

Adding bonds, trimming risk

State Street · Keith M Snell;Robert W Spencer · 2026-10-14 · English original

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

Macro backdrop

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

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

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

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

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

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

Directional trades and risk positioning

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Relative value trades and positioning

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

For Europe, attractive valuations and strong profitability measures drove a more optimistic outlook. In the US, strong sentiment indicators and supportive macroeconomic factors continue to underpin our forecast, though valuations remain the key headwind. Within the US, small caps benefit from more attractive valuations, but weak price momentum and less favorable profitability signals weigh on our outlook. For Pacific equities, both short- and longer-term price momentum indicators remain supportive, but relatively weak sentiment and profitability measures dampen our view of the region.

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

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

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

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