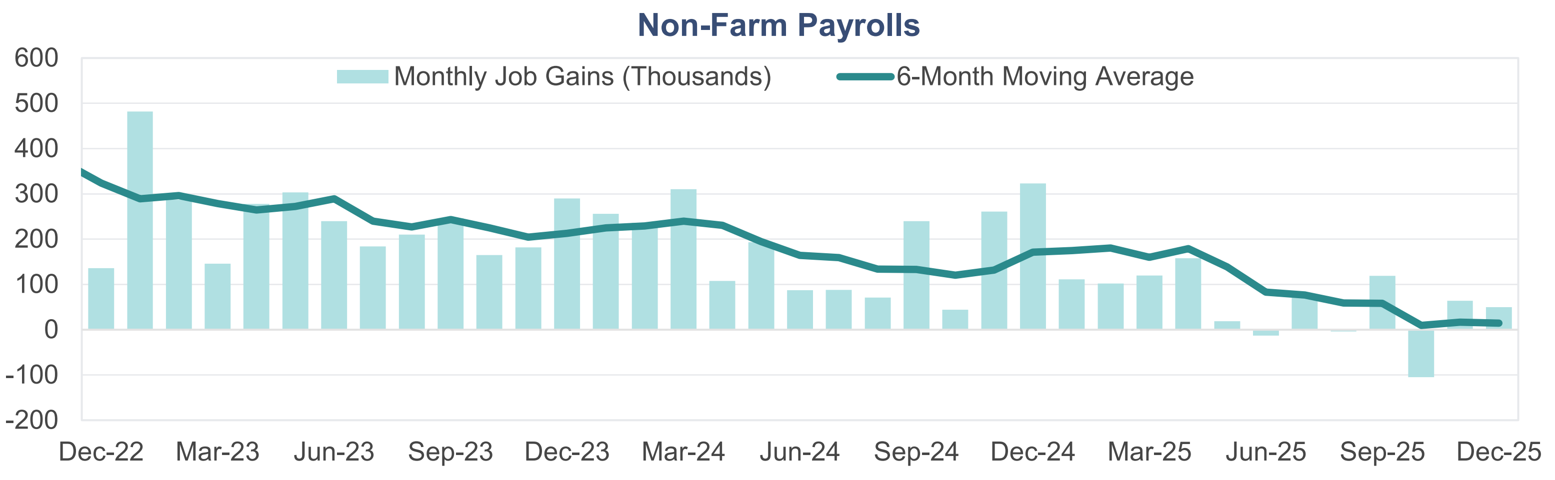
Taxable Fixed Income Commentary

4th Quarter 2025

Economic Overview

The fourth quarter of 2025 unfolded amid greater uncertainty as the government shutdown only served to cast doubt over the direction of the economy and cloud the outlook for market participants. Lasting a record 43 days and spanning crucial survey periods for government economic agencies, the shutdown functioned as a weight on an economy that was performing well at the start of the quarter. The market's first look at Q3 GDP, released nearly two months late due to the shutdown, showed an economy that continued to surpass expectations, growing at a 4.3% annualized rate. Consumers led the way, as consumption rose 3.5%, compared to 2.5% in the prior quarter. However, real disposable income was barely positive in the quarter, indicating that consumers tapped savings to drive consumption, as the personal savings rate fell to 4.0% in September from 4.6% in June.

Once the shutdown ended and the Q4 data backlog cleared, investors gained better insight into the economy, though with a few caveats. ISM activity indexes showed an economy continuing its recent trends, as a still contracting manufacturing sector made incremental progress towards stabilizing while the service sector demonstrated continued expansion. Meanwhile, the labor market remained mired in its low turnover state as firms remained hesitant to either hire or fire workers. Monthly job gains remained soft, with the October payrolls report meaningfully impacted by DOGE job cuts from earlier in the year, while the unemployment rate ticked up to 4.6%. Jobless claims data, however, showed a more benign labor market environment, averaging 219K in December, consistent with averages throughout the past two years. Meanwhile, inflation data was marred by the government shutdown. While the BLS was able to release a November CPI reading that showed core inflation falling to 2.6%, it was unable to conduct its typical surveys for October. Consequently, the BLS had to make myriad assumptions, impacting the quality of the report and forcing investors to wait for better quality data in the months ahead. The impact from the disruptive shutdown will actually continue to impact inflation readings for the next year. Finally, amid flat real income growth and uncertainty around the government shutdown, consumer confidence fell further during the quarter and challenged the multi-year lows set in 2022 when the Fed was embarking on its aggressive rate hike cycle.



