Fixed Income Quarterly

Confluence INVESTMENT MANAGEMENT

June 2026

A Roller Coaster Named “Supply Shock”

Every sector experiences its own ride.

- Treasurys have held steady.
- The Fed has maintained rates amid leadership change.
- Corporate bonds have flooded the market and remain expensive.
- The housing affordability crisis has kept MBS in an attractive deep-freeze.
- Municipal credit quality remains solid, but issuer selection matters more.

Most global markets rode a geopolitical roller coaster during the quarter, one that could aptly be named “Supply Shock,” reflecting the constriction of goods being supplied through the Strait of Hormuz during the Iran conflict. Crude oil was the lead car of the roller coaster as its large price fluctuations caused inflationary concerns across the global economy. In contrast, US Treasurys were a relative Ferris wheel, with yields rising and falling in more moderate form.

During the quarter, notable strength came from the US dollar (USD), which rose roughly 2% against other major currencies during the Iran conflict. This strength reflected the rising demand for the USD as its portion of international transactions rose to a record 51% in March – up from 49% a month earlier – continuing a long, steady rise (see Figure 1). The trend reflects a global dependence on the USD for trade and confidence in the strength of both the US economy and its financial assets.

Figure 1

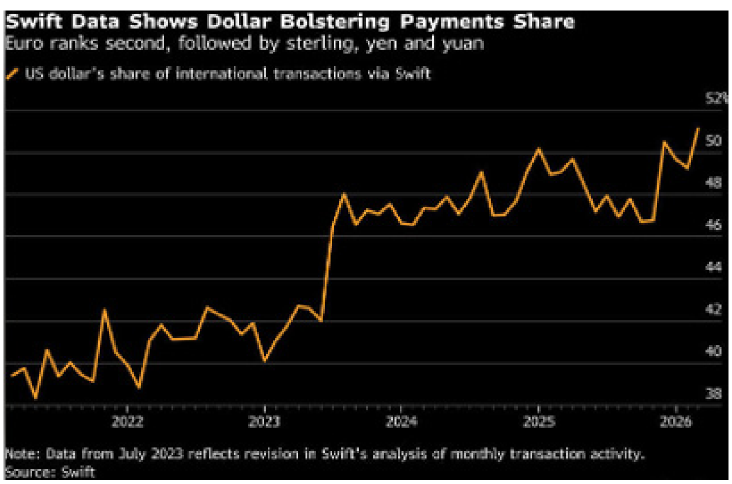
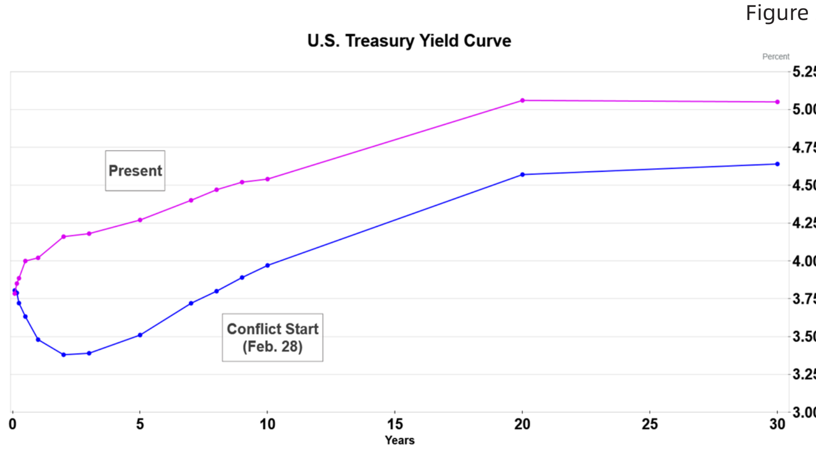


Figure 2

(Source, Figures 1-2: Bloomberg)

A stalwart performer on the roller coaster was the 60/40 stock/bond portfolio, which demonstrated remarkable resilience. After a decline at the beginning of the Iran conflict, the Bloomberg Global 60:40 Index fully rebounded to its pre-conflict trendline, despite a sell-off in bonds (see Figure 2). This pairing combines bond yields with the earnings of stocks, which often change at different times for different reasons. Recently, the yield on the 10-year Treasury exceeded the S&P 500 earnings yield to an extent not seen since early 2002, reflecting the appeal of bonds relative to stocks.

