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Ken Kozlowski and the  
Markets & Investing podcast present:

## Fixed-Income Markets; Current State

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Ken: Hi everyone, I'm Ken Kozlowski, Chief Investment Officer of Equitable Investment Management. And on today's Markets and Investing podcast, I've got the pleasure of welcoming Jeffrey Sherman from DoubleLine Capital. Jeff is DoubleLine's Deputy Chief Investment Officer. He is a thought leader, portfolio manager, and public speaker in the industry. Jeff is the lead portfolio manager for his firm's multi-sector and derivative-based strategies, and has been named Money Management Executive's "10 Fund Managers to Watch". So Jeff, thank you so much for coming and being with us today, and we look forward to spending some time with you.

Jeff: Thanks, Ken. Always good chatting with you, and hopefully we have some good content for the listeners today.

Ken: Yeah, so before we get into specific markets, how would you describe the fixed income environment we're in right now?

Jeff: Well, I think it's one where you have competing forces, and I like to call them the push in the pulls of markets. And you have the push coming from the kind of insatiable demand for credit products today. And you have some of the pull where we still haven't really got out of slaying of the inflation dragon. We also have kind of a pretty solid growth environment still, which leads to some pressure on rates. So you have this environment where we've had this eerie stability in the rates markets, but there's still the ability to generate incremental return around it as well. And so I think the fixed income markets are a good place for income by definition in today's environment, And I think what's really nice about it is that

even though inflation probably will tick up a little bit from the current levels we're seeing, you still have the ability to generate real yields, that is in excess of inflation. So I think there are some good opportunities out there, but there's also some challenges as well.

Ken: So when we look across fixed income, treasuries, credit, mortgages, emerging markets, What are the areas that are kind of quietly zigging while others are zagging? And what do those divergences tell you about where the risks or opportunities are right now?

Jeff: Yeah, I mean, great, great question. I mean, the zigging and zagging to me has been these kind of competing forces between the public and private markets. And you've seen them, the privates really dominate the headlines over the last, I'll say, six months or so. And there's been some hiccups out there. I mean, and the big question is, does it lead to something big or is there contagion or things there? But if I got into specific markets, I would say the one thing that's looking a lot different than the rest is the emerging world today. And we know that there are a lot of challenges within the developed world with all the spending, the fiscal policies, fiscal dominance. We've got the president of the U.S. wants to bring interest rates down in the middle of that, and the bond market's fighting that. But in the emerging world, we have a lot of tailwinds right now. If you think about fiscally, they're much more prudent. Some of that's because they, I hate to say it, but they've restructured over the years. It's a kind way of saying they defaulted already on some of their sovereign debt. But the other thing that's very interesting in emerging markets is the local currency. And that's been something we've added to across our strategies last year. And it's one that just, it's just been on a tear. And every positive attribute you could have, fiscal responsibilities are getting better. You have rates that are higher that are coming down. So you get that tailwind in terms of performance, but also the currencies are benefiting. So even in these bouts where you've seen the dollar have strength against the developed world, it's still been weak against these emerging currencies. And so I think that's a trend that we're going to continue to see over the next couple of years. And I think that even though when you look at the trailing returns, at like 20-plus percent, I think you're going to continue to see some of those. It may not be the same magnitudes, but I think that there's the opportunity that, at least this year, to probably get another double-digit return there. So that's one where we've had this kind of stasis in, I'll call it, U.S. interest rates, where the 10-year Treasury has only moved within the range of like 35 basis points over the last 5 1/2 months. And that's since the Fed cut rates even. And so when I look at that, that's where I see the big divergence occurring. And I think rightfully so. And I think it's something that, again, you have to size it accordingly. It has a lot more risk when you go to local currency, EM versus U.S. Treasuries. But I do think that that's something that investors should really put on their radar and really start to be thinking about those non-dollar allocations.

Ken: Yeah, you just mentioned risk and in the fixed income market. And how do you decide which areas to watch out for and where to really focus in your funds and your portfolios?

Jeff: Yeah, I mean, risk is the hardest thing out there, right? Return is easy. They tell you what the yield is and you just kind of estimate it from there. What we're trying to really think about today is what are brewing risks in the system. And so, you know, for the last few years, we've been talking about the buildup of leverage. It doesn't really materialize. We knew the private market was one where a lot of the leverage is today. It's where a lot of the like hairier credit is. By definition, it's supposed to be in those markets as well. But when I think about brewing risk today, I'm trying to figure out, is this the year that the bond market is going to allow the continued financing of the AI CapEx spend? So I use some jargon

there. So the artificial intelligence movement, they're spending a lot of capital and trying to invest in these systems and the like and have competing models out there. And to date, you know, or at least let's say through the first half of last year, it was primarily done through either free cash flow off the names, or it was done through the equity issuance. Now we've started to see it come into the bond market. And so this is one thing we're trying to get a handle on, you know, understanding, okay, it's not just the obvious businesses under attack, but it's the knock-on effects as well. And so, you know, if you rewind the clock two years ago, that wasn't on our radar, right? Because again, that risk sat in the equity market, but now they're coming to the bond market to finance and the estimates of what needs to be financed the next couple of years, it's in the trillions. And so we're going to see what the threshold is for the bond market, how much it's willing to finance, because bond investors take a different view on that risk, right? We don't get to participate in upside. If we do our job, we get our money back, right? And so to us, that's something that investors should be thinking about. Do you really want to double down on those risks today? Now, the other risk I think that we've seen and we've been managing for many years now is the headline risk, right? With politics, the geopolitical environment has been very charged for the last decade or so, and the policies have been kind of wonky moving back and forth. And so trying to get out of those things that aren't on the crosshairs of either the current administration or things that we think are brewing over time. So it's a kind of an abstract answer to a very definitive question. But at the end of the day, it comes back down to underwriting. Okay, it's not just this credit in all conditions. It says, okay, what if something exogenous comes? What if we have an AI replacement? What happens to those businesses? And so I think at the end of the day, you know, most fixed income comes down to underwriting and understanding risk, but it's trying to then think about it in this, you know, multivariate world where it's not just saying, okay, can this business continue to thrive, but knowing that the world is ever changing and very rapidly right now.

