Confluence
INVESTMENT MANAGEMENT

Fixed Income Quarterly

December 2025

Two Turtle Doves

- Two dovish Fed policy actions in the fourth quarter have set the stage for ongoing accommodation in 2026, although we expect a measured approach.
- Intermediate maturities continue to help address both reinvestment risk and interest rate risk.
- Municipal fundamentals remain strong as state and local issuers enter a slower-growth environment supported by elevated reserves, disciplined budgeting, and stable tax revenues, resulting in limited credit deterioration and largely stable rating outlooks.
- We suggest allocations that are even-weight for Treasurys, underweight for corporates, and overweight to MBS, with an overall duration posture that is a bit shorter than the broad benchmarks.

Most of us are probably familiar with the traditional Christmas carol in which "true love" is expressed, in part, through a gift of two turtle doves. If this metaphor is to hold for the US economy, then the Fed showed its true love with two policy actions of a remarkably dovish nature. These actions will surely resonate during the holiday season in which they occurred, but they will also likely carry implications for the entire fixed income market in the new year.

The first dove: As the fourth quarter draws to a close, the Fed announced it has ceased its policy of Quantitative Tightening (QT), the process of allowing securities held on its balance sheet to mature without reinvesting the proceeds in new securities. QT pulls money from the economy by receiving cash payments for the principal of the maturing securities without injecting those payments back into the economy with new purchases, thereby reducing the overall money supply. All else equal, this is a restrictive policy. The Fed initiated this round of QT in June 2022, so ending it after three and a half years marks a change that reflects a shift to a neutral posture.

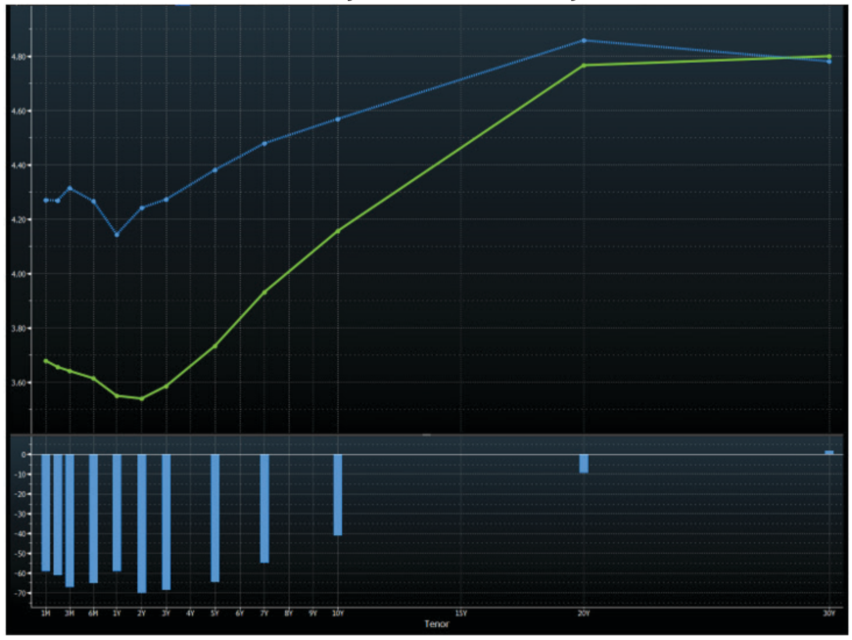
The second dove: Late in the fourth quarter, at the conclusion of its scheduled Federal Open Market Committee (FOMC) meeting, the Fed announced that it would reduce its target range for the federal funds rate by 25 basis points, from 3.75-4.00% to 3.50-3.75%. Earlier in the quarter, the market began discounting the possibility that the FOMC would hold its target steady, which would have suspended the easing cycle that began in September 2024. Since the market expected rate cuts to continue in 2026, the possible suspension of the cutting cycle has inspired concerns about the economy in the new year. The fed funds rate anchors short-term interest rate levels, which tend to impact the yield curve and the economy as a whole. This continuation of the cutting cycle, therefore, is seen as accommodative for economic growth. Taken together, these two holiday-season "turtle doves" suggest the Fed is relatively confident that inflation poses less risk than a softening employment market in the new year.

