

Roosting Hawks & Rising Rates

Sticky Near-Term Inflation Amid Elevated Oil Prices

- Bonds continue to offer attractive yields with low volatility.
- Treasury yields have risen in response to oil-induced inflation and changing Fed policy. Longer-term rates indicate an expectation of milder future inflation.
- Corporate bond issuance is elevated, while spreads are historically tight.
- The return/risk profile of MBS remains attractive.
- Municipal bond yields have risen amid record issuance and tighter Fed policy, improving tax-exempt income opportunities despite near-term price pressure.
- We favor a modestly shorter duration profile and extend the recommended overweight in Treasuries and MBS, with a continued underweight to corporates.

Around the world, inflation hawks came home to roost at global central banks during the summer. In the US, the Federal Reserve raised the federal funds rate by a quarter point, reversing course from the rate cuts of 2024 and 2025 (see Figure 1). The Fed was joined by the central banks of the eurozone, the UK, Japan, and Canada, all of which either raised rates or held steady with hawkish messages. Persistent signs of above-target inflation were mostly attributed to the Iran conflict and elevated energy prices, along with their ripple effects. For example, high oil prices led to high diesel fuel prices, which in turn have led to higher prices for agricultural and consumer products that rely on diesel for harvesting and transportation. In response to uncertainties about the duration of elevated oil prices and the extent of these inflationary ripple effects, central banks proceeded with tighter monetary policy.

While inflation clearly weighs on the health of the consumer, the changing shape of the Treasury yield curve implies that its recent escalation is not yet a long-term concern for bond investors. The entire yield curve rose after the Iran war began, with shorter-maturity yields rising more than those of long-dated maturities (see Figure 2). This suggests the market does not expect a long-term upward shift in inflation beyond the effects of the conflict-induced price increases. It further implies measured confidence that the Fed and other central banks will take adequate measures to combat inflation, rather than allow it to accelerate as it did post-COVID.

Other longer-term measures also support this view. The closely followed five-year breakeven rate, which indicates inflation expectations by subtracting inflation-protected interest rates from nominal rates, has held steady at lower long-term levels. In fact, longer-term inflation on this metric is below the five-year average of 2.5%, depicted by the red line in Figure 3 (next page).

Figure 1: Federal Funds Target Rate

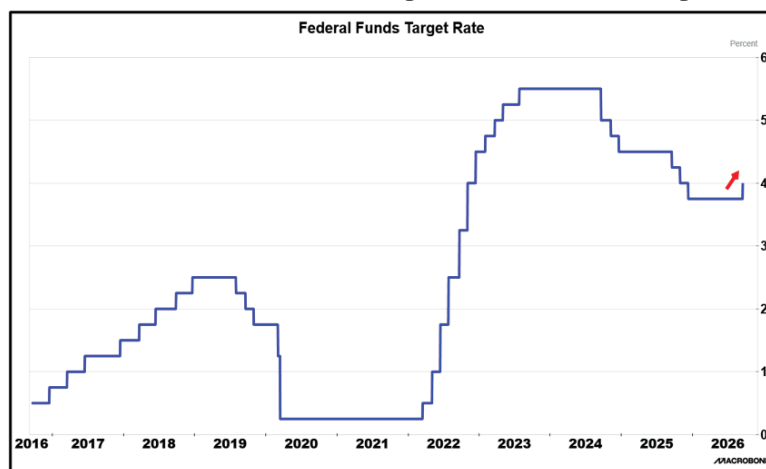
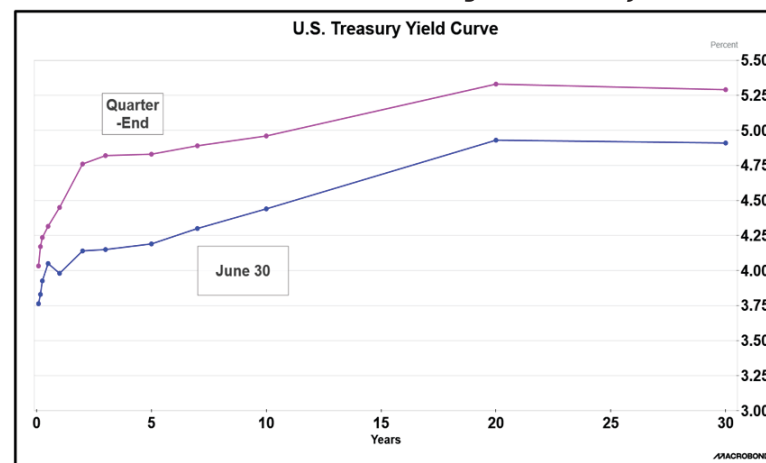


