WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

March 31, 2025

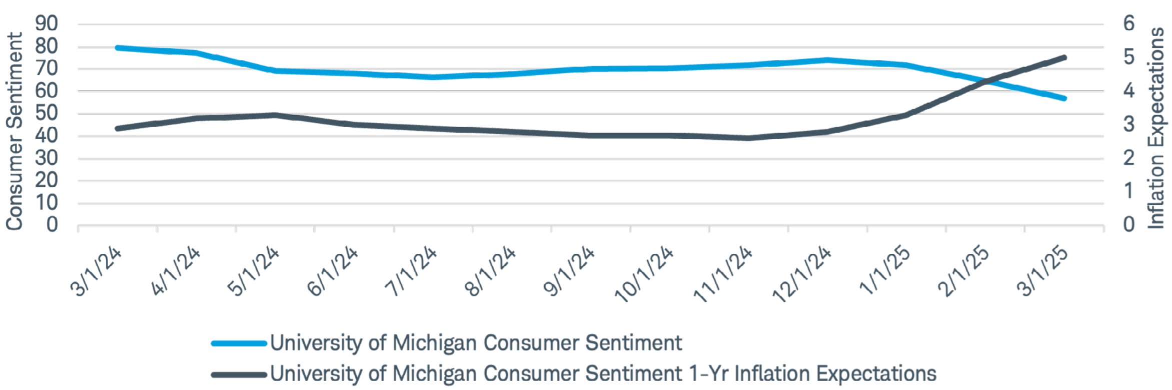
Reimagining Global Trade (and the Volatility That Goes Along with It)

John Majoros, Senior Portfolio Manager and Head of Taxable Strategies

This year started with much promise. The new administration's focus on business and growth overshadowed the background talk of tariffs and trade wars and the implications for inflation and economic growth. Fast forward to the end of the first quarter and those very concerns have come front and center, repricing the U.S. Treasury market as well as domestic risk markets broadly.

We could write many pages on how we got to the current global trading system and the historical basis for the current tariff regime, however, to get to the point, the Trump administration is looking to remake the current system, which has led to increasing volatility across nearly all financial markets. This has affected much of the recent stream of consumer sentiment numbers and the expectations related to wider tariff policies, and more specifically, the rhetoric surrounding those decisions. For example, the University of Michigan sentiment numbers have plummeted since the Trump inauguration. In that same survey data, one-year inflation expectations increased to 5%. While we must see how this data translates to actual inflation and growth numbers, it is hard to ignore given that two thirds of domestic economic activity is tied to individuals.

Consumer Sentiment & 1Yr Inflation Expectations



Source: Bloomberg as of 3/31/2025

This soft data brings up the specter of (dare we say) stagflation, which would be a very ugly economic outcome and one that we have not seen in this country for decades. That said, the actual hard data has been generally sound, and the economy continues to perform reasonably well, although GDP has slowed. It remains to be seen how much this volatility and uncertainty surrounding administration trade policy will damage the economy, but we suspect there will be some economic weakness in the coming quarter based on the volatility of tariff policy, Department of Government Efficiency layoffs, and potentially delayed business investment.

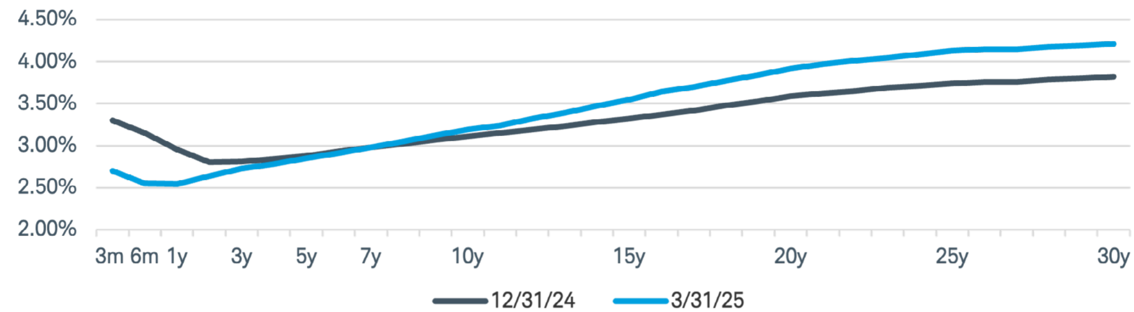
All this has put the Federal Reserve (the Fed) in a bit of a pickle, so to speak. Though there has not been weakness in the jobs data yet, it is clearly a different market than it was a year or two ago as there is evidence of more balance. That, and the slowing of the economy, would probably give the Fed latitude to lower rates and buffer the economy against the current bout of volatility, although the stickiness of inflation, despite progress, lowers the probability of them doing so. And again, the idea that consumers are still concerned about inflation expectations, probably prevents the Fed from lowering rates, unless we see an accelerated weakening of the economy and/or the job market, and even then, a rate cut would be somewhat difficult to justify.

