

Principal Morley

Interest rate strategy

SEPTEMBER 30, 2025



DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

During the third quarter of 2025, U.S. Treasuries were range-bound, but yields finished modestly lower as the Federal Reserve (Fed) delivered a 25 bp “insurance” cut on September 17th, as the Fed reckoned with a softening labor market and an uptick in inflation, amid policy crosscurrents in Washington. Quarter-over-quarter, the 2-year Treasury fell from 3.72% to 3.60% (-12 bp), the 5-year from 3.79% to 3.74% (-5 bp), the 10-year from 4.24% to 4.16% (-8 bp), and the 30-year from 4.78% to 4.73% (-5 bp). The curve’s shape was modestly steeper, with 2s10s steepening 4 bp to +56 bp, while 5s30s held near +99 bp, reflecting Fed policy easing bolstering the front end while persistent term-premium and the risk of increasing inflation kept the long end elevated. Rate volatility faded into quarter-end with the MOVE index dropping into the 70’s. The Treasury held coupon auction sizes steady at the August refunding, as the Treasury’s continued preference toward bills helped duration supply clear with only modest tails.

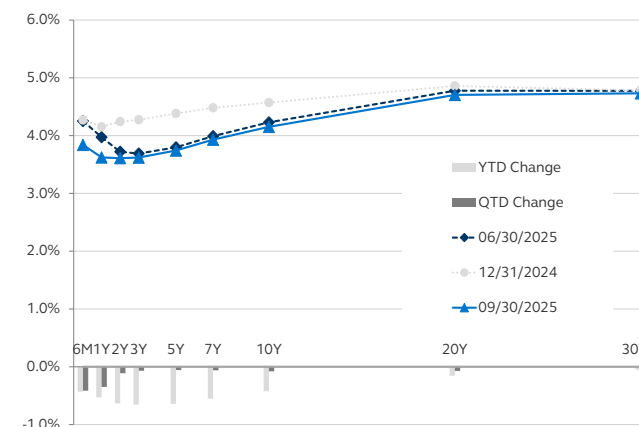
Hard data were “disinflationary-enough” to validate the Fed’s quarter-point cut, without unmooring the long end. Although August core PCE printed slightly higher at 2.9% y/y, the 5-year breakeven ended the quarter near 2.45%, indicating medium-term inflation expectations remained contained. Labor market data disappointed as nonfarm payrolls (NFP) rose just +22k in August, with prior months revised lower, keeping the 3-month moving average at just 29k versus 209k at the start of the year. The unemployment rate ticked up to 4.3% in August, while wage growth cooled, as federal spending cuts and tariff policy uncertainty potentially weighed on the economy.

At the Fed’s September meeting, as was expected the Fed lowered the Fed Funds rate to a range to 4.00%–4.25% and kept QT in place at previously announced caps. The updated Summary of Economic Projections (SEP) nudged the macro path toward slightly firmer growth and lower unemployment with gradual disinflation in future years. The Fed projected the unemployment rate to tick up to 4.5% before retracing to 4.3% and core PCE increasing to 3.1% before falling back to 2.1% by ‘27. Crucially, the projected policy path (“Dot Plot”) shifted lower versus June, with the 2025 median funds dot at 3.6%, consistent with two more cuts priced in the fourth quarter, while the longer-run dot was left unchanged at 3.0%. This signaling helped to anchor the front-end while leaving long-end term premium little changed.

Outlook

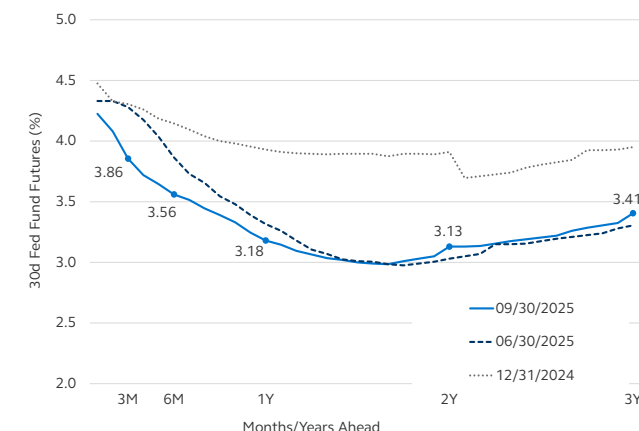
After a nine-month hiatus, the Fed resumed its rate cutting cycle at the September meeting and the debate on the terminal rate returned. Powell’s characterization of policy rates as “modestly restrictive” is consistent with the median long-term expectations for the neutral rate according to the SEP. Forward market pricing appears consistent with the implied terminal rate, but assumes a faster pace than implied by the Dot Plot which indicates a more bearish trajectory in the economy or a more dovish reaction function, possibly due to political pressure. In the near term, there will be no change to the Fed’s data-driven reaction function as an overall resilient economy is undermined by a fragile labor market and soft housing sector. Also, the market is waiting for any incremental pass-through impacts of tariffs on inflation figures which should be more pronounced as we head into 2026.

