



Quarterly Bond Market Overview

June 30, 2025

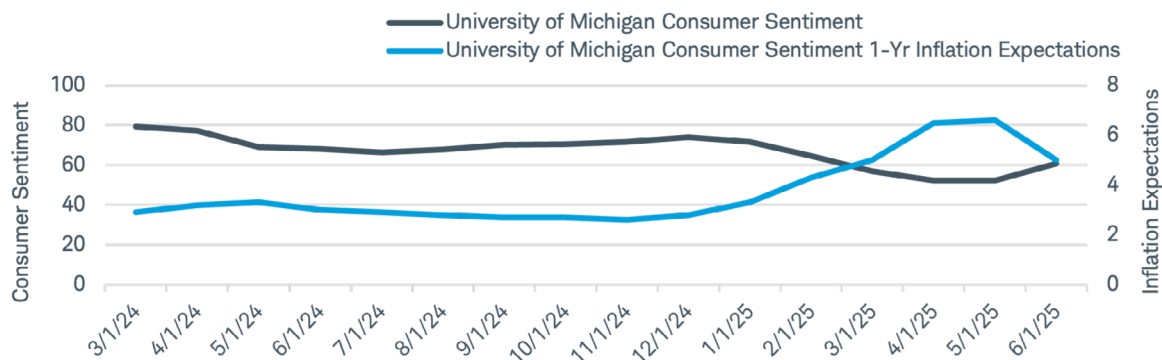
The Fog of Tariff Wars

Brian Ferry, Senior Portfolio Manager and Head of Taxable Strategies

Visibility for both companies and consumers in the first week of April had not been as murky and uncertain since the onset of COVID in March of 2020. The swift escalation in Tariff Policy on “Liberation Day” by President Trump caught the market off guard, let alone our trading partners. The magnitude of the announcement left previous economic data in peril and upcoming data suspect. The market was blindsided, and the pronouncement left investors glued to their social media timelines for any updates– especially on weekends.

The weakness in soft economic data (surveys) during the first quarter did not materialize into a significant downturn in hard economic data that many were expecting in the second quarter. Certain data points did soften – such as a drop in Durable Goods, ISM New Orders fell for both Services and Manufacturing, and the Housing market collectively was weaker. On the other hand, Inflation readings held steady or fell in some cases (PCE). Inflation expectations also fell, Payrolls remained firmly positive, and Consumer Sentiment, which seemed to have bottomed out at the start of the quarter, has since been on the rise. The end result for the quarter is that the overall economy remains on solid footing, but we must acknowledge there are some sectors that have been more negatively impacted by the President's trade policy.

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



Source: Bloomberg as of 6/30/2025

The Federal Reserve (Fed) remained on the sideline during the quarter despite having held two meetings. The committee took a ‘wait-and-see’ approach and favored flexibility during this period. Comparing their statements at the May versus June meetings it appears they have gained more confidence in their economic outlook, although there is still concern. The committee also provided an update to the DOT Plot, or their expected interest rate cuts for 2025, and reaffirmed that two cuts are still the base case for remainder of the year. The third quarter will be crucial to the rate cut path as Chair Powell acknowledged they believed that if inflation were to materialize it would start to appear in the July data points. July also happens to coincide with the trade deadline for reciprocal tariffs to be imposed on other countries (EU, Japan, India are the significant deals) if no trade deal is reached. We believe July could be the key for the market to get its visibility back and exit this truly unprecedented Trade Policy and the foggy it brings.