Tax-Exempt Market

Jason Diefenthaler, Managing Director and Head of Tax-Exempt Strategies

The municipal bond market had an eventful first quarter. News flow and economic policy uncertainty drove increased volatility and broadly negative returns. Intermediate and longer-term tax-exempt yields were higher by as much as 10-40 basis points (bps), with 10-year AAA yields ending near their 12-month highs at 3.19%. This led the Bloomberg Municipal Bond Index to a total return of -0.22% during the quarter.

Bloomberg AAA Tax Exempt Yield Curve

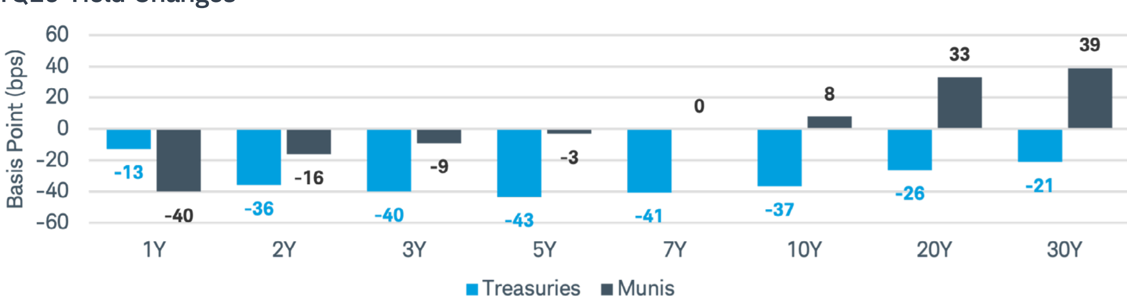


Source: Bloomberg as of 3/31/2025

The negative performance reflected a combination of investors moving towards a more risk-off tone, concerns about possible changes to the tax exemption of municipal bonds, deteriorating supply and demand dynamics, and widening of municipal-to-Treasury yield ratios. This led the Bloomberg Municipal Bond Index to underperform the Bloomberg US Treasury Index by 314 bps during the quarter. For context, the only other instances over the last 20 years in which munis underperformed Treasuries by that degree over a quarter was at the start of the COVID pandemic (1Q20, -883 bps) and the Great Financial Crisis (3Q08, -551 bps & 4Q08, -801 bps).

The tax-exempt yield curve experienced a sizeable steepening move to start the year, with 1-year yields lower by 40 bps and 30-year yields higher by 40 bps. This created meaningful performance bifurcation across the market, with the short end outperforming the long end by more than 250 bps. The yield spread between 2-year and 10-year tax exempt bonds (“2s10s”) rose by 24 bps during the quarter to end at +55 bps – its steepest reading since August 2022. The steepening further out the curve was even more dramatic, with the slope from 2-years to 30-years rising by 55 bps to +157 bps (near its steepest reading since 2017). Given the dramatic steepening in the slope of the curve, and with taxable equivalent yields on long AAA rated bonds ending the quarter near 7% for high income tax investors, extending duration is looking increasingly attractive for investors that have a longer term investment horizon and a tolerance for additional volatility.

1Q25 Yield Changes



Source: Bloomberg as of 3/31/2025

Issuance patterns continued to exceed expectations during the quarter. The $123 billion in issuance through the first 3 months of 2025 is the biggest start to a calendar year in at least a decade. The spike in supply prompted Bank of America, the largest municipal underwriter in each of the last 11 years, to raise their 2025 issuance forecast from $520 billion to $580 billion (which would eclipse 2024's record year of issuance). This supply spike coincided with a softening in demand, with Lipper reporting municipal fund outflows of more than $1.1 billion during the last 3 weeks of March. This supply and demand dynamic drove a few challenging days for issuers as a handful of deals had to increase offer yields in order to achieve sufficient investor interest. The net effect in the secondary market was that municipal-to-Treasury yield ratios saw adjustments higher, with 10-year ratios rising from 68% at the end of 2024 to a 12-month high of 76%. 30-year ratios rose from 80% to 93%, also a 12-month high, further supporting the relative value narrative on longer duration areas of the market.

Lower rated municipal bonds benefited from strong investor demand and solid performance. The Bloomberg Municipal BAA Index outperformed the Bloomberg Municipal AAA Index by 47 bps during quarter, bringing the trailing 12-month outperformance to 158 bps. These relative returns run the risk of masking several underlying negative currents across the market, as general credit surveillance is showing a deterioration in the upgrade to downgrade ratio and higher instances of negative rating actions for challenged sectors, including healthcare and higher education. S&P delivered 155 rating upgrades during the first 2 months of the year compared to 179 downgrades (0.9:1 ratio). Negative outlook revisions were more than double positive actions. There were some notable downgrades, including the City of Chicago IL based on budget constraints and multiple Los Angeles CA-area credits due to implications around January's wildfire events. We anticipate credit stress will likely be further exacerbated by the shifting relationship between state and local governments and Washington DC, with potentially massive reductions in federal dollars likely to have a material impact on many issuers, sectors and securitized revenue streams.

