Taxable Fixed Income Commentary

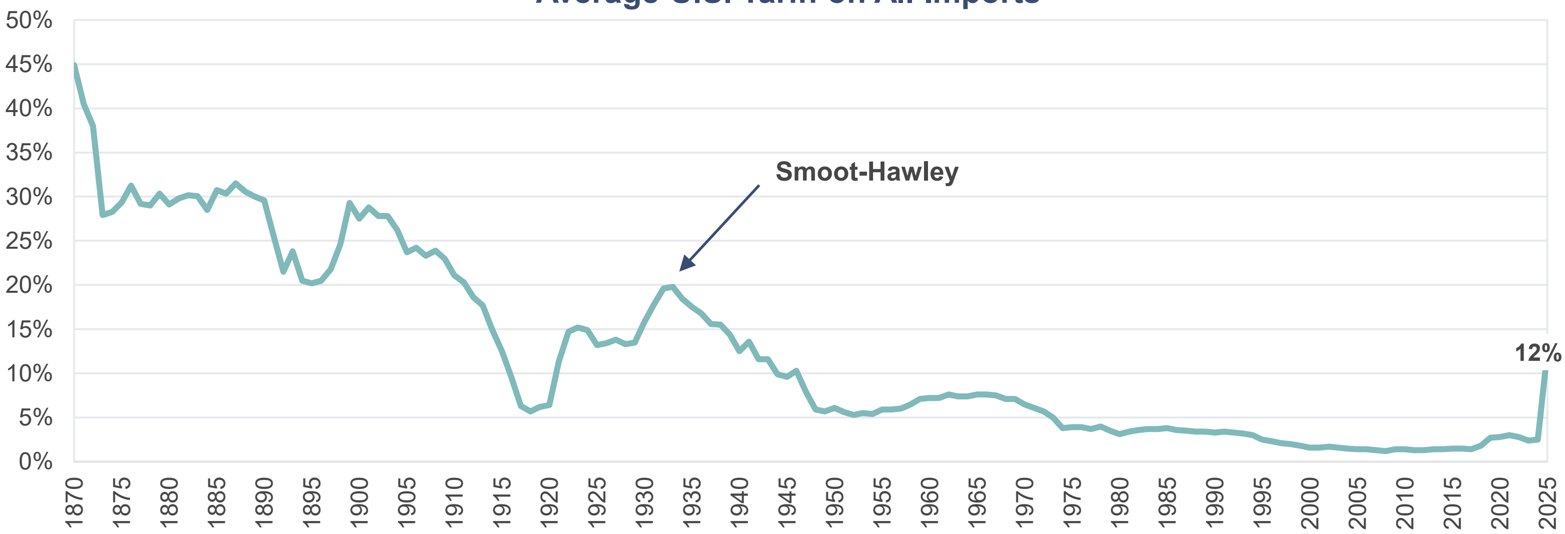
2nd Quarter 2025

Economic Overview

Uncertainty and volatility defined the second quarter, as market participants grappled with the ever-shifting fiscal policy backdrop. President Trump's April 2 tariff announcements rocked global markets, sending the CBOE VIX Index to one of its highest levels in its history, surpassed only by the periods around the Global Financial Crisis[1] and COVID-19, as investors shed U.S. dollar-denominated assets and fled to perceived safe-haven assets. Following significant capital market dislocation, the White House quickly announced a 90-day pause on implementing the tariffs, easing tensions. Investors, thereafter, proceeded to slowly climb the wall of worry over the course of the quarter, shrugging off continual trade headlines, growth concerns, and heighted geopolitical tensions in the Middle East. Remarkably, despite trading in a 60-bp range, the 10-year U.S. Treasury yield finished the quarter just two bps higher for the quarter, while the 2-year yield fell 16bps and the 30-year rose 20bps.