U.S. Treasury Yield Curve



Source: Bloomberg

Market Implied Fed Policy Rate



Source: Bloomberg

Corporates

SEPTEMBER 30, 2025

Highlights

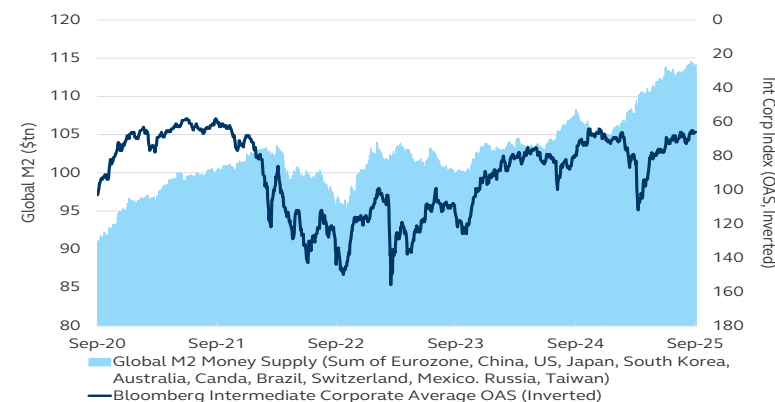
In the third quarter of 2025, the Bloomberg U.S. Intermediate Corporate Bond Index posted a total return of 2.04% providing excess returns relative to U.S. Treasuries of 0.72%, lifting YTD figures to 6.58% and 1.16%, respectively. Index spreads tightened by 9 bps during the quarter, despite steady headline risk and a heavy primary calendar, ending the quarter at 66 bps. The tone of markets skewed risk-on, as the S&P 500 set fresh highs in September aided by the resumption of FOMC rate cuts, despite notable disappointments in the nonfarm payrolls data. The investment grade credit market shrugged off tariff headlines (pharmaceuticals, trucking, furniture, and cabinetry) and a looming government shutdown, as spreads ended the quarter near multi-decade tight.

Primary market technicals were constructive during the quarter. September investment grade corporate new issue supply totaled \$214bn (+61% vs. the four-year average \$133bn), ranking as the fifth-largest month on record. The net issuance of \$130bn (tempered by heavy 2020 five-year maturities rolling off) was well absorbed. Overall third quarter supply totaled \$397bn. Year to date new issuance has increased 3% over last year (+23% higher than the four-year average), while net supply was down 24% YoY. Beyond favorable net supply dynamics, demand for credit has been persistent in the current yield environment. Broadly, global liquidity has supported both economic activity and asset prices (Chart 1). Finally, fundamentals remained supportive of the sector: for Q2 2025, S&P 500 earnings rose with approximately 80% of companies beating EPS estimates, while revenues advanced mid-single digits, consistent with stable margins. Consensus for the third quarter is 7-8% y/y EPS growth with positive breadth across most sectors.

Outlook

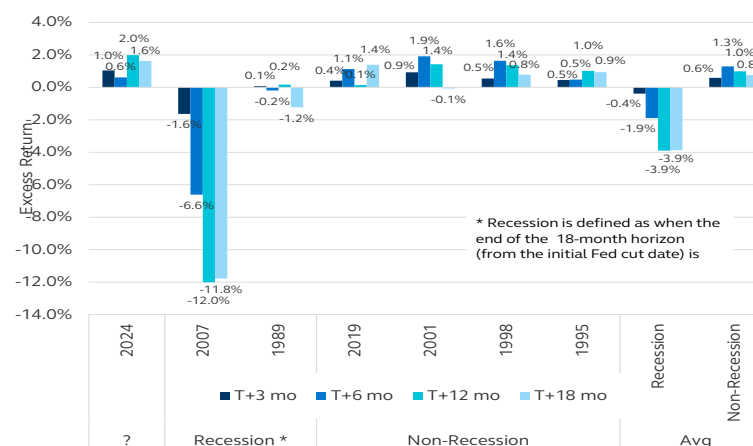
Corporate valuations have stayed in a narrow range over the summer, and we would expect that to continue as we head into a seasonally strong quarter for credit risk. As the economy moved further away from the Liberation Day tariff shock, overall activity and demand rebounded with Q3 GDP tracking north of 3%. After absorbing record September issuance quite well, the market faces the prospect of significantly less supply while demand for corporate bonds remains healthy. As the Fed continues its policy cutting cycle, spreads should perform assuming there is no recession, due to easier financial conditions and increased liquidity (Chart 2). Thematically, increased event risk with large scale M&A, restructurings and LBOs could be an overhang going forward. Increased “animal spirits” resulted in announced M&A volumes spiking by +52% y/y in the third quarter. So far, the impact has been manageable, but the debt financing pipeline will grow as this trend accelerates.

