

## What Hump?

- The current yield curve reflects expectations of easier Fed policy, implying an overnight rate of around 3% in coming years.
- Longer-maturity Treasuries indicate positive economic growth with a measure of inflation.
- Although tariff and immigration policies pose some uncertainties regarding growth, inflation, and Fed policy, attractive opportunities exist in intermediate maturities.
- We recommend overweight exposures in the Treasury and Mortgage sectors, with an underweight allocation to Corporates.
- We suggest a slightly shorter overall duration posture.

In 1974, cinematic fans were treated to the release of *Young Frankenstein*, a film co-written by Mel Brooks and Gene Wilder, who also starred in the production. The character of Igor, played by Marty Feldman, had a large hump on his back. Igor was seemingly in denial of the hump's existence, comedically responding, "What hump?" to an inquiry about the condition. The hump also changed from one side of his back to the other throughout the film. Fifty-one years later, we currently have a bond market characterized by a shifting hump.

This chart shows the US Treasury market yield curves. The blue line illustrates the yield curve from December 2022 (near the end of the Fed's aggressive tightening cycle), with its "hump" in short maturities, forming an inverted yield. The red line shows the current yield curve, where the hump has now shifted into longer maturities, forming an upsloping yield curve. The blue line reflects the previous market expectation that the Fed would take its rate target above 5%, which turned out to be a generally correct forecast. The inverted shape, though, indicated an expectation that the Fed would tighten too much and cause a recession, which turned out to be an incorrect forecast.

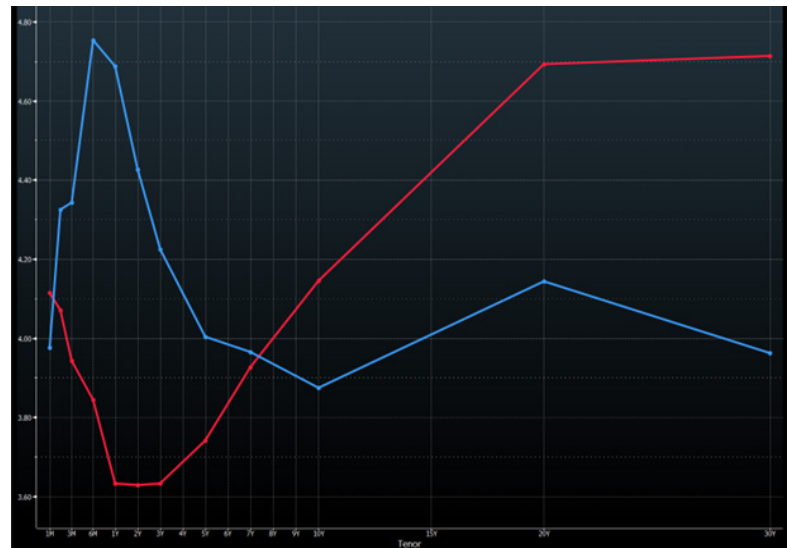
Today's yield curve in red illustrates the expectation that the Fed will likely lower short-term rates by 1.0-1.5% over the course of the next couple of years. The positive slope after the third year indicates a broad expectation of future growth and modestly higher inflation. Still, the ongoing inversion in shorter maturities obviates the characterization of the current yield curve as normal. In the parlance of *Young Frankenstein*, a better label might be "Abby Normal."

For our part, we're mostly in agreement with the broad expectations reflected in today's yield curves, although it's not obvious if the Fed will be able to ease its overnight rate all the way down to the neighborhood of 3%. Changing tariff and immigration policies create uncertainty with regard to both growth and inflation. But the economy has proven quite resilient thus far and a recession seems unlikely. We believe the shifting of the hump from the short end to longer maturities creates an attractive point in intermediate maturities with an overall duration posture that is slightly shorter than normal. Perhaps it could also be characterized as Abby Normal.