Throughout the quarter, incoming economic data suggested that economic activity gradually downshifted amidst the fiscal policy turbulence. ISM activity indexes showed that the manufacturing sector continued to modestly contract while the services index revealed that service providers were treading water. Consumers felt the weight of the trade policy implications, with the University of Michigan Consumer Sentiment Index falling to its second lowest level in 20 years, driven by skyrocketing inflation expectations on the back of tariff announcements. Coincidentally, the only time in the past 20 years with worse consumer sentiment was in 2022 when headline CPI inflation crested over 9% post-pandemic. Underscoring the survey data, consumers pulled back during the quarter, with nominal consumer spending falling 0.1% in May. On an inflation-adjusted basis, consumption fell 0.3%, marking the third month of negative real consumption year-to-date. However, the labor market provided steady performance, as the unemployment rate ticked down to 4.1% and the economy added an average of 150,000 jobs per month during quarter, compared to an average monthly job gain of 168,000 in 2024. Finally, inflation was relatively stable at 2.7% on a year-over-year basis in May, as measured by the Fed's preferred core PCE Index.

Average U.S. Tariff on All Imports



[1]Refers to the Global Financial Crisis of 2008. Chart data is as of 06.30.2025. Source: Tax Foundation. All data referenced herein is as of 06.30.2025 unless otherwise noted. Yields are subject to market conditions and are therefore expected to fluctuate. Textual data source: Bloomberg L.P. Abbreviations: BPS = basis points; Fed = Federal Reserve; ISM = Institute for Supply management; CPI = Consumer Price Index; PCE = Personal Consumption Expenditures. Please refer to the last page for important definitions and disclosures.

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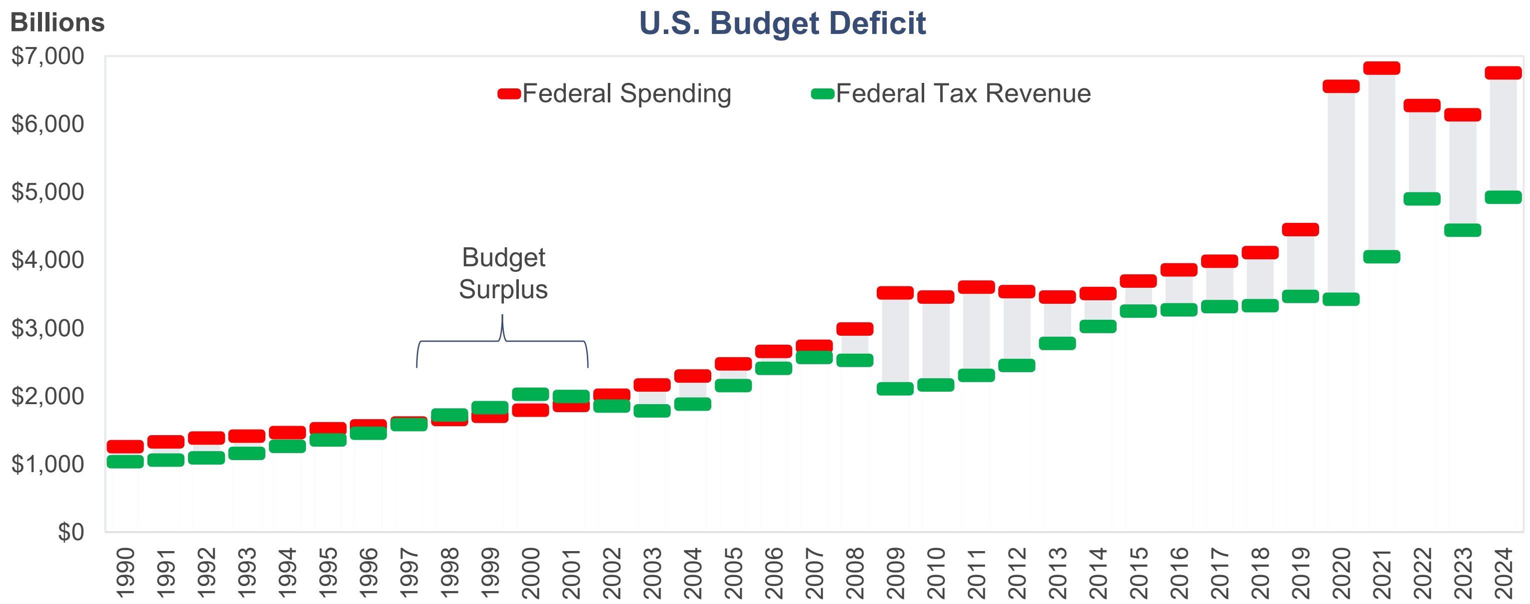
Throughout the headline volatility, the Fed was remarkably quiet. The Fed left interest rates unchanged at its June meeting, marking the fourth consecutive meeting of steady policy rates. The Fed's median year-end fed funds rate projection was unchanged at 3.75-4.00%. However, there was an increasing divide among Fed members, with seven members calling for no cuts this year and eight calling for two cuts. Two members projected one cut while another two expected three cuts. In March, just four Fed members expected zero cuts this year. Meanwhile, reflecting ongoing policy uncertainty and its impact on economic activity, the Fed downgraded its 2025 growth outlook to 1.4% from 1.7%, increased its unemployment rate forecast by 0.1% to 4.5%, and raised its core inflation outlook to 3.1% from 2.8%.

