

Conflict, Curves, and Credit *Stability in an Unstable World*

- In the early weeks of the conflict with Iran, prices were pressured lower across stocks, bonds, and gold, while the US dollar and crude oil posted gains.
- The expectation for further Fed easing dissipated in the first quarter as the Fed evaluated ongoing inflationary pressure from tariffs plus short-term pressure caused by higher oil prices.
- A shift to tighter Fed policy expectations often pressures Treasury yields higher, and this dynamic offset a decline in yields caused by safe-haven buying.
- We recommend an underweight exposure to corporates and overweight allocations to Treasuries and MBS.
- Munis remain supported by strong demand, with higher Treasury yields creating modest pressure and better value in the intermediate section of the curve, reinforcing the case for selective exposure rather than broad beta.
- With low relative volatility, bonds continue to provide important risk control in portfolios. We recommend exposures to intermediate maturities with a duration profile a bit shorter than common bond indexes.

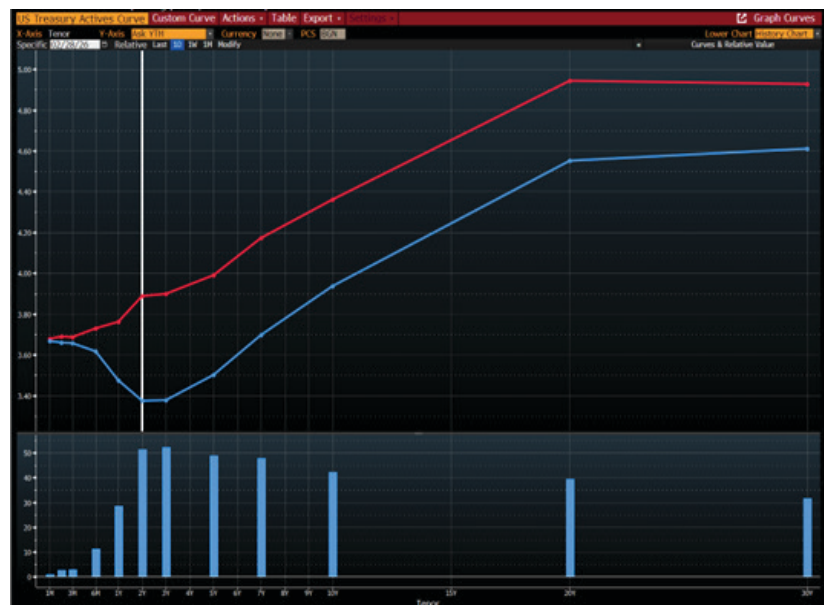
The first quarter was marred with rising uncertainty as the conflict with Iran came to a head in March. Two consequences were front of mind in the bond market. Inflation, which was already above the Fed's 2% stated target before the conflict, could experience incremental cyclical pressure from the spike in oil prices and cause the Fed to shift away from easier policy. At the same time, concerns arose about the possibility of a recession, which may foster lower inflation and easier Fed policy. Equity, bond, commodity, and currency markets responded in disparate ways to the conflict, making it difficult to know which force was dominant.

The Fed's policy direction was on a knife's edge prior to the conflict, with FOMC voting members expressing a wide range of opinions on whether to continue easing, hold steady, or even tighten. Ultimately, the bond market came to a consensus that the Fed would shift away from easier policy. We can see this change in our first graph, which illustrates the Treasury yield curve just prior to the beginning of the conflict (blue line) compared to conditions near the end of March (red line). The two-year Treasury yield (white line) can serve as a good proxy of expectations for the average Fed overnight rate for the next couple of years. Therefore, the rise in the two-year yield reflects how expectations have changed.

The blue bars on the bottom of the chart show how much yields have risen across maturities. Usually, when market risk rises, investors tend to shift away from "risk assets," which drives Treasury yields lower. However, it's also often the case that longer-term yields rise when the Fed shifts to tighter policy. With these two forces working against each other, it appears that tighter Fed policy exerted more pressure on moving rates higher than the downward pressure of safe-haven buying, at least in the early weeks of the conflict.