Despite the government shutdown and data vacuum, the Fed continued to normalize its policy rate during the quarter by cutting its key rate 25 bps at the October and December meetings. The Fed cited labor market concerns combined with a modestly restrictive policy stance as basis for the rates, notwithstanding a higher inflation rate. In its December meeting's statement, the Fed returned to using the phrase "the extent and timing of additional adjustments" to its policy rate when discussing potential future rate moves, language first used one year prior when the Fed indicated it was likely on hold. At 3.50-3.75%, Fed Chair Jerome Powell stated that policy rates are now at the upper end of the estimated range of neutral, i.e., the policy rate that is neither accommodative or restrictive, and that the hurdle for additional cuts in the near term is likely higher.

Chart sources: Bureau of Labor Statistics (BLS); Sterling Capital Management Analytics. All data referenced herein is as of 12.31.2025 unless otherwise noted. Yields are subject to market conditions and are therefore expected to fluctuate. Textual data source: Bloomberg L.P. BPS = basis points; Fed = Federal Reserve; GDP = gross domestic product; ISM = Institute for Supply Management; DOGE = Department of Government Efficiency; CPI = Consumer Price Index. Please refer to the last page for important definitions and disclosures.

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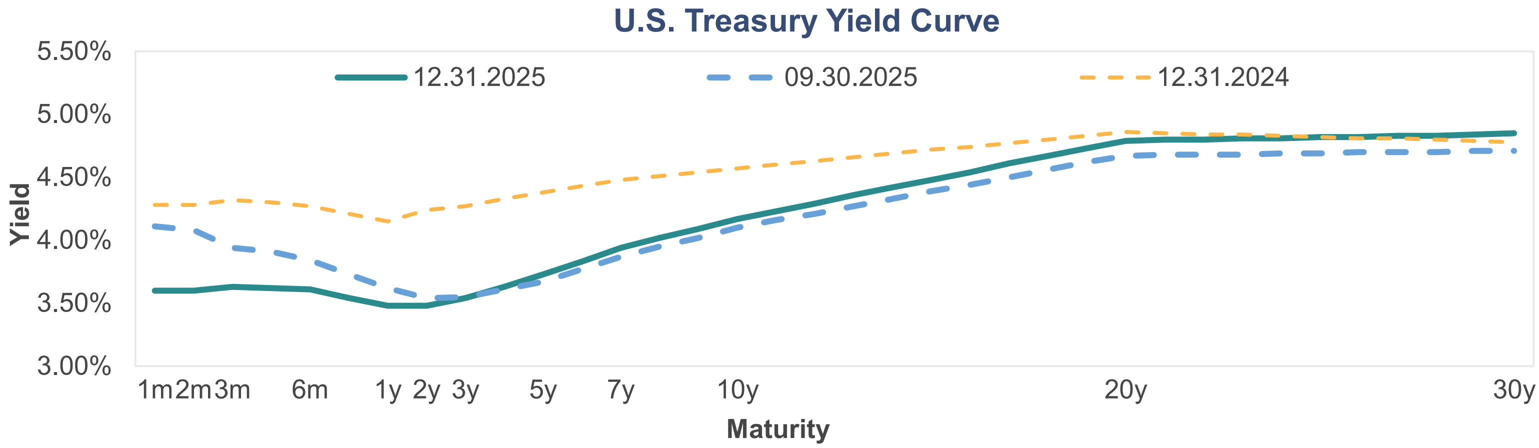
The Fed's updated economic projections for 2026 were little changed from the last update in September: one fed funds rate cut to 3.25-3.50% as previously forecast, unemployment rate unchanged at 4.4%, core PCE down to 2.5% from 2.6%, and 2026 growth outlook revised to 2.3% from 1.8%. Powell was careful to note in his press conference that the upgrade to 2026 growth was largely driven by a catch-up in activity in Q1 following drag from the government shutdown. Lastly, the Fed restarted asset purchases, focusing on short-dated Treasury securities, primarily Treasury bills, to ensure bank reserves remain ample and to minimize volatility in short-term funding markets.

U.S. Treasury yields twisted steeper during the quarter, largely reflecting the Fed's rate cuts. The 2Y Treasury yield fell 14 bps, while the 10Y yield rose just 2 bps and the 30Y rose 11 bps.