Outlook

We believe the current fiscal policy environment of higher tariffs and greater policy uncertainty represent a headwind to growth this year. Households and businesses alike remain cautious amidst the uncertainty, and an economy with restrained capital allocators will struggle to grow above trend. As such, we look for economic growth in the mid-1% range this year, with significant risks to either side of that forecast. Further, the Fed finds itself in a very challenging positioning, as the economy is slowing, the labor market is loosening, and yet inflationary pressures remain in the system. The Fed is appropriately in a wait-and-see mode with core PCE at 2.7% while the economy is still adding jobs on a monthly basis.

Portfolio durations will be managed approximately neutral to benchmarks, while maintaining a bulleted yield curve position. While the yield curve has steepened in recent months, we continue to expect relative underperformance of the longer-dated maturities versus intermediate-dated maturities. With entitlements, defense, and interest expense accounting for over 75% of federal spending, Congress has limited options to meaningfully cut spending and improve the fiscal trajectory of the U.S. Consequently, we expect steadily increasing U.S. Treasury issuance over time, weighing on longer-term maturities. Meanwhile, underlying inflation remains well above the Fed's 2% target, and cutting too much too soon risks reigniting inflationary pressures. We have maintained a more cautious risk posture considering policy volatility. We prefer higher-quality spread products that are relatively insulated from trade policy yet would look to add back to risk allocations should valuations improve and better align with our forward outlook.



All data referenced herein is as of 06.30.2025 unless otherwise noted. Yields are subject to market conditions and are therefore expected to fluctuate. Textual data source: Bloomberg L.P. Chart data is as of 12.31.2024, the most recent information available. Chart source: Federal Reserve Bank of St. Louis. This information must be read in conjunction with the important disclosures and definitions on the last page.

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Corporate Credit

Corporate bonds experienced a rather wild quarter, undergoing large swings in performance early in April before volatility all but disappeared in June despite a tumultuous geopolitical environment. While corporate spreads widened in anticipation of higher tariffs during the first quarter, President Trump's "Liberation Day" announcement sent shockwaves through the market as investors worried about the dual threat of higher costs and lower growth. In the four trading sessions following April 2, OAS on the Bloomberg U.S. Corporate Index widened 16 bps to its widest level since November of 2023 at 119 bps. Over the same period, the OAS on the Bloomberg U.S. Corporate High Yield Index spiked by 119 bps to 453 bps. Trump's announcement of a 90-day delay in the implementation of the so-called "reciprocal" tariffs on most countries was met with tremendous relief, sparking the beginning of a rally in corporate bonds that lasted for the duration of the quarter despite the Israeli and U.S. strikes on Iran near quarter-end. For the quarter, the OAS on the investment-grade index closed 11 bps tighter for an excess return of 1.04%. The OAS on the high yield index ended the quarter 57 bps tighter at 290 bps, with quarterly excess return of 2.17%. Dispersion across ratings buckets was slightly skewed in favor of lower-quality, BBs posting quarterly excess return of 2.06% compared to 2.27% for single-Bs and 2.65% for CCCs.

