WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

September 30, 2025

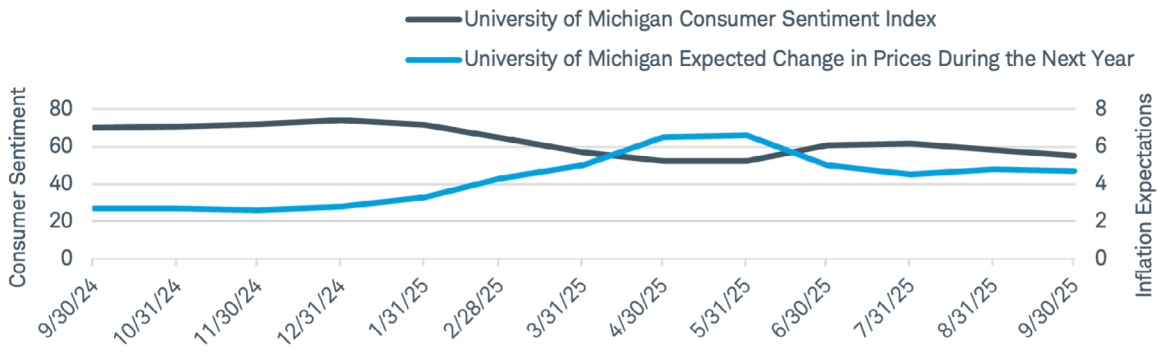
The Return of Jay

Brian Ferry, Senior Portfolio Manager

The Federal Reserve (Fed) cut rates by 25 basis points (bps) at the September meeting, prompting investors to price in 1-2 additional cuts by year-end. It has been a full year since the Fed started their abrupt rate-cutting cycle last September. In a short twelve-month period, the U.S. economy has faced countless bouts of uncertainty around a resurgence in inflation and multiple growth scares due to fiscal policy. In the third quarter, the fixed income market started to gain clarity on the immediate impact of the new administration policy. Impacts from these policies, in our view, will take time to play out over the intermediate term, and the new policies may not be as disruptive to the economy as initially feared.

One of the biggest surprises last quarter was the continued upward revisions to second quarter GDP. When the final data set was released, GDP came in at an impressive 3.80%, a significant improvement over the negative -0.60% print in the first quarter. The consumer powered the economy yet again, despite their broader economic concerns. Consumers pivoted quickly and switched their spending to services from goods–which are not as impacted by tariffs. Business investment also remained healthy and was a positive contributor to the upward revisions in Q2's GDP, partly due to the massive artificial intelligence (AI) spend. Inflation, on the other hand, showed signs of unease in the report. It has been steadily on the rise since April and is expected to remain elevated, and above the Fed's target, as shown in the release of their most recent projections.

U. of Michigan Sentiment (1yr data set/monthly) and U. of Michigan 1yr Inflation Expectations (1yr data set/monthly)



Source: Bloomberg as of 9/30/2025

If growth is better than expected and inflation is elevated why did Fed Chair Jay Powell and the FOMC cut rates at their September meeting? The short answer is the labor market. The Fed has long stated that its dual mandate of price stability and full employment have been equally balanced, however, at the last meeting they turned their focus to employment by their actions. Earlier in September, a week before their last meeting, the Bureau of Labor Statistics released their annual Payroll Revision report which showed 911,000 fewer jobs were created over the previous 12 months than originally thought –which could raise alarms for voting members. The current government shutdown does not help the employment picture

and is a net negative regardless of its duration. The economy has demonstrated resilience in navigating numerous self-inflicted wounds this year, but the accumulation of events may have finally begun to take its toll and, we believe, that's why Chair Jay Powell has re-entered the ring.

Tax-Exempt Market

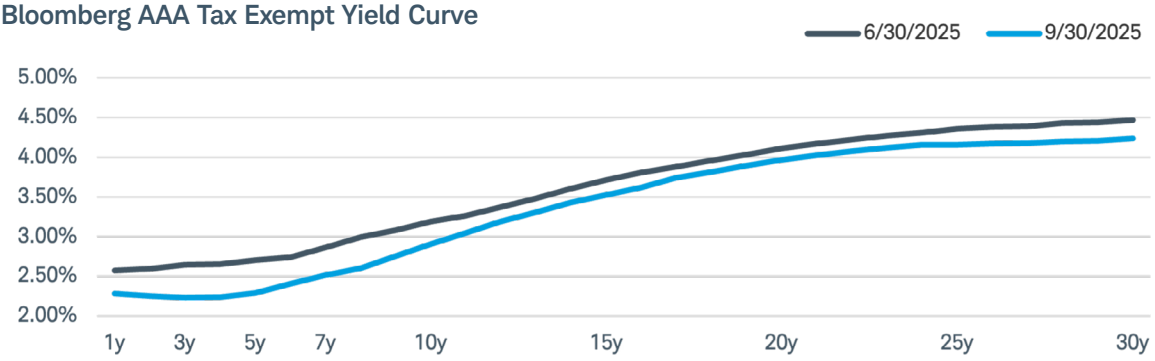
Jason Diefenthaler, Managing Director and Head of Taxable and Municipal Strategies