Money Supply & Credit Spreads



Source: Bloomberg

Excess Return Post Initial Fed Cut (BBG Int Corp Index)



Source: Bloomberg

Mortgage-Backed Securities (MBS)

SEPTEMBER 30, 2025



Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

The Bloomberg U.S. MBS Index posted total and excess returns of 2.43% and 0.83%, respectively, during the third quarter, powered by a sustained decline in rate volatility and attractive valuations relative to credit sectors. U.S. Treasury yields declined across maturities and the yield curve steepened during the quarter. The two-year yield fell 0.11% to 3.61%, the five-year fell 0.06% to 3.74%, the ten-year declined 0.08% to 4.15%, and the thirty-year declined 0.04% to 4.73%.

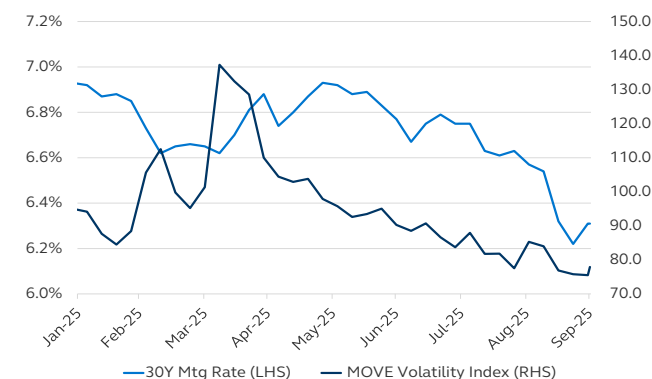
In response to a softening labor market, the Fed resumed its easing cycle in September, lowering the federal funds rate by 0.25% to a range of 4.00% to 4.25%, and reinforced expectations for two additional cuts this year. New Trump appointee Stephen Miran was the sole dissenter, favoring a 50-bps cut. The pace of runoff on the Fed's MBS holdings came into focus late in the quarter as Fed Governor Bowman spoke out in favor of outright MBS sales to more quickly move towards an all-Treasury portfolio. The markets discounted the likelihood of such a move as it would run counter to the administration's goal of improving housing affordability.

Mortgage rates plunged by nearly 50 bps during the quarter, bringing the 30-year fixed rate to around 6.30%. Prepayments on higher coupon 2022-25 vintage collateral increased sharply as over a quarter of these borrowers have a 50+ bps incentive to refinance their loans. Originator supply totaled \$322B gross and \$51B net for the quarter, but bank and traditional foreign demand remained subdued, leaving money managers and REITs to take down the bulk of net supply. Positive flows into fixed income funds supported MBS demand, allowing spreads to tighten along with other fixed income sectors. The current coupon MBS nominal spread declined by 16 bps to +103 bps and the MBS index OAS declined by 6 bps to close the quarter at +31 bps.

Outlook

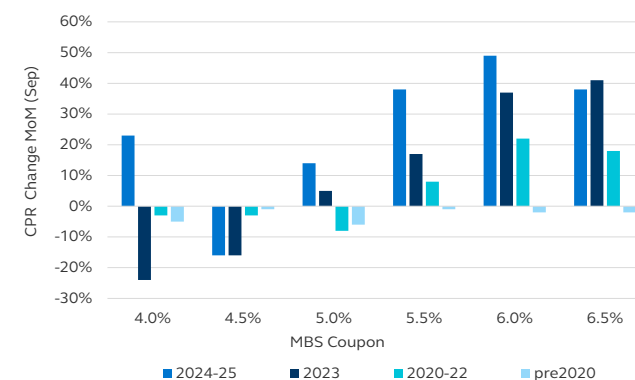
Refinancing activity is expected to pick up for higher-coupon mortgages following the recent rate rally, while implied rate volatility remains in line with long-term averages. Light organic supply has continued to offset tepid demand from foreign and bank investors, while aggregate fixed-income inflows, along with demand from REITs and non-traditional foreign buyers, have provided additional support. Spreads tightened over the third quarter, but remain modestly attractive on a relative basis, particularly for production coupons. Although GSE reform continues to pose headline risk due to potential disruptions in the mortgage market, we do not anticipate meaningful progress in the near term.