Outlook

The 2026 outlook is arguably better than the prior 12 months, though not without risks. On the positive side, peak trade policy uncertainty is most likely in the rearview mirror, there is fiscal stimulus in the pipeline via tax code changes for both corporations and households, and the Fed has provided a cumulative 175 bps of easing over the past 15 months. We look for more consistent growth in 2026 versus the volatility of 2025, average low- to mid-2% growth throughout the year. We expect corporations to reengage spending after holding for much of 2025 due to policy uncertainty and we look for higher-income earners to continue driving consumption. Now that the Fed has adjusted rates closer to their estimate of neutral, we expect the Fed to be on hold in the coming months with a bias to deliver another cut later in the year provided inflation moves closer to 2%. Finally, with an eye on mid-term elections later in the year, we expect the Trump administration to strike a more growth-friendly posture compared to 2025.

On the risk side of the ledger, several unknowns remain on the horizon. Powell's replacement to lead the Fed will be announced in the first quarter and the extent to which that person honors the Fed's independence remains to be seen. President Trump has made clear his intent to nominate someone who will aggressively ease policy rates, yet with inflation expected to remain in the mid to high 2% range throughout 2026, the ability to cut rates without stoking inflation fears remains limited. Should the new Fed chair eschew independent monetary policy and cut rates for political reasons, inflation would likely rear its ugly head, and longer-term interest rates could move sharply higher. Meanwhile, AI capex spending played a dominant role in driving growth and equity returns in 2025. It remains to be seen whether companies can monetize such tremendous spending and if the equity market continues to reward continued investment. Stock market gains helped propel consumption in 2025 and a pullback in stocks could hurt consumer sentiment and thus consumption if the market more meaningfully discounts AI spending. Finally, while we expect stabilization in the labor market in 2026, the risk remains that companies prefer to lean into AI implementation to improve productivity versus adding headcount. A meaningful deterioration in labor demand would dampen growth prospects via weaker sentiment and consumption, while likely bringing greater monetary policy easing into play.

Chart source: FactSet. All data referenced herein is as of 12.31.2025 unless otherwise noted. Yields are subject to market conditions and are therefore expected to fluctuate. Textual data source: Bloomberg L.P. PCE = Personal Consumption Expenditures; AI = artificial intelligence; capex = capital expenditures. This information must be read in conjunction with the important disclosures and definitions on the last page.

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Corporate Credit

The fourth quarter was dominated by two events that drove mixed relative performance and positive total return for credit markets. The Fed delivered two more 25 bp cuts during the quarter, despite dissents, while a cooler than expected CPI print for November reinforced the positive tone into year-end, even as investors questioned the robustness of the shutdown-delayed data. These factors kept technicals positive and supported a strong push in late-quarter investment grade issuance, which totaled $310B in the quarter. High yield primary market activity remained selective and up-in quality, printing $65.1B in the quarter. Both investment grade and high yield saw a surge in issuance related to datacenter construction and other AI-related capital expenditures including $10B+ deals from hyperscalers like Google, Meta, Oracle, and Amazon. This surge in issuance led to record investment grade issuance totals for both the months of October and November while pressuring valuations in the technology and media sectors.

With excess returns of -1.04% and -0.83%, respectively, the performance of technology and communications weighed down the collective performance of investment grade corporates for the quarter. The downgrade of chemicals company FMC Corporation caused excess returns for the basic industries sector to turn negative for the quarter, while worries about the potential for higher defaults in the private credit space had a similar impact on the finance company sector. Every other sector in the index finished with positive excess returns, led by energy, REITs, and healthcare. The Bloomberg U.S. Corporate Index posted excess returns of -0.04% for the quarter, taking year-to-date excess returns to 1.19%. Returns were mostly carry-driven as spreads remained near multi-year tights, ending the quarter unchanged at 78 bps.

The Bloomberg U.S. Corporate High Yield Index posted excess return of 0.16% in the fourth quarter and 2.60% for the full year. The index OAS tightened by 1 basis point to 266 bps in the fourth quarter. Lower-quality segments of the market underperformed, reflecting some investor caution with spreads in the lower ten-year decile. CCCs posted negative excess return of -0.96% compared to positive excess return of 0.36% for BBs and 0.42% for single-Bs.

Corporate credit fundamentals remain in good shape. Investment grade margins are close to historical peaks, while debt growth remains modest and below nominal GDP growth. Revenue for investment grade corporates grew by 4.8% year-over-year in the third quarter according to JP Morgan, the strongest growth in 11 quarters, with EBITDA growth of 6.2%, the most since the fourth quarter of 2022. Although debt increased 4.3% year-over-year and interest coverage declined modestly to a still-strong 9.6x, leverage was almost unchanged at 3.1x. A 20% increase in capital spending was an area of concern, driven by the passage of the One Big Beautiful Bill Act and the datacenter build-out, which remains a major theme going into 2026.