The 3rd quarter was marked by shifting economic winds, as inflation uncertainty kept policymakers on cautious footing despite the labor markets exhibiting notable signs of weakness. U.S. Treasury yields finished the quarter modestly lower across the curve, although the quarter over quarter view masks a period of relatively high intra-quarter rate volatility. Ten-year Treasury yields hit a high of 4.48% in July, a low of 4.02% in September, and closed out the quarter at 4.15%. Treasury yield curve movements were notable during the period. The 2-year to 10-year slope (2s10s) increased by as much as +61 bps in late August, 3 bps steeper than where the quarter began. The 2-year to 30-year (2s30s) slope reached a multi-year high of +131 bps in August before finishing at +112 bps, roughly 6 bps steeper for the quarter. Against this backdrop, the Bloomberg U.S. Treasury Index posted a total return of 1.51% during the quarter.

After underperforming Treasuries throughout the first half of the year, municipal bonds bounced back with strong relative performance during the period. The Bloomberg Municipal Bond Index returned 3.00% in the 3rd quarter, outperforming the Bloomberg U.S. Treasury Index by 148 bps. The quarter was punctuated by September performance, with the municipal market posting its strongest single month return since late 2023.

Tax exempt yields declined meaningfully across the curve, with shorter maturities leading the rally. Two-year AAA yields fell 35 bps to 2.25%, five-year yields dropped 41 bps to 2.29%, 10-year yields fell 29 bps to 2.90%, and 30-year yields declined 23 bps to 4.24%.

Bloomberg AAA Tax Exempt Yield Curve



Source: Bloomberg as of 9/30/2025

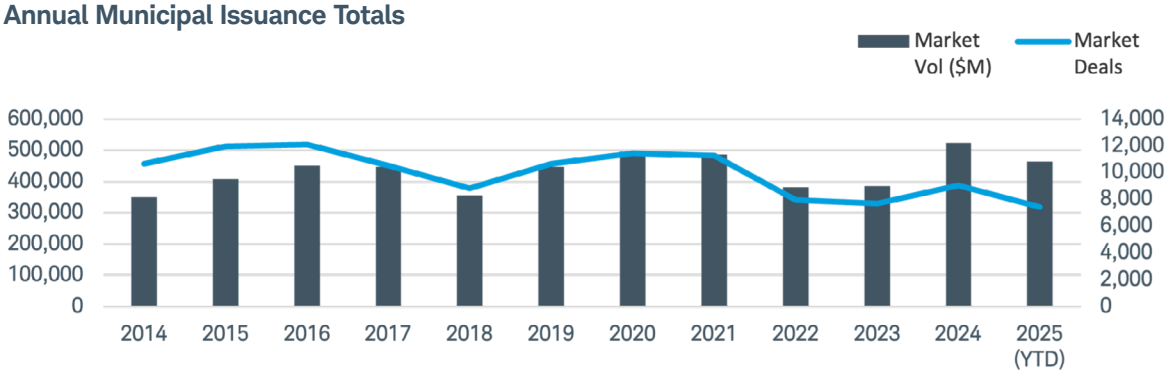
Performance dispersion was evident. Longer-duration municipals (munis) led returns (the Bloomberg Municipal Long Index (22+) returned 3.82% compared to a return of 1.52% for the Bloomberg Municipal Bond 3-year (2-4) Index), while higher quality bonds outperformed lower rated credits. The Bloomberg Municipal AAA Index (+3.08%) outperformed the Bloomberg Municipal BAA Index (+2.84%) for the second quarter in a row, and the Bloomberg Municipal High Yield Index lagged, with a +1.63% total return amid idiosyncratic weakness in names such as Brightline Florida and Puerto Rico. Coupon structure was also another key performance input during the period, with lower rated coupons benefiting from strong convexity-driven returns as rates fell.