Figure 2: Treasury Yield Curve



For perspective, the recent increase in rates pales in comparison to 2022, when high inflation triggered rapid rate hikes by the Fed. The bond market, as measured by investment-grade indexes, has delivered only modestly negative returns through the end of summer this year, in sharp contrast to the much larger losses delivered in 2022. To that end, even as rates around the world have risen to multi-decade highs, the US 10-year Treasury has generally stayed within its five-year trading range. The bond market has performed more mildly than headlines suggest.

We believe bonds offer important portfolio utility, particularly where income and risk control are priorities. We continue to favor a short- to intermediate-maturity profile, utilizing ladders. This profile delivers a mid-single-digit yield at a healthy premium to inflation with relatively low volatility. We recommend maintaining an overall duration profile that is slightly shorter than common investment-grade benchmarks.

Treasury Sector

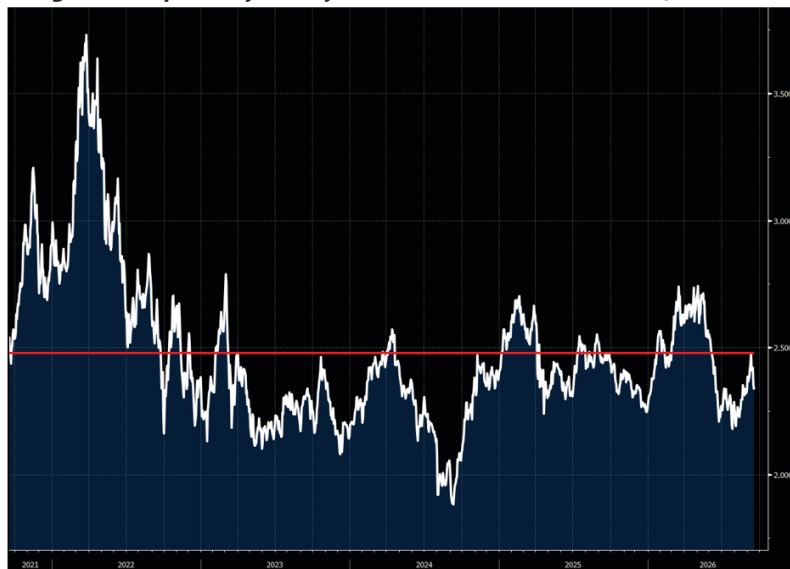
In our view, robust economic growth is a primary driver shaping the Treasury yield curve, including the 10-year rate. Looking back to the turn of the century, nominal US GDP growth has exceeded the yield on the 10-year Treasury by roughly 1%, on average. Accordingly, the recent increase in the 10-year rate reflects ongoing economic growth and roughly aligns with historical trends. The economy's recent acceleration widened the gap to roughly 1.5% during the third quarter (see Figure 4). If economic growth remains robust, the 10-year yield may continue to rise; however, if growth decelerates, the door may open for the yield to decline.