Lastly, there has been increased dialogue out of Washington DC and across the market about potential changes to the municipal tax exemption. Attempting to handicap the likelihood of changes is a complicated and highly uncertain exercise at this stage, with the options running a wide spectrum that could include specific sector carve outs, a cap on exemption based on specific tax brackets, or no changes at all. This conversation is not a new one: risks to the exemption have been discussed on several occasions over the last few decades when federal budget negotiations have become challenging. While we are hesitant to say, "it's different this time", we acknowledge that investor concerns are warranted given the sheer uncertainty around the forward outlook for U.S. economic policy. Ultimately, preserving the full tax exemption would be in the best interest of state and local governments and the investors that have helped facilitate infrastructure investment for more than a century. Leaving the exemption in place would benefit investor demand, keep borrowing costs relatively low for critical infrastructure projects, and maintain the stability of the municipal market. While we acknowledge the risks are real and present, we expect policymakers will carefully weigh these factors before considering changes to an efficient form of much needed public infrastructure funding.

Taxable Market

John Majoros, Senior Portfolio Manager and Head of Taxable Strategies

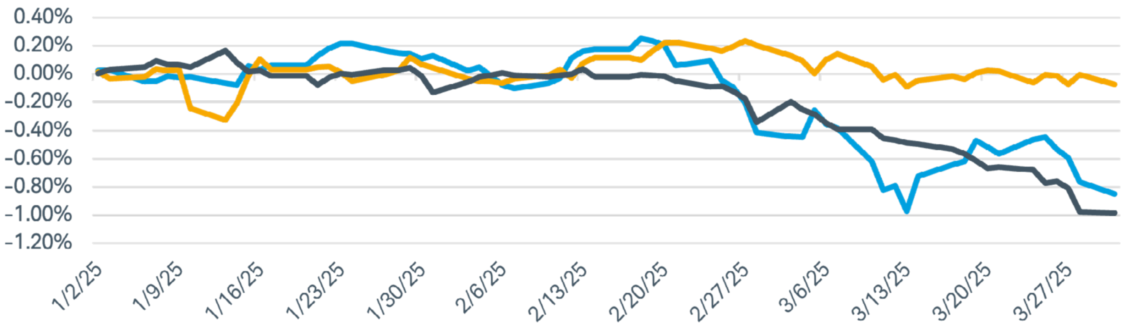
After rates rose initially in January, they declined across the U.S. Treasury yield curve as risk market volatility, especially in equities, gave a bid to the U.S. Treasury market. 10-year U.S. Treasury yields declined from around 4.50% to 4.21% over the quarter, while the 2-year U.S. Treasury saw a similar move, declining approximately 30 basis points. The U.S. Treasury yield curve was slightly steeper. The Fed did not move the Federal Funds Target rate during the quarter. Overall, total returns across nearly all sectors of the fixed income market were decidedly positive.

The fundamentals of the corporate bond market remained strong as company cash flows and balance sheets are in a healthy position broadly. New issue volumes were robust and slightly ahead of 2024's first quarter. 757 deals were done in the investment grade market totaling $575 billion. Secondary trading markets were active. Spreads were wider, reflecting the risk-off mood of the markets. The Bloomberg Corporate Bond Index option-adjusted spread (OAS) widened 14 basis points to 94. Not a huge move but a meaningful widening given that the spread ended 2024 at multi-year lows. Again, with the volatility and downward momentum of the equity markets, we might have expected a larger move, but strong fundamentals and attractive overall yields kept demand up and dulled the widening momentum.

The taxable municipal market, an important market for many of our investment strategies, performed slightly better than the overall corporate market, which is consistent with its higher overall credit quality. While fundamentals of this market remain strong, and benefit from the large transfer of funds to state and local governments during the COVID period, the effect is starting to wear off. Issuance was relatively sanguine at $8.5 billion over the quarter but 13% higher compared to the same period last year. The technical dynamics of the taxable municipal market remain constructive as supply is relatively limited and demand robust.

The agency mortgage-backed sector performed slightly better than credit sectors of the market. Earlier in the year, there was no denying that the extra yield investors receive above Treasuries for owning mortgage-backed securities (MBS) was attractive both outright and compared to, for example, corporate bonds. This helped buffer performance during this volatile period and demand for MBS was strong despite banks, a large buyer of MBS traditionally, remaining mostly on the sidelines. Overall, MBS pass through OAS ended the quarter at +36 basis points, 7 bps tighter. We believe that this outperformance relative to credit could continue if the market remains volatile.

Excess Returns over Treasuries



Source: Bloomberg as of 3/31/25

Jason D. Diefenthaler

Managing Director, Head of Tax-Exempt Strategies

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

Mr. Diefenthaler earned a Bachelor of Science in finance from Florida State University. He is a member of the Southern Municipal Finance Society and the National Federation of Municipal Analysts.

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Mr. Majoros earned a Master of Business Administration in finance from Fordham University and a Bachelor of Business Administration in finance from Cleveland State University.

Disclosures

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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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