## Treasury Sector

The bond market has steadily delivered good returns so far in 2025, even as most markets have experienced higher levels of volatility. Long-term Treasury rates are mostly unchanged this year, while short- and intermediate-maturity yields have declined. These declines reflect an expectation that the Fed will continue to ease, ultimately lowering its overnight interest rate target to around 3%. Meanwhile, the long-term rate stability indicates inflation may rise a bit but won't get out of control.

Treasury Yield Curves: December 2022 and September 2025



(Sources: Bloomberg, Confluence)

We believe it's a little early to make a call either way. The ultimate effects of new policies related to tariffs and immigration are still unknown, and we feel these are difficult to predict. On the one hand, if growth is curtailed, the Fed may feel compelled to ease more aggressively. On the other, if inflation emerges, the Fed may be somewhat limited in how much it can ease, while longer maturity Treasury yields may be pressured upward.

Fortunately, we believe there's a fairly straightforward strategy to address the current uncertainty: Focus on intermediate maturities, particularly in the 7-10-year range. We believe this part of the yield curve provides a dual utility. First, this tenor helps protect against high levels of reinvestment risk in cash and short-maturity bonds. Second, yields around 4% are attractive and above our expected level of inflation. Against this backdrop, we suggest a modest overweight to the Treasury sector with this posture.

## Corporate Sector

Credit remarks remain awash in a high level of liquidity, likely a combination of an ongoing low default environment, attractive nominal yields, continuing economic growth, easier Fed policy, and a manageable inflationary trend. Coming into 2025, corporate lending spreads were historically tight, but uncertainty related to tariffs widened spreads in the second quarter. Then, as markets adjusted to new policies and economic growth and inflation remained on constructive paths, credit spreads again returned to historically tight levels. On this chart, the 10-year average spread is the red line.

In our view, one of the consequences of the pandemic was that it lengthened the credit cycle by re-setting lending terms. Effectively, this allowed the corporate credit market to establish proper lending standards without having to work through an unpleasant default period. However, we're now a few years past that reset and with corporate spreads well below the 10-year average, we feel the return opportunity isn't particularly compelling, especially when tight spreads have eliminated a margin of safety. For these reasons, we recommend an underweight allocation to the Corporate sector.

*Corporate Investment-Grade Spreads, 10 years ending September 2025*



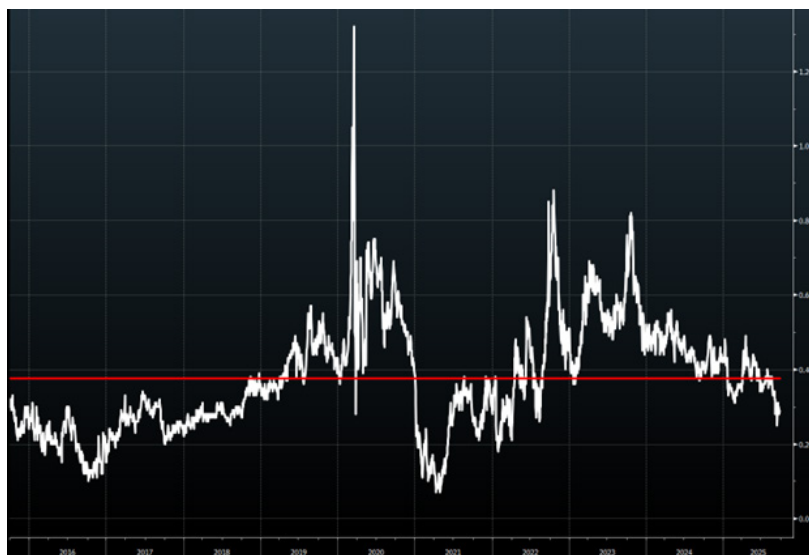
(Sources: Bloomberg, Confluence)

## Mortgage-Backed Securities (MBS) Sector

The MBS sector began 2025 with attractive spreads that continue to deliver good value in the bond market. High-quality Agency MBS provide an opportunity to allocate to intermediate maturities, while taking de minimis credit risk. Typically, the tradeoff for high MBS credit quality is substantial interest rate risk. For example, if interest rates rise, then refinancing slows, MBS duration extends, and prices are pressured lower. However, if interest rates decline, then refinancing increases and MBS duration shortens, creating heightened reinvestment risk. Accordingly, MBS often deliver more attractive returns when interest rates are generally stable.