Figure 3

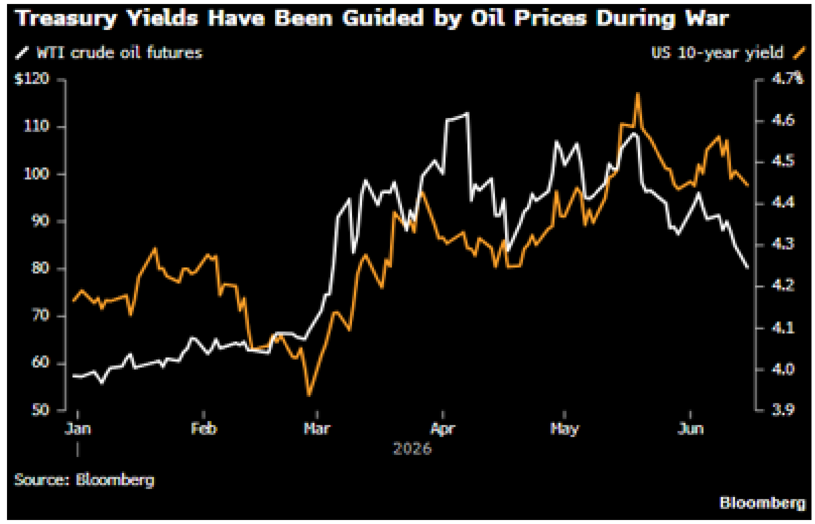


An important facet of the Supply Shock roller coaster, and its attendant inflation, was the recognition that product shortages and oil price spikes would likely prove temporary. This perspective is visible in the Treasury yield curve (see Figure 3, previous page), where long-term yields and inflation expectations changed in measured form relative to shorter tenors. Confidence that inflation would ultimately settle down was particularly noteworthy, given that leadership at the Fed changed in the second quarter, with Kevin Warsh taking the helm. Inaugural messaging from Warsh, supported by the current administration, indicates ongoing independence at the Fed. Ultimately, that independence should help foster a constructive investment environment across all markets.

Treasury Sector

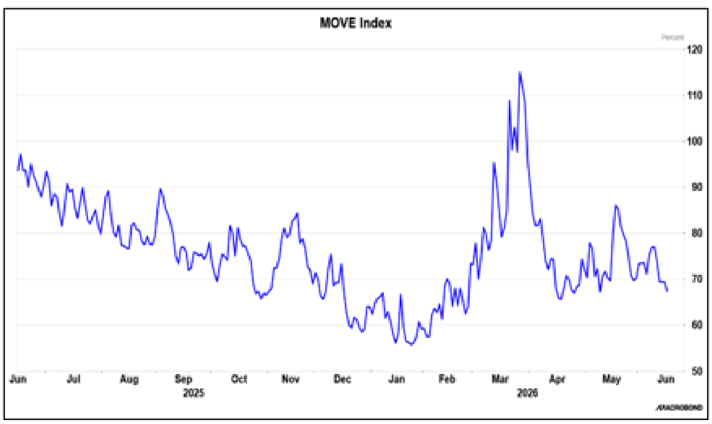
Treasurys navigated the second quarter with remarkable stability and consistency amid the quarter's turbulent atmosphere. Focusing first on the bellwether 10-year Treasury note, history has shown that the yield on this issue typically rises 65 basis points during an oil shock, after which it tends to gradually subside to its pre-shock level. This time, the yield rose roughly 50 basis points. This relatively contained upturn occurred against the backdrop of emerging pre-conflict inflation concerns, which makes the relatively modest increase in the 10-year amidst an oil shock even more remarkable. The note's correlation with the price of oil since the conflict began is clear (see Figure 4). As the price of oil declines, the 10-year yield, all else equal, may follow suit.

