difficult, the proposal is likely to introduce greater policy uncertainty and individual credit volatility. Well-capitalized public universities and large, nationally recognized schools are better positioned to absorb these challenges. In contrast, smaller, low-rated institutions with limited resources face rising credit strain as policy, funding and regulatory dynamics shift. We continue to favor large, comprehensive universities and research institutions with strong reputations, broad geographic appeal, sufficient liquidity and a clear focus on reinvesting in modern, high-quality facilities.

The taxable municipal market remains volatile, amid fiscal policy shifts, trade uncertainties and evolving federal policies. We therefore maintain a disciplined, selective approach focused on credits with strong fundamentals and stable revenues. Emphasizing credit quality, relative value and portfolio diversification helps us manage risk effectively. We continue to monitor sectors sensitive to federal policy risks, such as healthcare, higher education and vulnerable infrastructure, while avoiding issuers with weakening fundamentals or long-term headwinds.

**Performance:** Our taxable municipal holdings generated positive performance in our 1-5-year strategy and were neutral in our shorter-duration strategies in the second quarter. On a return basis, positive excess returns that were generated by Higher Education, Not-for-Profit and State and Local Tax-backed issues were slightly offset by holdings in the Airport sector.

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