Beyond the tenor of the two-year maturity, we see an interesting dynamic in that the shape of the curve is largely unchanged. Maintenance of this shape tells us that although recent concerns have caused the Fed to shift away from easing, longer-term

Treasury Yield Curves



(Sources: Bloomberg, Confluence)

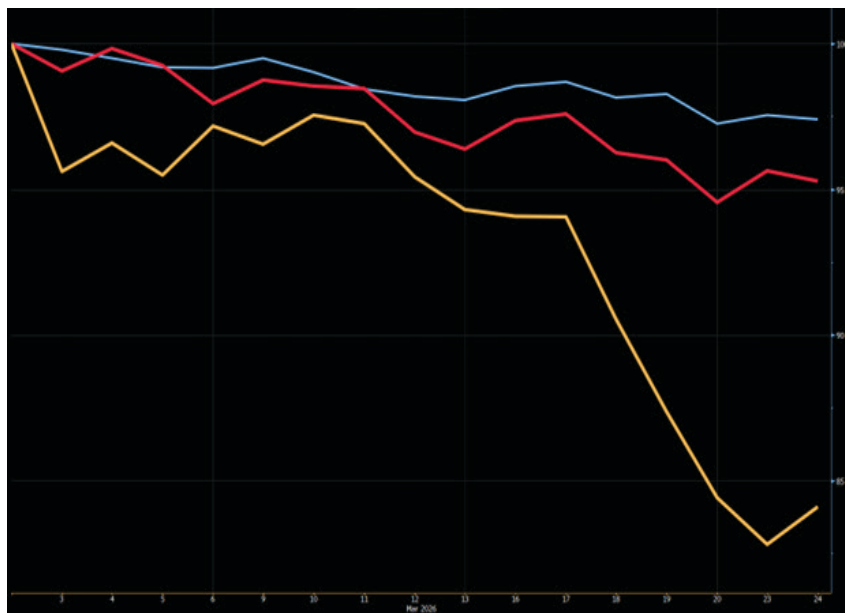
expectations are stable because the shift in rates across maturities has generally been parallel. Perhaps this is an indication that lower economic growth will offset inflationary pressures, but it might also reflect a measure of respect for the Fed's ability and willingness to address inflation over multi-year periods. Regardless, we believe the curve still lacks enough slope to compensate for inflation uncertainty; therefore, we prefer a focus on intermediate maturities with an overall duration profile that is slightly shorter than common bond indexes.

Treasury Sector

The conflict with Iran had a broad effect across a wide range of markets. The downward pressure was, in many circumstances, quite acute, and riskier asset classes declined, including most equities and REITs. Meanwhile, both the US dollar and crude oil rose. Somewhat surprisingly, both gold and US Treasuries traded lower, even as these asset classes have historically been regarded as safe havens. On the accompanying chart, we show the price changes of Treasury bonds (blue), equities (red), and gold (yellow), normalized to a common beginning point, just before the conflict began.

Commodities and equities have much higher volatility profiles relative to bonds, a condition apparent through the early weeks of the conflict. So, while Treasury bond prices did decline, the low volatility profile meant that the downward pressure was mild relative to equities and gold. It has been somewhat disappointing that, in the early weeks of the conflict, the correlation between risk assets and Treasury bonds has been positive, meaning that portfolio diversification utility has been lower. Nonetheless, the consequences of the conflict are wide ranging, and the outcomes are still uncertain. Therefore, the low relative volatility of Treasuries can continue to provide an important measure of portfolio risk control, particularly if the Iran conflict becomes more complicated and longer in tenor. For this reason, we recommend an overweight exposure to Treasuries.