Third quarter earnings for high yield companies showed the strongest revenue growth in three years and the highest margins in two years, although an eighth consecutive quarter of year-over-year EBITDA growth was offset by a sharp increase in total debt, driven by an increase in capital spending. Leverage ticked down slightly to 4.4x, still strong but slightly above the long-term average of 4.33x, while interest coverage has stabilized this year at around 4.2x. Overall, corporate credit fundamentals remain supportive, although valuations leave little room for spread tightening in our opinion.

Outlook

We believe that the economy has potential to remain healthy this year as the lagged impact of easier monetary and fiscal policy serve as strong tailwinds for growth. We expect this to continue to support consumer and company fundamentals while providing healthy demand for risk assets. However, valuations across most sections of the credit markets continue to hover near their all-time tights, leaving little room for upside.

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Additionally, we see risks from further financing needs related to datacenters and other AI-related capital expenditures and higher M&A activity, leading to periods of technical weakness in 2026. For these reasons, we enter the year with a roughly neutral position in investment grade corporates and a relatively conservative view on high yield. We expect spreads to remain within a fairly tight range and look to tactically take advantage of any improvements in valuations.

With event risk on the rise thanks to a more supportive environment for mergers and acquisitions, we favor financials, where mergers tend to be bondholder-friendly, over industrials. Within financials, we prefer wider trading sectors for better carry and modest spread compression potential, including finance companies and life insurance. While heavy supply in the technology and communications sectors will likely continue in 2026, we believe there is potential for issuance to undershoot expectations for certain issuers. We are broadly market-weight in these sectors but could move to overweight if they continue to underperform due to technical weakness.

Securitized Products

Securitized products continued to perform well during the fourth quarter, with all major subsectors outperforming duration-matched Treasuries. Agency MBS again led the way, with excess returns of 0.69% for the quarter and an eye-popping 1.71% for the full year 2025. MBS continued to benefit from declining interest rate volatility, manageable net supply, and increased investor optimism following the resumption of interest rate cuts from the Fed. The sector was further boosted by increased purchases by Fannie Mae and Freddie Mac (the GSEs), with data showing their combined retained mortgage portfolios grew by approximately $66B from the end of June through the end of November. This additional support has helped keep MBS spreads tight and push mortgage rates lower, as evidenced by the MBA 30-year contract rate dropping by approximately 15 bps to 6.31% during the quarter, despite 10-year Treasury rates being slightly higher over the same period.

ABS spreads widened in the fourth quarter as a variety of factors weighed on investor demand, albeit leaving spread levels near their averages for the past year in most sectors. OAS on the index widened three basis points. AAA-rated segments of the market widened five basis points as the continuing flow of new deals, especially in prime auto loans and leases, finally met some resistance from the buy side of the market. Esoteric sectors performed reasonably well, keeping pace with on-the-run sectors. Subordinated bonds underperformed and widened 21 bps in Q4. Subprime auto loan subordinated bonds were hit harder as the market repriced risk on the heels of the news of the Tricolor Holdings fraud-related bankruptcy. Fourth quarter 2025 new issue volume reached $84B, with October and November contributing $76B of the quarterly total, which was up from just $55B in the fourth quarter of 2024. Much of the increase in the primary market this year has been from esoteric segments of the market such as data centers and fiber deals. Total issuance reached a new record level of $340B, 9% ahead of last year's total. Despite the ups and downs of the quarter, ABS outperformed duration-matched Treasuries by 0.16% for the fourth quarter and 0.55% for all of 2025, which is close to the carry earned in ABS.

Non-agency CMBS outperformed duration-matched Treasuries by 0.25% during the quarter and 1.26% on the year. This quarter's outperformance was primarily driven by the sector's yield advantage, as spreads were largely unchanged. Elevated new issue supply limited further spread tightening, with total issuance up 21% compared to the same period last year. Sector fundamentals continued to improve. Commercial property prices rose in November, with the RCA Commercial Property Price Index up 0.3% over the past three months and 1.6% year over year. The Trepp delinquency rate remained broadly stable, ending the quarter at 7.3% versus 7.23% three months earlier. Notably, the office delinquency rate declined month-over-month during the quarter, while lodging delinquencies increased by 0.8%. We are monitoring lodging closely given the sector's relatively high sensitivity to economic conditions.