While tariff relief served as the main driver of the positive performance for corporates, strong technical conditions underpinned the rally. Fears of a major pullback in foreign demand proved unfounded as attractive yield levels above 5% continued to draw in buyers, while investment-grade supply slowed and redemptions (coupon payments and maturities) increased. Gross supply for investment-grade bonds followed the typical seasonal pattern, falling 34% quarter-over-quarter to $426B to reach $1.07T year-to-date, roughly in line with the first half of 2024. However, net supply totaled just $32B thanks to $394B in coupons and maturities, much of which came from bonds issued during the pandemic-era surge in issuance during 2Q2020.

In contrast, high yield supply was robust, coming in at $76.3B for the quarter (up 12% sequentially and roughly flat to the second quarter of 2024), as lower yields attracted issuers to the market, while investor demand remained high. After experiencing an outflow of $12.6B in April according to Lipper, high yield recovered all of this and more in May and June, netting an inflow of approximately $2B in the quarter.

Investment-grade sector performance for the quarter mirrored the performance of the overall index with cyclicals, lower-rated industries, and names that underperformed badly in the wake of Liberation Day before rallying to recover throughout the quarter. BBB-rated securities underperformed Treasuries by 1.70% and single-As by 0.52% on an excess return basis over the first eight days of the quarter but recovered all of that and more, ultimately outperforming Treasuries by 1.16% and single-As by 0.14% for the quarter. Financials, industrials and utilities performed largely in line, while REITs, metals & mining, cable, and tobacco outperformed at the industry level. The June credit downgrades of Warnermedia (formerly Warner Brothers Discovery) by both S&P and Moody's moved the company into the high yield index and caused the media sector to underperform Treasuries by 2.75% for the quarter.

Our View

While a trade deal with the U.K. came about quickly, negotiations with other major partners look much more difficult and the risk of higher tariffs remains. Tariffs on imported goods are now higher than they have been in generations. While the economy remains on relatively solid ground, signs of slowing could be seen this quarter in the labor market data. The current administration's shoot-from-the-hip method of policymaking further adds to uncertainty. Given these risks, we remain rather unenthusiastic about corporate valuations, as upside looks extremely limited at current levels with investment-grade and high yield spreads trading in the third percentiles on a 10-year basis. However, we acknowledge the strength of recent market technicals whereby demand easily absorbs net supply. We expect this dynamic to carry forward into the next few quarters and therefore do not feel the need to reduce risk further.

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Securitized Products

Securitized products rode a wave of volatility during the second quarter, though by quarter's end, all major subsectors finished with positive performance relative to duration-matched Treasuries. Agency MBS were battered early by a highly volatile interest rate backdrop, typically a bad scenario for MBS. With trade and tariff headlines changing by the hour and U.S. fiscal concerns front-and-center, yields adjusted quickly, and investors demanded higher spreads to hold MBS as a result. That said, the sector finally managed to recover during the month of June, as interest rate volatility declined and the market gained comfort with the general direction of trade negotiations. Additionally, while details are still non-existent on the effort to privatize Fannie Mae and Freddie Mac (the GSEs), President Trump committed to preserving government support of both entities' credit guarantees in the event of a release from conservatorship, which helped remove some of the tail risks and lent more support to the improvement in MBS performance. Despite trailing Treasuries by nearly one percent in the middle of April, the sector managed to fully recover and finished the quarter ahead of duration-matched Treasuries by ten bps.

ABS spreads rallied in the second quarter, overcoming setbacks from late March and early April, when the tariff announcements produced meaningful risk-off effects. Triple A-rated, on-the-run segments of the market tightened eight bps, while subordinated bonds tightened 25 bps and esoteric sectors tightened seven. Second quarter new issue volume reached $76B, which was down from $88B in the first quarter and $89B in the second quarter of 2024. The slowdown in the primary market, concentrated during the market dislocation in April, was primarily due to prime auto lenders waiting for better market conditions prior to issuing. Secondary trading activity subsided in late May and early June, as spreads tightened and new issuance resumed. Trading volumes picked up again into quarter-end, and liquidity conditions during the quarter remained solid despite the spread volatility. Strong investor demand and the commensurate spread tightening caused ABS to outperform similar-duration Treasuries by 27 bps for the second quarter, which very nearly recovered the underperformance of ABS in the first quarter.