A second major force has been the oil price shock caused by the Iran conflict. Although oil prices and Treasury yields are not usually correlated, this can change during oil price shocks, and Figure 5 depicts how the correlation especially tightened over the summer. The recent rise in the 10-year Treasury resembles patterns seen during past oil price shocks, suggesting markets recognize that high levels of inflation may affect near-term Fed policy. However, since longer-term maturities incorporate longer-term inflation expectations, increases in their yields have been more muted relative to shorter maturities. Still, the longer the oil supply disruptions last, the longer current inflation may persist, which could ultimately pressure Treasury yields even higher. If oil prices were to decline, history suggests that the recent increase in the 10-year Treasury yield, along with the rest of the yield curve, may at least partially reverse.

With elevated fiscal spending, one thesis has gained headline traction: Rising government debt is driving up interest rates. Although this concept may seem to be common sense, there is actually no historical relationship between the size of the budget deficit and the direction of interest rates. To that end, just because rising government debt and higher rates have recently unfolded concurrently, it does not confirm causality. History has shown that economic growth, inflation expectations, oil price shocks, and Fed policy are longstanding drivers of interest rate direction. We believe that remains the case in the current cycle.

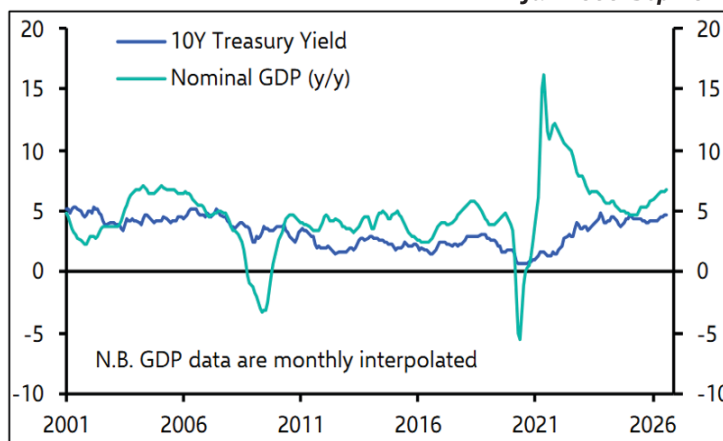
Treasuries offer attractive mid-single-digit yields at a healthy premium to inflation, with high liquidity and virtually no credit risk. For these reasons, we continue to prefer an overweight exposure to the Treasury sector.

Figure 3: Implied Inflation from Five-Year Breakeven Rate, 2021-2026



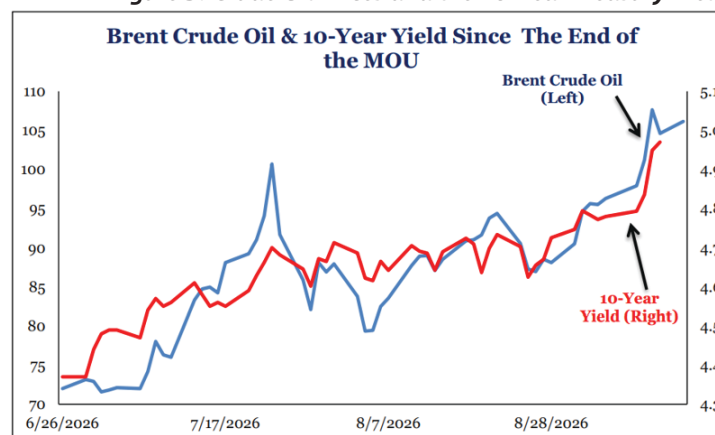
(Sources: Bloomberg, Confluence)

Figure 4: Economic Growth & the 10-Year Treasury Yield, Jan 2000-Sep 2026



(Source: Strategas)

Figure 5: Crude Oil Prices and the 10-Year Treasury Yield



(Source: Strategas)

Corporate Sector

The record-setting volume of investment-grade (IG) corporate issuance persisted in the third quarter, with both July and August setting monthly records. Issuance for the year through August reached nearly \$1.9 trillion, increasing nearly 30% through the same period in 2025. Although large technology companies led the way, many corporations took advantage of historically tight spreads with new issuance. This pace appears set to continue, especially in the technology sector, where hyperscalers plan to keep expanding data center and related infrastructure beyond 2026.