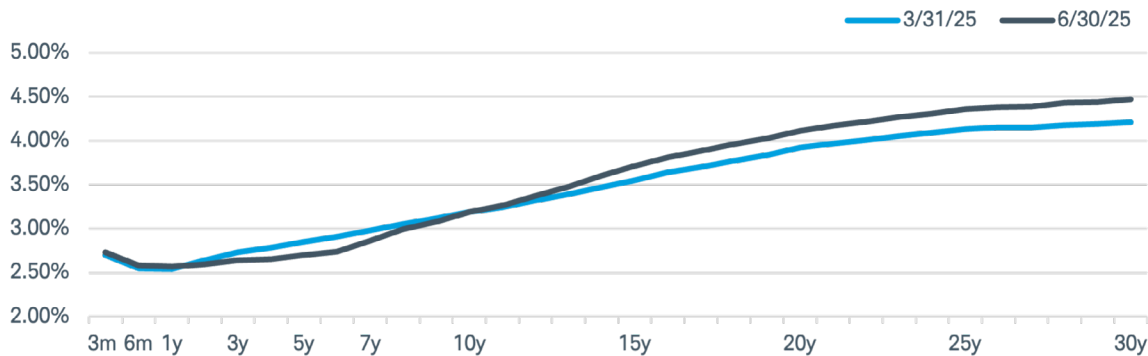
Tax-Exempt Market

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

Municipal bonds (munis) posted modest losses in the second quarter of 2025, with the Bloomberg Municipal Bond Index declining -0.12%, bringing the year-to-date return to -0.35%. Performance was bifurcated across the curve, with positive returns out to 10-year maturities, while longer bonds posted increasingly negative results as the curve steepened. The municipal market notably underperformed U.S. Treasuries by 61 basis points (bps), reflecting a quarter marked by pronounced volatility and clouding expectations for future Fed policy action. The early quarter rally in Treasuries, triggered by the “Liberation Day” announcement from President Trump and growing concerns around tariffs and the possible impact on consumer spending, sharply diverged from the more volatile muni response. This disconnect led to several days of severe swings in tax exempt yields in April, underpinning the quarterly underperformance of munis.

The municipal yield curve steepened meaningfully, reflecting shifting rates expectations and a recalibration of term premiums. The 2-year and 10-year yields (2s10s) slope ended the quarter at +60 bps, the steepest in over two years, while the 10-year and 30-year yields (10s30s) and 2-year and 30-year yields (2s30s) slopes reached +131 bps and +188 bps, respectively (10s30s are at their steepest levels in over a decade). 10-year taxable-equivalent yields (TEYs) ended June near 5.4% while 30-year TEYs closed at roughly 7.6% for top tax bracket investors. These levels can present compelling long-term income opportunities for investors that can tolerate higher volatility.

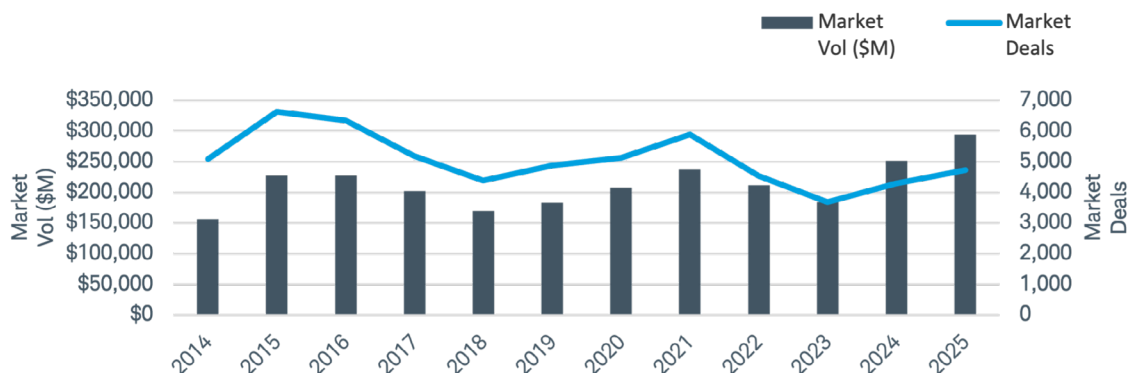
Bloomberg AAA Tax Exempt Yield Curve



Source: Bloomberg as of 6/30/2025

Supply surged during the quarter to a record \$171 billion, bringing the year-to-date total to \$294 billion – also a record pace. The YTD total represents a +17% year-over-year increase, which is even more impressive when considering that 2024 also set a record for new issuance. This elevated issuance continues to be driven by the wind-down of COVID-era federal stimulus dollars, inflationary pressures impacting capital costs on infrastructure projects, and concerns around diminishing federal support – especially for higher education credits and public-school districts. There is a growing sense that these supply patterns will persist, with some strategists suggesting that the market could grow towards \$5 trillion in the coming years, breaking out of the long-held \$4 trillion range.