Relative Price Changes of Gold (yellow), Stocks (red), and Treasuries (blue)



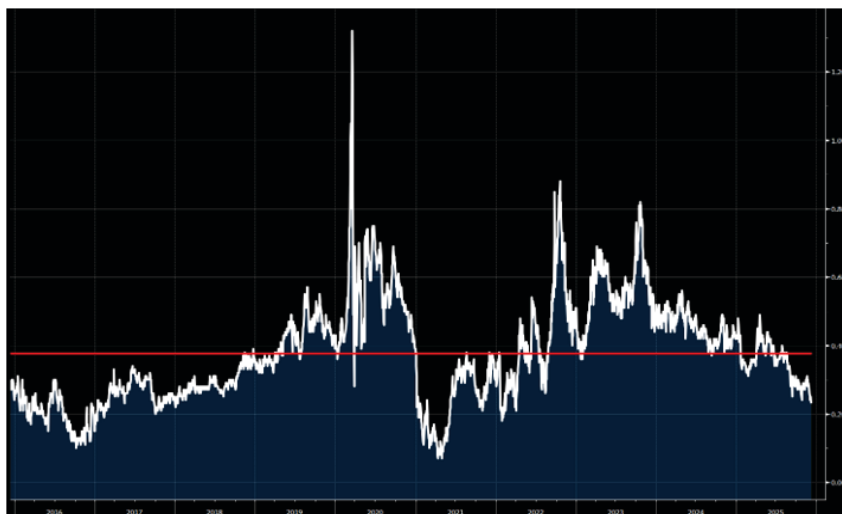
Gold is represented by the US dollar spot price; stocks are the S&P 500; bonds reflect the active 10-year Treasury price. (Sources: Bloomberg, Confluence)

Corporate Sector

Investment-grade corporate bond spreads widened in the first quarter and, given the downward pressure exerted on riskier assets by the Iran conflict, it would be reasonable to presume that the conflict is the cause. However, a closer evaluation reveals that most of the widening of the spread actually occurred prior to the conflict. The natural questions are why were spreads widening before the conflict, and why haven't they widened more since it began?

On the former question, our view is that corporate bond spreads began the year at historically tight levels, likely a function of high liquidity and mild levels of defaults (see the chart, where the red line illustrates the 10-year average spread). When spreads are unusually tight, there is a tendency to tack back toward historical levels. This factor may have been at play, although it seems that widespread concerns about the private credit markets probably also played a role. We mentioned last quarter that we don't believe a systemic problem exists in private credit markets, and we continue to believe that is the case.

Investment-Grade Bond Spreads, 10 years ending March 2026



(Sources: Bloomberg, Confluence)

On the latter question, it is rather enigmatic that corporate bond spreads haven't really widened much since the Iran conflict began, even as riskier asset classes generally declined. It could indicate that corporate bond investors don't believe a recession is very likely. However, given the rising level of uncertainty related to inflation, economic growth, Fed policy, and the Iran conflict, we believe corporate spreads should be wider than the historical average, not tighter. Accordingly, we recommend an underweight exposure to the corporate bond sector.