Figure 4



(Source: Bloomberg)

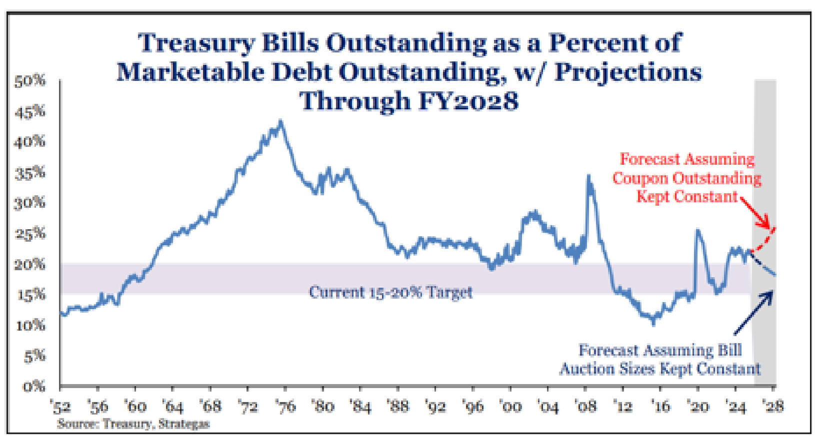
Figure 5



Broadening the scope to Treasurys as a whole, the MOVE Index, which measures the volatility of the entire range of Treasury maturities, has already reverted to prewar levels, demonstrating the resilience of this market (see Figure 5).

Signs of new and expanding sources of private-sector demand for Treasurys are emerging, most prominently for T-bills. The US Treasury has acknowledged this trend and will likely shift the mix of debt issuance to a higher level of T-bills to match this shift in the demand profile. This would actually move the level of T-bill issuance back toward its historical norm (see Figure 6). Meanwhile, the participation of foreign private investors has markedly increased from 12.8% of public issuance in 2025 to 17.7% thus far in 2026. Both domestically and abroad, demand for Treasurys remains robust. Taken together, the size, stability, and growing demand in this market reinforce our overweight recommendation for this sector.

Figure 6



(Source: Strategas)

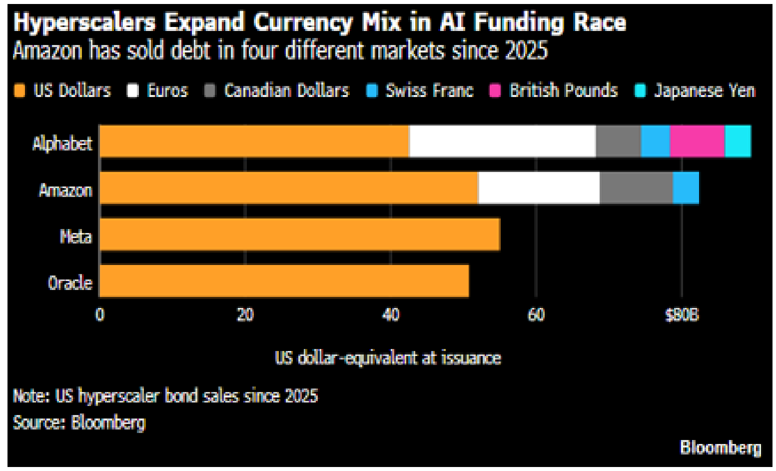
Corporate Sector

The second quarter witnessed record levels of investment-grade (IG) corporate issuance, centering on the rush to build data centers. Although the high level of borrowing spanned the economy, it was the Technology, Communications, and Utilities sectors that led the charge. Gross debt issuance during the quarter exceeded $500 billion, supporting projections for a 2026 total of $1.75 trillion, which is approaching the record of $1.95 trillion.

This surge of borrowing results from three contributing factors. First, technology companies have a need for debt capital to support the development of artificial intelligence (AI) components and supporting infrastructure, such as data centers, power plants, and expanded electricity grids. Second, historically tight yield corporate-bond spreads make the current environment particularly attractive to borrowers. Third, there is confidence among bond investors to purchase corporates, given healthy corporate balance sheets and strong earnings.

The general concern for this sector is not credit quality but rather valuation. By several measures that we track, credit quality is strong. For instance, credit rating upgrades have been consistently outnumbering downgrades, and the dispersion of yield spreads from one company to the next is historically small in most economic sectors. This indicates consistently strong credit quality versus a few strong outliers skewing the results. Still, there are signs that the large amount of new supply is inducing investor fatigue. For example, some larger issuances have seen subscription rates drop from initial notice, while incremental issuance has had some spread widening. Additionally, the largest technology companies are increasingly going abroad to raise debt, having satiated the domestic market (see Figure 7). Accordingly, the relative return for the extra risk taken versus Treasurys might prove disappointing, and thus we generally recommend an underweight to this sector.