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Outlook

Following another strong quarter of outperformance, the agency MBS market looks increasingly stretched in terms of valuations. The OAS of the index roughly halved over the year, dropping from 43 bps to start the year down to 22 bps at year end. When looking at coupon exposure, many lower and middle coupons have OAS values in the low-to-mid teens and we continue to focus our overweight exposure on higher coupons, where we see better relative value even after considering elevated prepayment risk. While we don't expect broad MBS spreads to widen significantly in the near term given still benign technical landscape and ongoing support from the GSEs, we do see the sector as a source of funds as we uncover more attractive alternatives in other asset classes.

The modest widening of ABS spreads in the fourth quarter leaves the market near the midpoint of our gauges of relative value. This should provide some room for spreads to tighten going into 2026 as the market reopens for business. ABS continues to offer wider spreads than short corporate bonds, which are trading near their long-run tights, as well as higher credit ratings overall. We believe there is room for ABS to outperform and narrow the gap. We continue to favor subsectors that offer additional spread over prime auto loans and credit cards without veering into the most esoteric sectors. These include fleet lease, rental fleet, timeshares, and private student loans. Most forecasters estimate the 2026 primary market to meet or exceed the record issuance in 2025. Changes in government student loan programs leave room for some potential extra issuance in the private student loan market. Data centers and other non-traditional ABS sectors, which are not part of the Bloomberg Barclays index, have driven most of the growth in the ABS market over the past few years, and are likely to do so again next year. We are adding selectively in the technology/data center space. However, we believe it is important to consider the totality of related risk exposures in a portfolio, given that ABS, CMBS, unsecured debt, and newer corporate debt arrangements are all being used to fund rapid expansion.

In CMBS, we continued to add new five-year last cash-flow super-senior AAAs, which remained attractive on a relative value basis, with limited downside risk. We have built a meaningful overweight position in these securities over the last two quarters, which has contributed positively to relative performance. While we may pause additional purchases given the size of the current overweight, we expect to maintain the position given their compelling relative values and solid credit fundamentals as we head into 2026.

Taxable Municipals

Taxable municipal securities outperformed duration-matched Treasuries by 0.31% during the quarter, as spreads tightened 2 bps and investors continued to reach for yield. Issuance was again muted, with total taxable issuance coming in at $7.3B, as municipalities continue to favor the tax-exempt market.

Municipal credit fundamentals remained largely stable during the fourth quarter, supported by solid state-level fiscal management and resilient economic activity, despite pockets of emerging pressure. Moody's reported that rating actions in the third quarter reflected a second consecutive modest tilt toward quarterly downgrades, driven primarily by challenges within the local government sector—most notably K-12 school districts—where rising labor and benefit costs, combined with demographic-driven enrollment declines continued to strain operating budgets, though from high investment grade rating levels. In contrast, state-level credit conditions remained favorable, underpinned by stronger-than-expected tax revenues and improving pension funded ratios. According to the National Association of State Budget Officers, aggregate rainy day fund levels declined slightly in fiscal 2025 from the prior year, though the majority reported increases and projected further increases in fiscal 2026, continuing to provide states with meaningful flexibility despite a gradual normalization from peak surplus levels.

All data referenced herein is as of 12.31.2025 unless otherwise noted. Yields are subject to market conditions and are therefore expected to fluctuate. Textual data sources: Bloomberg L.P.; Mortgage Bankers Association; Moody's Investor Services; National Association of State Budget Officers. This information must be read in conjunction with the important disclosures and definitions on the last page.

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Looking ahead, Moody's maintained stable outlooks across most sectors heading into 2026, citing broad economic stability and expectations for modest revenue growth. Indicators of consumer activity remained supportive, with Transportation Security Administration data showing average daily passenger throughput of approximately 2.48MM, up 1.15% year-over-year, signaling continued strength in travel and discretionary spending.

Outlook

Taxable municipal bonds continue to be a fundamentally solid asset class, offering diversification to portfolios. That said, given current valuations, we have gradually scaled back our allocation in favor of more attractive opportunities elsewhere. While we do not anticipate significant upside at these levels, we still consider them a strategic holding, particularly for accounts with limited access to other asset classes like corporates or securitized credit.

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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 **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.

Non-farm payroll refers to the number of jobs in the private sector and government agencies. It excludes farm workers, private household employees, proprietors, non-profit employees, and actively serving military.

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.

Real **gross domestic product** (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year, expressed in base-year prices.

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

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.

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