Municipal Yield curve dynamics remained a key theme. The 2s10s slope widened to +100 bps by the end of August before flattening to +66 basis points at quarter-end, while the 2s30s slope moved out to +240 bps before retracing to +199 bps. Importantly, the 10-year to 30-year (10s30s) slope ended September at +133 bps, near its steepest reading in over a decade, underscoring the rally on the front end and persistent dislocations in long end demand that we've seen for most of this year.

Relative value metrics highlight this steepness. Taxable-equivalent yields beyond 10 years remain compelling, generally well north of 7% for AAA rated credits, while municipal-to-Treasury yield ratios also reflect value on the long end; 30-year ratios ended the quarter north of 90%, which places that level in the upper 10th percentile over the last 5 years. Inside of 10 years, however, ratios have compressed to near 12-month lows (2-year at 63%, 10-year at 70%), which presents a more mixed relative value picture when compared to taxable alternatives.

Market technicals were supportive despite heavy new issue supply. Year-to-date new issuance volumes reached $464 billion by the end of September, according to Bloomberg, putting it well on pace to break last year's record. Meanwhile, demand remains strong, with the combination of new money flows into open-end funds and ETFs, and sizeable summer reinvestment dollars leading to orderly trading conditions throughout the quarter. LSEG Lipper reported net inflows of more than $11 billion during the period.

Annual Municipal Issuance Totals



Source: Bloomberg as of 9/30/2025. Please note the 2025 figure is year to date whereas the other years are for the full calendar year.

The credit outlook for the municipal market remains fundamentally stable despite some minor underperformance in lower rated bonds during the quarter. Compressed credit spreads are presenting a challenging relative value backdrop, somewhat driven by low issuance from BBB rated issuers. We are seeing increasing instances where elevated supply in higher rated sectors is creating a more attractive value proposal for investors. This reinforces the importance of flexibility and adaptability for active strategies navigating these market dynamics.

The 4th quarter will certainly raise questions about the federal government shutdown, which could be in play for an extended period. In our experience, municipal bond investors rightfully want to understand the potential implications for their portfolios. Fortunately, we have the ability to draw on prior experience, with the U.S. having managed throughnumerous shutdowns over the years, including 10 in recent decades. Shutdowns primarily affect non-discretionary appropriations, and essential employees will typically continue working. The longest shutdown on record, 35 days from December 2018 to January 2019, resulted in no material negative impacts for municipal credits.

However, the implications from a regional perspective are certainly important to consider, with areas like Washington DC, Northern Virginia, and parts of Maryland generally considered the most economically vulnerable to a prolonged government shutdown. And unlike past scenarios, there has been a growing narrative in this instance that the shutdown could be used as an opportunity to permanently reduce the federal workforce, potentially introducing a higher degree of long-term economic and fiscal risk to these regional governments. Our research team is closely monitoring the potential impacts for specific sectors, including hospitals, state housing finance agencies, bonds backed by federal grants (such as GARVEEs), airports, and of course, state and local governments. Ultimately, however, our view is that federal government shutdowns primarily represent a headline driven event rather than a fundamental credit risk to the municipal sector.

Taxable Market

Brian Ferry, Senior Portfolio Manager

It was another constructive quarter for the fixed income market. The broad measure of the market, the Bloomberg U.S. Aggregate Bond Index, had a total return of 2.03% in the third quarter, adding to the year-to-date gains, to finish with a total return of 6.13% for the first three quarters of the year. It has been a very balanced year in the composition of return for the market. Half of the total return year-to-date has come from a downward shift across the yield curve and the other half from interest payments. Embedded in the total return figures was the significant contribution to performance from spread sectors which were able to collectively outperform each month of the quarter– as you will see in the following paragraphs.