Figure 7

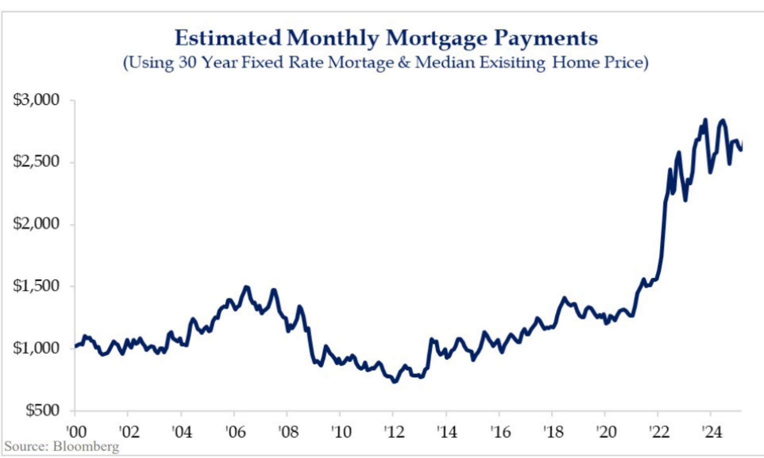


(Source: Bloomberg)

Mortgage-Backed Securities (MBS) Sector

Affordability continued to exert itself as a dominant factor in the US housing market. Rising mortgage rates and home prices combined to drive the estimated average mortgage payment beyond $2,500 (see Figure 8). The beginning of the quarter witnessed a brief downward trend in mortgage rates, only to turn back higher and finish the quarter with the 30-year-fixed rate well above 6.5%. Commensurately, home sales have remained in the doldrums, growing 0.7% over the first five months of the year. The 10-year Treasury yield serves as the basis for most mortgage rates and, unless this yield declines, housing affordability is likely to remain a challenge.

Figure 8



(Source: Strategas)

Another consequence of current mortgage rates is how much higher they are relative to existing mortgage rates. This condition has lowered housing turnover, which in turn has dramatically lowered MBS prepayment rates, down to historically low levels. For MBS investors, lower coupon MBS today have limited duration extension risk, given that prepayment levels are unlikely to decline even lower. Low levels of extension risk typically reduce the amount of interest rate risk that is systemic to MBS in most market environments. At the same time, lower coupon MBS trade well below par, creating an opportunity for appreciation, should mortgage rates decline.

From a technical perspective, the ongoing purchases of $200 billion of MBS by Fannie Mae and Freddie Mac are proceeding on course, offsetting the Federal Reserve's rotation away from MBS, projected at $180 billion for the year. Other market participants, such as foreign buyers, also appear set to maintain stable purchasing activity. Additionally, major banks are responding to the easing regulations by increasing their rate of MBS purchases. These market conditions underpin our overweight recommendation for the sector.

Municipal Bond Sector

Municipal bonds rode their own version of the fixed income roller coaster during the quarter, but the ride ultimately reinforced the sector's appeal. Like Treasurys, municipal bonds were affected by inflation concerns and shifting rate expectations. Unlike corporates, however, the sector is not broadly priced for perfection. The most important feature of the market is that tax-exempt yields remain meaningfully higher than they were during the low-rate era. For investors in higher tax brackets, this creates attractive tax-equivalent income and a better starting point for total returns.

We view this higher-yield environment as an opportunity, particularly if inflation follows the historical pattern of prior oil-related supply shocks and gradually subsides. In that scenario, lower Treasury yields could provide a tailwind for high-quality municipal bonds. Duration should be added thoughtfully, but the steeper municipal curve makes intermediate and select longer maturities more compelling than they were when investors were paid very little to extend.

Credit fundamentals remain broadly sound. State and local governments continue to benefit from healthy reserves, manageable debt burdens, and essential-service revenue streams. However, the sector is becoming more selective. Certain areas, including weaker health care issuers, small colleges, transit systems, project finance, and lower-rated credits, may face greater pressure from rising costs, demographic shifts, or uneven revenue trends.

Therefore, our constructive view is not a call to reach indiscriminately for yield. Rather, we favor high-quality tax-exempt income, active credit selection, and disciplined duration exposure. In a market where corporates appear expensive, municipals offer a differentiated source of income, resilience, and potential opportunity.

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Confluence Investment Management LLC

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