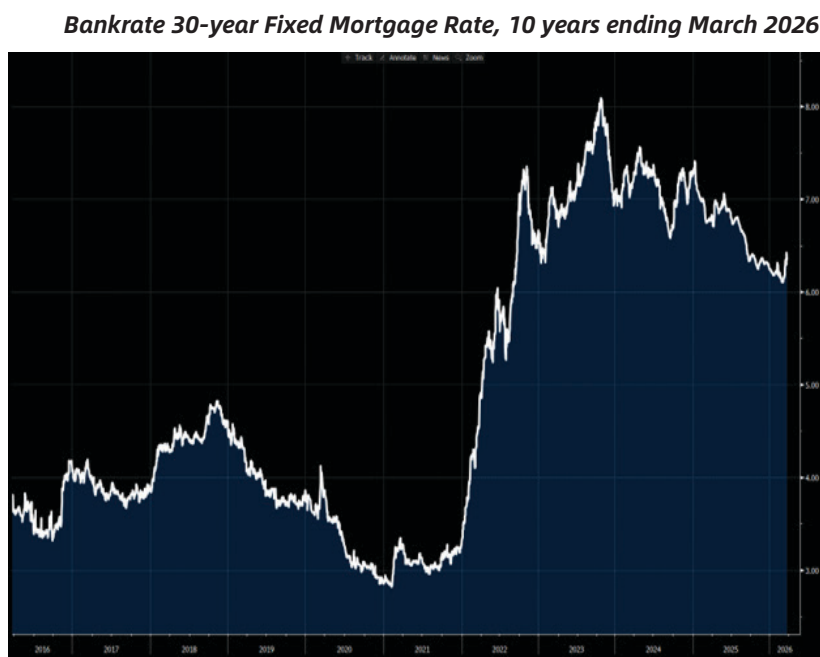
Mortgage-Backed Securities (MBS) Sector

Conditions continue to evolve across different corners of the financial markets, but we see ongoing stability in the MBS sector, even as there are some notable forces in the mortgage market. Perhaps the most visible is a widespread desire for low mortgage rates. Policy makers, new homebuyers, and existing homeowners would all prefer to see mortgage rates decline. Lower mortgage rates increase affordability for new homebuyers, while also creating optionality (to move or refinance) for existing homeowners. In addition, housing turnover and refinancing both tend to stimulate economic growth.

So, at what level would we consider a mortgage rate "low"? For new homebuyers, an attractive 30-year mortgage rate today would generally be below 6%. Although this level is an improvement relative to recent years, it's still not low enough to address the escalation in home prices. To really move that dial, 30-year mortgage rates would need to decline by 1-2%. At the same time, existing homeowners who took advantage of low rates during the pandemic would face higher mortgage payments today if they were to move. According to FHFA, over half of active mortgages are at rates less than 4%. Thus, while low mortgage rates were beneficial during the pandemic, the residual effect today dampens homeowner mobility and effectively takes refinancing out of the picture.

Given the broad preference for lower mortgage rates, it's natural to wonder what's keeping them high. The answer is related to the 10-year Treasury, which is the reference rate for 30-year mortgages. The 10-year Treasury yield is a market rate, which is set by a multitude of market forces and is generally outside the direct control of policymakers. Policies have emerged to make mortgages more widely available, and Fannie Mae and Freddie Mac are purchasing MBS. These efforts can help lower rates at the margin, but the linchpin remains the 10-year Treasury yield. At this juncture, a decline of over 1% seems unlikely, suggesting little improvement in housing turnover any time soon.

For MBS investors, stubbornly high mortgage rates provide a measure of ongoing stability. Seasoned MBS durations are unlikely to extend, and any declines in mortgage rates would increase MBS prepayments, allowing MBS investors to monetize deep discounts to par that are currently in the market. We feel these conditions create an attractive return/risk profile and lead us to recommend an overweight allocation to the MBS sector.



(Source: Bloomberg)

Municipal Bond Sector

Municipal bonds have been influenced more by shifting rate expectations than by any deterioration in underlying credit conditions. As the market adjusted to a reduced likelihood of near-term Fed easing – driven in part by persistent inflation pressures and higher oil prices – Treasury yields moved higher, creating modest headwinds for municipal valuations.

Despite this pressure, demand for municipal bonds has remained strong, supported by consistent inflows and reinvestment needs. This technical backdrop has helped stabilize the market and absorb increased issuance, while also allowing for some improvement in relative value, particularly in the intermediate portion of the curve.

Fundamentally, municipal credit remains sound. State and local issuers continue to benefit from conservative fiscal management and elevated reserve levels built over recent years. While revenue growth has normalized from post-pandemic highs, collections across personal income, sales, and property taxes remain sufficient to support operating budgets and debt service. Importantly, issuers have demonstrated flexibility in adjusting expenditures as conditions evolve, preserving credit quality across the market.

At the sector level, essential-service revenue bonds (water, sewer, electric utilities, and transportation) continue to exhibit durable fundamentals, supported by predictable demand and rate-setting authority. Healthcare and higher education remain more uneven, reinforcing the need for careful credit selection, though pressures appear isolated rather than systemic.

Overall, defaults remain rare, rating agency outlooks are stable, and credit deterioration is largely idiosyncratic. In the current environment, municipal bonds continue to offer high-quality, tax-efficient income, with performance increasingly shaped by interest rate movements and curve positioning rather than changes in credit fundamentals.

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