Rates and volatility declined during the quarter



Source: Bloomberg

Prepayment reactivity by coupon and vintage



Source: Bank of America

Asset-Backed Securities (ABS)

SEPTEMBER 30, 2025

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index returned 1.65% during the third quarter, which outperformed like-duration Treasury returns by 38 basis points, but lagged the 72 basis points of excess returns from intermediate investment grade corporates.

A near record setting pace of issuance has been met with strong demand. ABS new issuance totaled \$92 billion in the third quarter as compared to \$76 billion for Q2, bringing the year-to-date total to \$257 billion as compared to \$257 billion for the same period in 2024. Relatively attractive yields and benign fundamentals, albeit with pockets of weaker credit performance, have continued to drive interest. Non-traditional sectors have also benefited from growing acceptance among insurance companies and other investors seeking higher yields and spreads.

Investment grade ABS secondary market trading volumes continued to be elevated at \$58 billion for the quarter, down slightly versus \$61 billion traded in Q2. Investors were net sellers of \$0.1 billion.

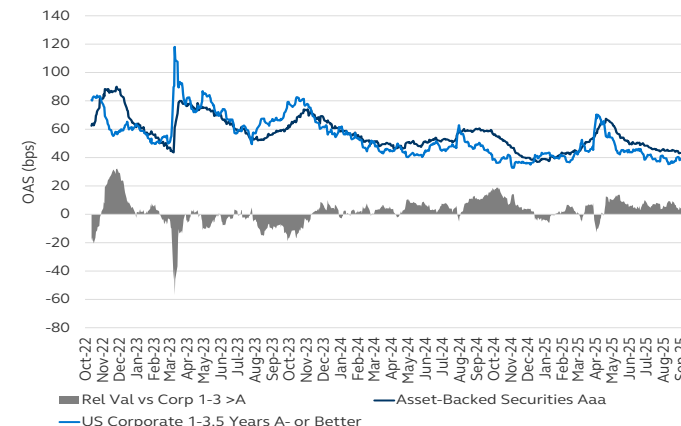
Outlook

The policy focus is shifting from the uncertainty surrounding tariff negotiations to growth-supportive measures such as deregulation and tax cuts, which are expected to gain traction through the remainder of the year and into 2026.

The Federal Reserve faces a delicate balance between its dual mandate of price stability and full employment. Inflation remains well above target and may move modestly higher as the full effect of tariff passthrough materializes, while the labor market continues to soften, with very slow hiring contributing to a gradual rise in the unemployment rate. If labor data remains weak, the Fed is likely to provide additional rate cuts, viewing tariff-driven price increases as a one-time adjustment rather than a persistent inflationary concern. Meanwhile, risk appetite remains robust, supported by healthy corporate fundamentals and attractive fixed income yields. Although valuations are tight by historical standards, they are justified by strong demand and favorable technical conditions.

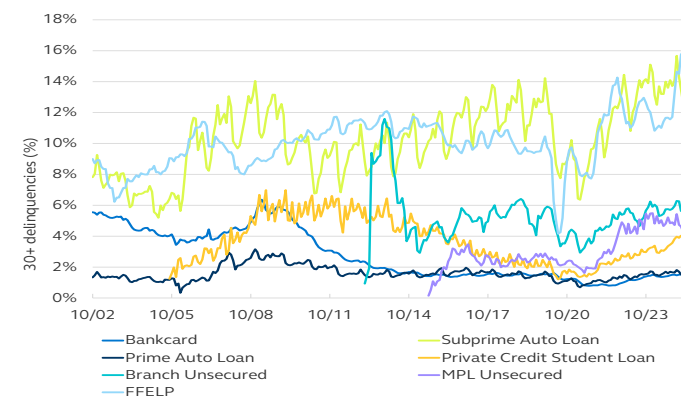
Structured credit fundamentals remain stable but show early signs of erosion, with a softer outlook for the second half of 2025 given the impact of tariffs, a slowing economy, and rising concerns around the consumer. On the technical side, demand has been robust and continues to outpace new issuance. Elevated flows into annuity and money manager funds, alongside low volatility, have also outweighed any macro concerns. Valuations are facing some resistance, with yields compressing as interest rates decline. However, strong technicals should keep spreads well supported.