Ken: So right now, what does the shape of the yield curve tell us? I know, the front end has come down. The back end has kind of stayed stubbornly high. We've seen a steepening. What are the things we could take away from that?

Jeff: One is the front end of the curve, the two, I'll call it the two-year treasury part of the curve, has been fighting the Fed for the last three years. It'd say, no, you're too tight, you're too tight, you're too tight. And now they're kind of almost in sync. Yeah, it's, you know, as of today, we're sitting here on February 26th <<2026>>. If you look at SOFR <<Secured Overnight Financing Rate>>, or the Fed funds rate to the two-year Treasury, it's about 20 basis points lower. So maybe that bond market's saying you should cut a little bit. But I think that what you see on the front of the curve is that it's kind of in lockstep with where policy is today. Where it has been, it was kind of front-running that policy for the last couple of years. And so what that tells me is that the bond market thinks we're closer to neutral than maybe some of the punditry says or some of the Fed governors say. But you bring up the back end. I think that's the most interesting part. And it's interesting because if you go back from like 2011 until we had the pandemic, and even until 21, no amount of duration was ever shun. You can't have enough duration. Everybody wanted it. Everybody loved interest rate risk. And that dynamic since 22 has changed. And this is not just a U.S. phenomenon. This is a developed world phenomenon. And if you look at where the 30-year Treasury is today, we're much closer to the high end of the range of the last three or four years than we are at the low end. Now, the front end of the curve is just the opposite. So that tells me that the bond market, one, wants some sort of inflation premium in the market, which, by the way, Ken, you and I have been around long enough. That's how the bond market used to trade pre-global financial crisis. So

it doesn't look that strange to me. It's just we had to dust off the cobwebs in our brain, right? But also, I think that at some point, the markets are signaling to our policymakers that we do not want to continue to pursue such large deficits. And that's not just the U.S., it's the UK, it's Germany, it's France, it's even Japan, which people thought that was never going to change. So that's what I'm getting from the curve. And I think, with the new Fed chairperson, he's historically been hawkish. He's been an inflation hawk. He's definitely on the balance sheet. He does not want the Fed to have such a sizable balance sheet. So he wants to unwind some of that. Well, that should put pressure on the back end of the curve, right, if you're moving out of those securities. And then if they're going to cut rates to offset that, leads to more steepener as well. So I like the curve steepener trade as well. I think that the 10-year has been very stubborn in this range, but I think it's rightfully so because the inflation's been somewhat stubborn. And so what I like about the Treasury market today, irrespective where you pick along the curve, even if you're buying T-bills, it's greater than the inflation rate today. So all those things, they tell us something about kind of where we are in the cycle. And I'll say that the bond market is not forecasting a recession right now. I mean, you're not seeing that from any of the signals there as well. So I think the bond market's extrapolating that, you know, we've got inflation under control somewhat. It's still a little high. But at the end of the day, it's looking forward to these policies and saying, you know, are we going to actually be able to grow our way out of it or are we going to inflate our way out of it? And that's, I think that's the challenge with the backend of the curve.

Ken: Yeah, thanks for that. And a related question, and it'll be our last question. So if you're a year from now and you're looking back at the prior year, what part of the market do you think would have surprised you the most if you had to, you know, guess about that right now?

Jeff: That's hard, because if I did know that, I would put the money on it, right? But it's hard to say, because, we're going to go through a midterm that's going to be ugly, right? And the midterm elections here, and, we're going to see how the American people are going to vote with just essentially the policies we're seeing. And I think there's winners and losers in that. And I think depending on the outcome of those elections is going to kind of dictate some of that. But as an investor, I never want to invest on politics whatsoever, unless we have a certainty of what's going on and it's going to impact a direct market. But I think probably what we're going to be talking about in a year's time is that, now, did we really need the liquidity? That stuff that we put all this stuff in the illiquid assets, did we really intend to do all of that? I think there's going to be, again, I'm not here to criticize the private markets, but I think there's going to be a rethinking and reshaping over the next one to two years there of people saying, maybe I own too much of that. It sounded fine when everything was good, but with hiccups, remember, people want liquidity during hiccups. Sometimes the private helps you and saves you from yourself. But I think we're going to be talking more about liquidity and stuff as well, because I think there's some challenges. We're later in this kind of cycle of this expansion based off low interest rates, and businesses are having to mark to market based on the current borrowing rates. I think that's going to cause some problems. But again, I'm not here forecasting that it's going to take down the overall US economy or that we're going to have a day of reckoning there. It's just, I think people say, you know, maybe I have too much of the alternative in my portfolio and good old-fashioned kind of public investing, maybe I need to go back and do a little bit more of that than what I have been doing for the last five years.

Ken: Great answer. And I just want to say thanks for sharing time with us. It's always great to get your views on what's going on in the bond market. And I just want to say thanks again.



Jeff: OK, well, thanks for having me. And we're happy to join and happy to share our views with your listeners. So thanks again, Ken.

Ken: Thanks, Jeff.

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