Although the market has thus far absorbed this supply, signs of saturation are appearing. The technology sector has shifted capital raising to foreign markets, with large issuances in the European Union, United Kingdom, Canada, and Japan. Additionally, hyperscalers have often had to offer higher yields on subsequent issuances in order to attract more buyers. This has resulted in “dislocated debt” – bonds trading at spreads wider than normal for their credit ratings. Of the roughly \$12 trillion of IG debt in the US and Europe, nearly \$1 trillion of that value has traded at dislocated spreads. Corporate earnings are holding up well, with low default rates among IG corporate borrowers, keeping credit quality relatively strong. However, with corporate spreads at historically tight levels along with increasing signs of saturation, we maintain our underweight recommendation.

Mortgage-Backed Securities (MBS) Sector

Housing affordability challenges worsened in the third quarter. Rising mortgage rates (see Figure 6), insurance costs, and tax burdens have raised the effective price of entry for homebuyers. Mortgage rates had been generally declining for the better part of three years, briefly dropping below 6% before the Iran conflict, but have since churned back to nearly 7%. Meanwhile, after rising more than 25% in recent years, homeowners insurance has risen an additional 4-8% this year, and property taxes have also risen nearly 4% on average in 2026. Taken together, the typical American family now needs 36% of its household income to cover its mortgage payment, well above the industry-standard 28% guideline. Strained housing affordability is weighing on home sales and, therefore, the volume of new mortgage originations remains low.

Rising rates have also curtailed the pace of refinancings. The decline in rates last year and in the beginning of 2026 inspired a wave of refinancings, but, with rates back to nearly one-year highs, fewer than 5% of borrowers now have an economic incentive to refinance for a rate reduction alone. As a result, refinancings now account for only 10% of new mortgages compared to roughly 50% earlier in the year.

Taken together, these trends are constricting the supply of new MBS. The Mortgage Bankers Association’s index of mortgage applications has declined roughly one-third since the eve of the Iran conflict, including a 9% decline in the third quarter (see Figure 7), which has downstream effects on the supply of new MBS. Meanwhile, aggregate demand has held relatively steady, with the government-mandated \$200 billion purchase program from FNMA and GNMA partially offsetting the Fed’s decision to reduce its MBS portfolio.

Because mortgage refinancing volume has been low for quite some time, MBS duration has already lengthened, and incremental extension risk has become limited. At the same time, seasoned MBS are trading at deep discounts to par, which should provide capital appreciation upside if refinancing picks up (though we think this does not seem likely in the near term). Accordingly, we consider the return/risk profile of MBS to be historically attractive, and we extend our overweight recommendation.

Municipal Bond Sector

The municipal bond market faced a more challenging environment during the third quarter as rising interest rates and exceptionally heavy new issuance weighed on prices. Tax-exempt issuance stayed at a record pace, reflecting ongoing infrastructure needs, rising construction costs, and investment in areas such as utilities and data center and related infrastructure. Despite the heavy supply, investor demand remained strong for much of the quarter, helping the market absorb the elevated issuance.