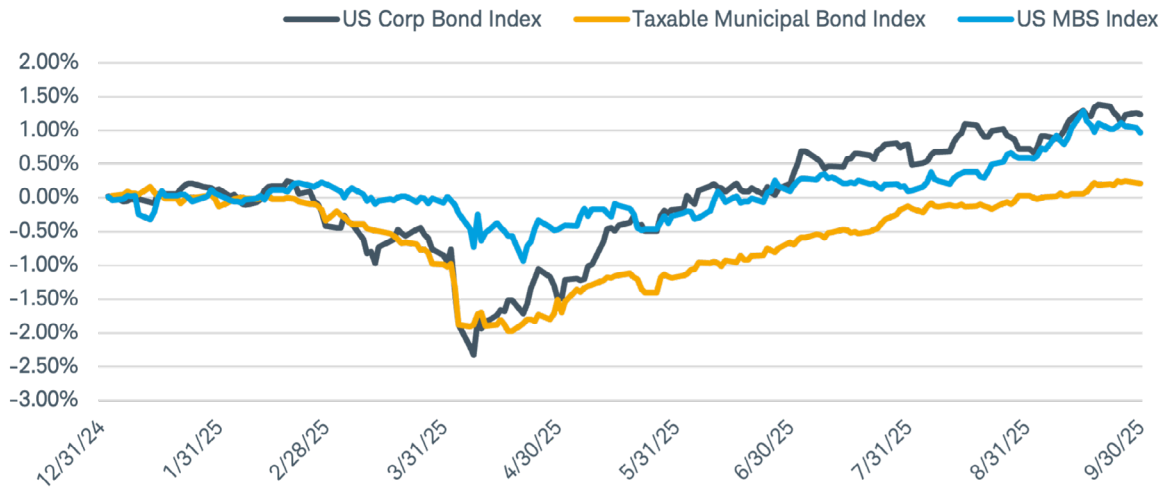
The corporate bond market welcomed the summer calm after a turbulent second quarter. The option-adjusted spread of the Bloomberg U.S. Corporate Index tightened from 84 bps at the start of the quarter, down to 73 bps at the end of September. Intra-quarter, the option adjusted spread (OAS) of the index touched a three-decade low of 71 bps. The

investment grade (IG) corporate bond market outperformed like duration Treasury bonds by 97 bps for the quarter. For the year, IG corporates have outperformed by 124 bps. Issuance came at a healthy clip throughout the third quarter and finished at $440 billion. September, a historically busy month, had its busiest month ever with $227 billion coming to market, highlighted by the jumbo $18 billion deal from Oracle. Year-to-date issuance stood at $1.4 trillion at the end of the quarter, similar to last year's pace.

The taxable municipal market also benefited from the drop in headline risk and associated interest rate volatility last quarter. The sector shifted from recovery phase from last April's hangover into outperformance gear in the third quarter. The Bloomberg Municipal Index Taxable Bonds outperformed like duration Treasury bonds by 84 bps in the third quarter. The sector has now outperformed for five consecutive months. Issuance for the quarter came in at $10 billion, an increase of 9% from the same time period last year. The diversity amongst issuers was well received by the market with 194 different issuers and not one of them came with over a $1 billion deal. Issuance for the year remains well ahead of last year's pace with $36 billion being priced in the first nine months of the year.

It was the quarter mortgage investors had been waiting for all year. Like the taxable municipal market, the mortgage sector had a rough first half of the year due to heightened interest rate volatility but was able to turn it around last quarter. The Bloomberg U.S. Mortgage Backed Securities (MBS) Index outperformed like duration Treasury bonds by 83 bps in the third quarter and 97 bps for the year. All coupons within the MBS stack have outperformed for the year, however, the third quarter saw a reversal of the leaders. The deeply discounted, low coupons swapped places with the high, premium coupons to be the best performers. Mortgage investors preferred to add convexity in the deep discount pools as prepayment fears mounted in the premium coupons over the move to lower long-end Treasury rates.

Excess Returns of Corporate, Taxable Municipal and MBS markets



Source: Bloomberg as of 9/30/25

Jason D. Diefenthaler

Managing Director and Head of Taxable and Municipal Strategies

Jason Diefenthaler is the Head of Taxable Separate Account and Tax-Exempt Strategies for Schwab Asset Management. In this role, he is responsible for developing, managing, and implementing Schwab Asset Management's taxable and tax-exempt fixed income investment strategies, including separately managed accounts, actively managed mutual funds, and exchange-traded funds (ETFs).

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Brian E. Ferry

Senior Portfolio Manager

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Mr. Ferry earned a Bachelor of Science in finance from Miami University. He is a CFA® charterholder and is a member of the CFA Society of Cleveland and the CFA Institute.

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About the Wasmer Schroeder Strategies: More than 35 years ago, the Wasmer Schroeder philosophy was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income. Originally founded by Martin Wasmer and Michael Schroeder, and now managed by Schwab Asset Management, the Wasmer Schroeder Strategies have grown significantly. From the beginning, management of the Wasmer Schroeder Strategies has held steadfast in its spirit of collaboration. We remain dedicated to uncovering opportunities and delivering results for our clients by working together every step of the way. The Wasmer Schroeder Strategies portfolio management team takes a dependable, collaborative, and insightful approach in the management of active fixed income tax-exempt and taxable strategies.

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