ABS Relative Value



Source: Bloomberg

30+ Delinquency



Source: J. P. Morgan

Commercial Mortgage-Backed Securities (CMBS)

SEPTEMBER 30, 2025

Highlights

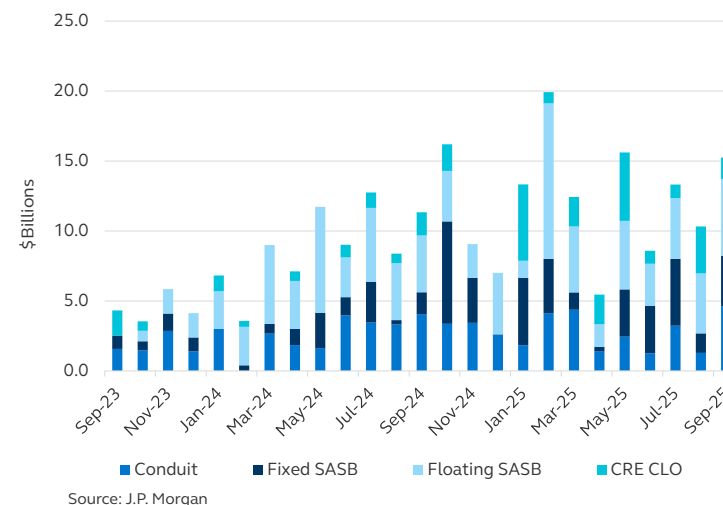
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 1.77% and 0.51%, respectively, during the third quarter. The market settled into a risk-on period with low volatility and a strong quarter for equities and corporate credit despite continued uncertainty on the path of interest rates, inflation, and the administration. Longer term Interest rates ended the quarter lower with the ten-year Treasury yield ending the quarter 8 bps lower at 4.15%, and trading within a range of 4.48% in mid-July to 4.02% in mid-September. A more mixed outlook for the economy was balanced by market expectations of lower rates with real estate ending the quarter on another upswing. Demand for higher quality CMBS was offset by a strong pick up in issuance. CMBS spreads ended the quarter tighter and the credit curve flattened as BBB spreads had a strong recovery after lagging the first half of 2025. AAA CMBS spreads ended the third quarter 11 bps tighter, AA spreads 18 bps tighter, A spreads 10 bp tighter and BBB spreads 90 bps tighter.

New issue activity in the sector recovered after a slower than average 2nd quarter. The \$39.4B of private label issuance, during the third quarter, was up from \$30.4B in the 2nd quarter. Private label conduit issuance during the quarter was \$9.1B compared to \$5.1B during the second quarter of 2025 and \$10.8B the third quarter 2024. Private label SASB issuance was \$23.9B compared to second quarter 2025 of \$16.6B and third quarter 2024 of \$18.2B. Secondary market activity picked up in September after summer holidays slowed the market down in August.

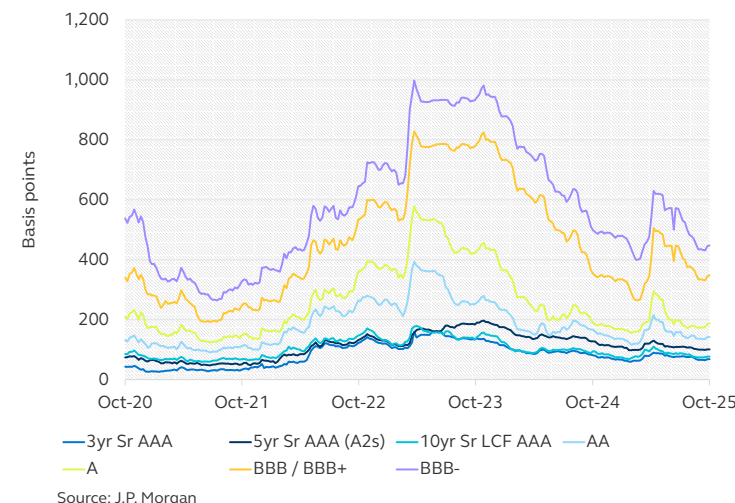
Outlook

The outlook for CMBS remains primarily focused on refinancing loans that mature in 2025 and 2026, the path of the economy, the path of interest rates and longer-term office loan fundamentals. Our outlook is that 2.0 CMBS underwriting should protect from loan defaults becoming systematic and headline risk remaining idiosyncratic which makes CMBS spreads and yields continue to look attractive relative to alternatives

Non-Agy CMBS Issuance



CMBS Spreads to Treasuries



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SEPTEMBER 30, 2025

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The Bloomberg U.S. Agency MBS Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg AAA ABS Index represents the asset-backed securities within the Bloomberg U.S. Aggregate Index.

The Bloomberg AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg U.S. Aggregate Index.

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