To complete the picture, we must draw attention to the Fed's guidance for its policy outlook for the new year. In his official statement to conclude the FOMC meeting, Chair Powell emphasized that the bar will be high for any further cuts in 2026. The committee considers the current rate policy to be neutral, in light of what continues to be a balanced risk landscape with respect to inflation and employment. The new "dots plot," which shows each committee member's expectation for the fed funds rate for the next two years, implies only one cut in the new year. In contrast, short-term interest rate markets indicate an expectation of three cuts in 2026, which would reduce the overnight target rate to 3.00%. At present, that market expectation appears a bit too optimistic to us, and we suggest an overall duration posture that is generally a bit shorter than the broad bond benchmarks.

Treasury Sector

Despite bouts of rising and falling volatility in equity markets, Treasurys were quite stable in 2025, even through news cycles related to tariffs, inflation, and changes by (and inside) the Fed. The yield curve near the end of 2025 (Figure 1, green line) compared to the yield curve at the end of 2024 (blue line) illustrates that while longer-term rates were steady, shorter maturity yields declined (blue bars on the bottom).

Treasury Yield Curves: near year-end 2025 and 2024



(Sources: Bloomberg, Confluence)

We share the view that potential forces that would drive rates either higher or lower are fairly balanced. As an example, the Treasury has signaled that it will shift its issuance even further toward the short end of the curve; however, the Fed has indicated that it intends to shift the asset mix of its balance sheet away from mortgage-backed securities in favor of purchasing more T-bills.

With this in mind, we remain focused on intermediate maturities (i.e., 7-10 years). While the short end of the curve is prone to lower yields as the Fed eases, the long end may become volatile if inflation proves higher than expected. The middle of the curve offers a measure of protection against both short-maturity reinvestment risk and long-maturity interest rate risk. Still, we do hold a degree of caution toward maturities in the two- to three-year range. Yields in this range reflect an expectation that the Fed will ease more than we anticipate. If the Fed is measured in applying easier policy, as we expect, this portion of the yield curve may experience upward pressure. The downward hump in the curve at the two- to three-year point shows why we find this tenor less attractive. Taken altogether, we believe an even-weight exposure to Treasurys with these maturity caveats is appropriate.

Corporate Sector

Corporate Investment-Grade Spreads, 10 years ending December 2025

(Sources: Bloomberg, Confluence)

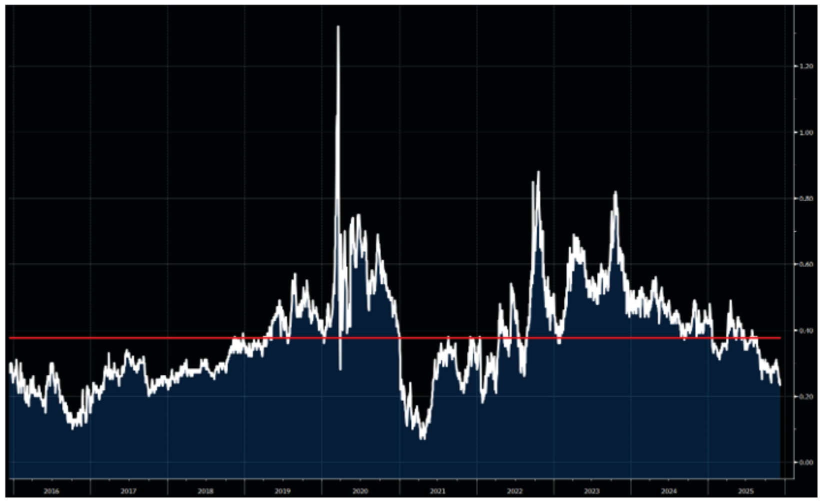
With relatively stable economic conditions, the corporate sector has experienced significant inflows and tightening spreads (Figure 2) below historical averages (the red line), reflecting an expectation that the benign default environment is likely to continue. In the fourth quarter, the large demand for corporate bonds was answered by new supply, much of which was provided by the Magnificent 7 and their need for capital to support AI infrastructure. While this initially put a measure of upward pressure on spreads, that pressure proved temporary as the market accepted the new supply without major disruptions. Accordingly, corporate bond spreads remain well below historical levels.