Non-agency CMBS outperformed duration-matched Treasuries by 54 bps during the quarter, despite heightened market volatility. The sector's relative strength was supported by broader market dynamics and improved supply technicals, including a 30% decline in index-eligible conduit new issuance compared to the first quarter. Fundamentals, however, showed some signs of softening. The Trepp delinquency rate rose to 7.1% in June, up from 6.7% three months earlier. The RCA Commercial Property Price Index declined approximately 0.8% over the three-month period ending in May. However, certain areas of weakness - such as rising office loan delinquencies - were widely anticipated, and the deterioration was not material enough to dampen investor sentiment. The prevailing view remains that the worst in commercial real estate is likely behind us, with sector fundamentals likely to resume their improving trajectory. Against this backdrop, investors increasingly favored yield over safety during as the quarter progressed, driving outperformance among lower-rated bonds relative to their higher-rated counterparts.

Our View

We took advantage of weakness in MBS early in the quarter to increase our overweight to the sector, with a continued focus on higher coupon pass-throughs for yield and seasoned CMOs for stability. While spreads tightened in June, we still view the sector as an attractive place to pick up income relative to Treasuries, while avoiding credit risk given ongoing macro uncertainties. Policy uncertainty and elevated interest rate volatility could weigh on the sector in the short term, but over a medium to longer term horizon, we think agency MBS is well-positioned to outperform. GSE reform remains a risk and front-of-mind, though we ultimately expect policy makers to avoid any changes that significantly disrupt the agency MBS market, as it currently functions as the backbone of the U.S. housing finance system.

All data referenced herein is as of 06.30.2025 unless otherwise noted. Yields are subject to market conditions and are therefore expected to fluctuate. Textual data sources: Bloomberg L.P.; Mortgage Bankers Association. Abbreviations: MBS = mortgage-backed securities; ABS = asset-backed securities; CMBS = commercial mortgage-backed securities; CMOs = collateralized mortgage obligations; GSE = government-sponsored enterprise. This information must be read in conjunction with the important disclosures and definitions on the last page.

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In ABS, the recovery and subsequent tightening of spreads in the second quarter leaves the market on the tighter side of our gauges of relative value and we do not anticipate much further spread tightening. Nevertheless, the sector continues to offer wider spreads than short corporate bonds, as well as higher overall credit ratings, so we continue to maintain exposure to the sector. We are monitoring unemployment, as any pickup there has the potential to weigh on ABS credit fundamentals in delinquencies and defaults, particularly in subprime autos and unsecured consumer loans. Additionally, with the resumption of federal student loan payments and collection once again being enforced, this is likely to pressure some consumers' ability to stay current on other obligations. This environment favors investment in more highly-rated tranches of ABS capital structures where investors are better insulated from potential credit deterioration, especially when the pricing of credit risk is on the tighter side.

On the commercial side, we continued to reduce our long non-agency CMBS exposure while maintaining an overweight in short-duration positions. This positioning is intended to mitigate portfolio volatility should broader market turbulence resume, while preserving a yield advantage. Looking ahead, we intend to modestly increase our allocation to short non-agency CMBS, which continue to offer a meaningful yield pickup over other fixed income alternatives. We believe sector fundamentals remain on a gradual path of improvement, and the downside risk in these positions is limited given their short spread duration and our continued focus on high-quality bonds.

Taxable Municipals

Taxable municipal securities outperformed duration-matched Treasuries by 0.17% during the quarter, as spreads were unchanged. Spreads were stable relative to corporate credit given that the sector is insulated from ongoing fiscal policy uncertainty. Issuance was again muted, with total taxable issuance coming in at $10.9B, as municipalities continue to favor the tax-exempt market.