Still, the current environment remains unique. Mortgage rates reached historic lows during and immediately after the pandemic, allowing a considerable proportion of homeowners to lock in fixed rate mortgage rates in the 3-4% range. These loans were pooled into MBS that also have fixed-rate coupons. With rates having moved higher, these MBS are now trading at deep discounts to their par values, with many prices around 85-90. At the same time, these MBS durations are less likely to extend, having already lengthened as few homeowners are interested in refinancing their mortgages. Taken all together, these low-coupon MBS would have lower duration risk if rates rise, while also having substantial upside to prices if rates decline.

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



(Sources: Bloomberg, Confluence)

Earlier this year, the constructive environment for MBS was generally not reflected in MBS spreads, which were higher than the 10-year average (red line on the previous chart). Although MBS spreads tightened below the long-term average later in the summer, we still find the sector to be a compelling value because of these unique circumstances. For this reason, we recommend an overweight allocation to the MBS sector.

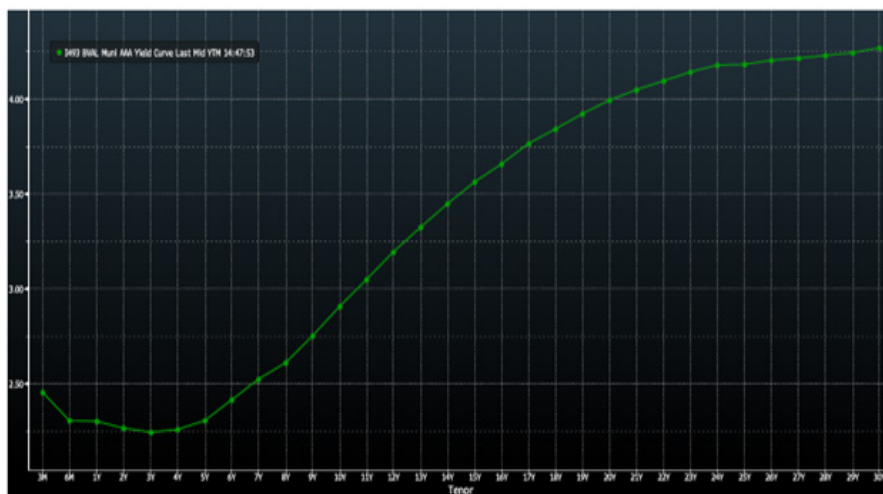
## Municipal Bond Sector

The municipal bond market has experienced a challenging yet dynamic year, shaped by shifting supply and demand conditions, evolving policy discussions, and strong underlying credit fundamentals. Through mid-2025, new issuance of tax-exempt municipals had surged to roughly \$256 billion, a 16% increase from last year that pressured valuations and contributed to weak sector returns earlier in the year. Rising supply, coupled with outflows from muni funds, left longer-dated maturities particularly vulnerable, steepening the yield curve as long-term yields rose faster than those at the front end.

Policy uncertainty also weighed on sentiment, with renewed debate about limiting state and local tax (SALT) benefits or altering the tax treatment of municipal interest. While those proposals have since lost momentum, the early uncertainty added to market volatility. More recently, however, conditions have improved. Demand has strengthened with renewed inflows into muni funds, and attractive yields relative to Treasuries have brought crossover buyers – non-traditional investors – back into the market.

Despite these swings, municipal credit quality remains a pillar of support. Most issuers are maintaining strong balance sheets and healthy reserves. With better liquidity, improved demand, and favorable relative yields, we believe municipals enter the second half of 2025 on stronger footing, offering compelling opportunities for tax-sensitive investors.

**Municipal Yield Curve, 3-month to 30-year yields**



(Source: Bloomberg)

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