Figure 6: Average 30-Year Fixed Rate Mortgage

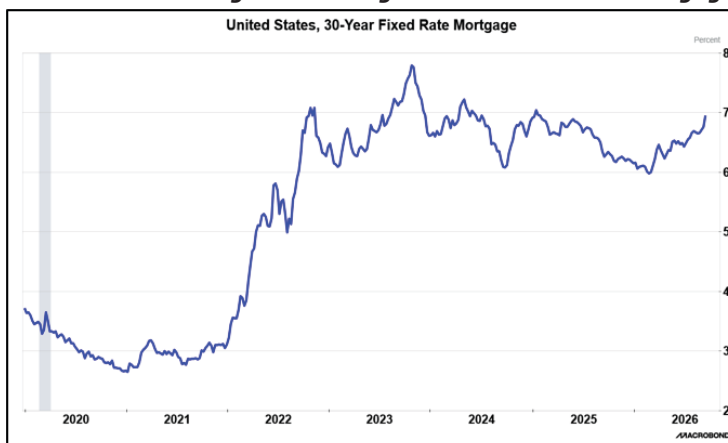
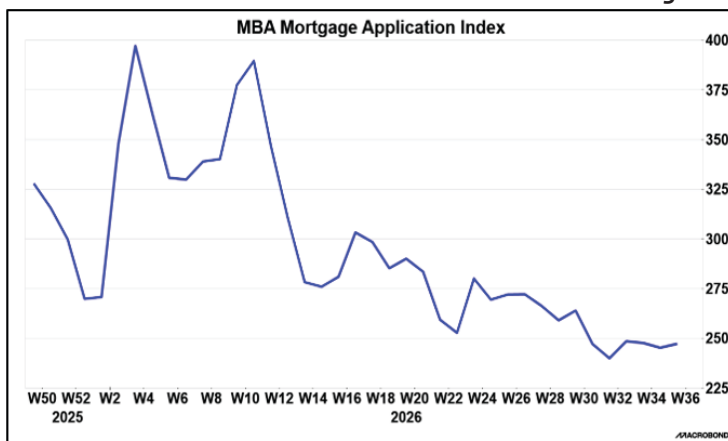


Figure 7



That supportive technical backdrop weakened somewhat in September as rising inflation expectations and a more hawkish Fed pushed yields higher across the municipal curve. Intermediate- and longer-maturity bonds experienced the greatest price pressure as rates rose, while fund flows also softened after an extended period of strong inflows.

Although higher yields have pressured near-term returns, they have also improved the sector's prospective return profile. Tax-exempt yields are now attractive on an absolute basis and translate into compelling taxable-equivalent yields for investors in higher tax brackets. Credit fundamentals are also broadly sound, with many state and local governments maintaining healthy reserves and manageable debt burdens.

Accordingly, we favor high-quality municipal bonds while maintaining a disciplined approach to both credit and duration. Heavy issuance may continue to create periods of volatility, particularly if rates remain elevated, but strong underlying demand and healthy municipal credit fundamentals provide support. We believe the recent rise in yields improves the longer-term return opportunity, particularly in short to intermediate maturities, where investors can capture attractive tax-exempt income without assuming the full interest rate sensitivity of the long end of the curve.

Confluence Fixed Income Strategy Committee

Mark Keller, CFA

David Miyazaki, CFA

Patrick Fearon-Hernandez, CFA

Greg Ellston

Kaisa Stucke, CFA

Daniel Ortwerth, CFA

For more information, contact a member of our Sales Team:

(314) 530-6729 or sales@confluenceim.com

See [Territory Map](#) on the Confluence website for sales coverage

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the author(s). Information is based upon sources and data believed to be accurate and reliable. Opinions, estimates, and forward-looking statements are as of a certain date and subject to change without notice. Actual results could differ materially from the results indicated by this information. References to expected returns are not promises or even estimates of actual returns an investor may achieve. Forecasts of financial market trends are subject to change without notice. Opinions expressed do not constitute investment, legal, tax, accounting or professional advice. Always consult an adviser regarding the legal, tax and financial suitability of securities investing. This information is provided for educational and illustrative purposes only and should not be construed as individualized advice or a recommendation. Such information should not be relied upon for, or in connection with, the making of investment decisions and is not an offer or solicitation to buy or sell any security or investment product. Investments or strategies discussed may not be suitable for all investors and investors should seek advice from an investment professional, if applicable. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Investing involves the risk of loss of the amount invested that investors should be prepared to bear. Please refer to our current written disclosure statement for a description of the risks associated with our investment strategies. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses. Investor results will vary, and past performance is not indicative of future results, which will fluctuate as market conditions change. A copy of Confluence's current written disclosure statement discussing our business operations, services, and fees is available upon request.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics, and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.