Part of the corporate spread volatility during the fourth quarter reflected concerns with the private credit markets. Massive capital flows into private credit in recent years have caused many investors to ponder whether a bubble is forming. At this point, we do not believe this to be the case. Granted, there have been some high-profile defaults, but private lending standards remain in relatively good order, and return expectations are not outsized. Furthermore, recent defaults appear idiosyncratic, with problems emerging from fraud in specific circumstances as opposed to a systemic condition across the entire private credit marketplace. As such, we do not see a bubble forming in the private credit markets.

Although the corporate sector appears positioned to benefit from generally low levels of defaults in the coming quarters, spreads are tight enough that we do not find the value proposition from this sector to be particularly compelling, and we continue with an underweight posture.

Mortgage-Backed Securities (MBS) Sector

30-year Fixed Rate MBS Spreads, 10 years ending December 2025



(Sources: Bloomberg, Confluence)

The MBS sector remains in a historically unique condition, where two of the sector's primary risks – extension and prepayment – appear unusually low, particularly for seasoned MBS. The circumstance is a combination of unusually low mortgage rates from the pandemic era along with the higher interest rates that unfolded in 2022. Low mortgage rates created a large proportion of MBS with coupons in the 3-4% range, while the rise in rates drove the prices of these MBS down significantly below par. Today, refinancing volume has already approached a nadir (homeowners have strong disincentive to refinance into a higher mortgage), meaning that low-coupon MBS have little incremental extension risk. At the same time, with prices well below par, these same MBS can appreciate if mortgage rates decline and refinancing volume rises.

Thirty-year fixed-rate MBS option-adjusted spreads (OAS) gradually tightened throughout most of 2025, rounding out the year at levels well below their 10-year averages (Figure 3, red line). Still, because the risk profile of seasoned MBS is unusually constructive, we continue to believe the return/risk profile is attractive, and we remain overweight this sector.

Municipal Bond Sector

Municipal credit fundamentals remain stable. Entering this phase of slower growth, most state and local issuers are doing so from a position of strength, supported by conservative fiscal management and elevated reserve levels built over the past several years. While revenue growth has normalized from post-pandemic highs, it has not meaningfully weakened. Personal income, sales, and property tax collections are moderating but remain sufficient to support operating budgets and debt service.

Importantly, municipalities have demonstrated a willingness to adjust spending as conditions evolve. Budget flexibility, combined with still-healthy rainy-day funds, has helped preserve credit quality across the market. Pension funding ratios continue to improve incrementally, aided by higher discount rates and more disciplined contribution practices.

At the sector level, essential-service revenue bonds (water, sewer, electric utilities, and transportation) continue to exhibit durable fundamentals, benefiting from predictable demand and rate-setting authority. Conversely, healthcare and higher education remain uneven, underscoring the importance of credit selection, though the stress appears isolated rather than systemic.

Overall, defaults remain rare, rating agency outlooks are largely stable, and credit deterioration is idiosyncratic. From a fundamental standpoint, municipal bonds continue to offer advisors a compelling combination of high underlying credit quality, essential-service exposure, and tax-efficient income, reinforcing their role as a core allocation in diversified portfolios, particularly for high-tax-bracket investors.

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Confluence Investment Management LLC

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