Credit fundamentals remained broadly sound, though sector-specific strains remained. Moody’s reported a continuation of positive rating migration with upgrades outpacing downgrades in the first quarter, highlighting municipalities’ resilience to fiscal policy changes. In addition, the U.S. Census Bureau seasonally-adjusted tax revenue data confirmed the positive rating landscape, reflecting an increase of 5.8% in total tax collected over the same period in 2024. The NASBO Spring Fiscal Survey of States detailed 34 states exceeded original revenue estimates in 2025, with nine on target, and only seven below estimate. States such as Alaska and Rhode Island were upgraded by Moody’s to Aa2 and Fitch to AA+, respectively, as each state demonstrated improved fiscal discipline. Tempering the positives, Moody's issued negative sector revisions on public ports and airports during the quarter reflecting the growing concern of negative impacts to travel and trade volume as economic growth projections weakened. Positively, Moody’s highlighted both sectors are characterized by strong liquidity, low leverage, and strong debt service coverage to weather weakening economic trends. Transportation Security Administration (TSA) showed average daily passenger throughput of 2.58MM passengers, with total passengers for the quarter a modest 0.85% lower year-over-year.

Our View

Taxable municipals remain a fundamentally strong asset class that provides diversification benefits to portfolios; however, due to valuations, we have reduced exposure over time in favor of better opportunities elsewhere. We do not see much upside at current levels but view it as a core holding for those accounts that are limited in other asset classes such as corporate bonds or securitized products.

Important Information & Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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Technical Terms: the technical terms below are sourced from Corporate Finance Institute, the Bureau of Economic Analysis (BEA), and MSCI.

The **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

The **core Personal Consumption Expenditure (core PCE) Index** is a measure of prices that people living in the U.S., or those buying on their behalf, pay for goods and services.

The **coupon rate** is the amount of annual interest income paid to a bondholder, based on the face value of the bond.

The **Federal Home Loan Mortgage Corporation** (FHLMC, commonly known as Freddie Mac), is a federally-backed government-sponsored enterprise created in 1970 to broaden the secondary mortgage market and deflate interest rate risk for banks.

The **Federal National Mortgage Association** (FNMA, commonly known as Fannie Mae) is a government-sponsored enterprise established in 1938 to guarantee mortgages for low- to moderate-income borrowers by securitizing mortgage loans through the issuance of mortgage-backed securities (MBS).

The **fed funds rate** refers to the interest rate that depository institutions (such as banks and credit unions) charge other depository institutions for overnight lending of capital from their reserve balances on an uncollateralized basis.

The **ISM Manufacturing Index** (Manufacturing PMI) indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. The **ISM Non-Manufacturing Index** (Services PMI) measures business activity for the overall economy; above 50 indicating growth, while below 50 indicating contraction.

The **"Liberation Day"** plan included a 10% tariff on all imports as well as reciprocal tariffs for 60 nations including 34% on China, 32% on Taiwan, 46% on Vietnam, 20% on the European Union, 25% on Canada, and 25% on Mexico.

The **Michigan Consumer Sentiment Index (MCSI)** is a monthly survey of consumer confidence levels in the United States conducted by the University of Michigan. The survey is based on telephone interviews that gather information on consumer expectations for the economy.

The **National Association of State Budget Officers Spring (NASBO)** has been in existence for nearly 80 years and is a professional membership organization for budget and finance officers. The survey referenced is a semi-annual report gathered from all 50 state budget offices. Spring survey referenced: https://www.nasbo.org/reports-data/fiscal-survey-of-states

Option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. Typically, an analyst uses Treasury yields for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

The **Real Capital Analytics' Commercial Property Price Index™** (CPPI™) measures the actual price experience of property investors, based on transaction data.

The **Smoot-Hawley Tariff Act of 1930** increased U.S. imports tariffs by an average of 40-60% in an effort to protect U.S. farmers during the Great Depression.

The **Trepp CMBS delinquency rate** refers to the percentage of loans within a financial institution's loan portfolio whose payments are delinquent.

The **University of Michigan Consumer Sentiment Index** measures public views on the economy, personal finances, business conditions, and buying conditions.

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The **Bloomberg U.S. Corporate High Yield Index** is an unmanaged, U.S. dollar-denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of $150 million.

The **Bloomberg U.S. Corporate Index** is an unmanaged index composited of the qualifying universe of investment grade rated taxable corporate bonds. The index includes U.S.-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.

The **CBOE Volatility Index (VIX)** is a real-time market index representing the market's expectations for volatility over the coming 30 days.

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