First-half Annual Issuances



Source: Bloomberg as of 6/30/2025

Despite the elevated issuance, demand remained robust, supported by reinvestment buying and a constructive technical tone. Lipper reported roughly \$600 million in net inflows from municipal bond funds for the quarter, with more than \$3 billion flowing out during April and more than \$3 billion flowing in during May, culminating in nine consecutive weeks of inflows through the end of June. While choppy, these flows helped stabilize trading conditions during one of the most volatile periods of the past two years, with the result being an orderly trade backdrop despite the record new supply. We anticipate demand to remain healthy over the summer, with the second half of July expecting to see particularly strong reinvestment demand.

Relative value improved over the quarter as munis cheapened modestly versus Treasuries. Muni-to-Treasury ratios ended the quarter at 72% (5Y), 76% (10Y), and 95% (30Y) – levels that are generally considered attractive from a longer-term perspective. Notably, during the April rate rally, ratios spiked dramatically as muni yields failed to keep pace with the Treasury rally, leading to brief periods of extreme dislocation. These technical imbalances have since moderated, leaving ratios slightly higher than where they began the quarter and offering attractive entry points for taxable-equivalent buyers.

Credit conditions remain stable but deserve closer scrutiny as economic momentum slows. While the Bloomberg Municipal AAA Index fell -0.09%, the Bloomberg Municipal BBB Index and Bloomberg Municipal Bond High Yield Index underperformed more sharply at -0.64% and -1.14%, respectively, driven primarily by longer duration exposures. Spreads did weaken, however, with the Bloomberg Revenue Bond Index underperforming the Bloomberg General Obligation Index by 20 bps, suggesting some fundamental repricing across risk sectors.

Notable credit developments included the downgrade of Brightline Trains Florida to junk by S&P – a large issuer in the below investment grade muni space with significant representation in many high yield funds. The State of Maryland lost its Aaa rating from Moody's due to its economic dependence on federal employment and associated downsizing, although there was no discernible market impact. Nonetheless, essential service, tax-backed, and GO credits have remained fundamentally sound. Proposed Medicaid funding reductions pose potential funding risks to rural hospital credits, and the divide in private higher education is deepening. Smaller institutions face enrollment and tuition pressures, while elite universities such as Harvard and Yale confront hostile federal policy – including threats to tax exempt status, research funding, and accreditation.

The municipal market has largely avoided direct disruption from recent legislative efforts. The GOP's "Big Beautiful Bill" passed the House and Senate by the narrowest of margins, omitting any provisions directly impacting municipal bonds or the tax exemption. However, the Congressional Budget Office's scoring of large forward deficits will be of continued focus as the House revisits the Senate's revisions, raising questions about potential offsets and further changes. Notably, the increase in the SALT cap from \$10,000 to \$40,000 remains in the legislation (capping out at incomes of \$500,000, and sunseting back to \$10k cap in 5 years), although criticism that the measure disproportionately benefits high-tax states will likely resurface in ongoing debate. While headline risk persists, especially in such a polarized political environment, we believe that the likelihood of major tax exemption changes in the near term remains low.

The second half of 2025 opens amid heightened uncertainty and diverging narratives for Fed policy. President Trump has publicly called for an immediate 250 bps in rate cuts, while Chair Powell and the FOMC remain cautious, particularly in light of potential inflationary effects from trade and tariff policies. Market consensus has now coalesced around two to three rate cuts, potentially commencing as early as July given that some Fed members, including Waller and Bowman, have adopted increasingly dovish tones in recent weeks.

Despite the steepness of the municipal curve, volatility is leading us to maintain a neutral duration posture, with selective duration and curve overweights in longer strategies where the TEY profile is especially compelling. On credit, we remain constructive on AA and single-A rated names, but are increasingly selective in BBB and high yield, particularly in sectors facing fundamental headwinds.

Finally, we are monitoring coupon structure risks. Spreads between 5% coupons and 4% coupons have narrowed significantly, creating a less compelling argument for moving down in coupon due to the added convexity and higher de minimis price risk. In our view, taxable-equivalent yields remain the most powerful argument for muni allocations today, particularly in a world where market volatility, policy uncertainty, and global dislocations are likely to persist over the coming quarters.

Taxable Market

Brian Ferry, Senior Portfolio Manager and Head of Taxable Strategies

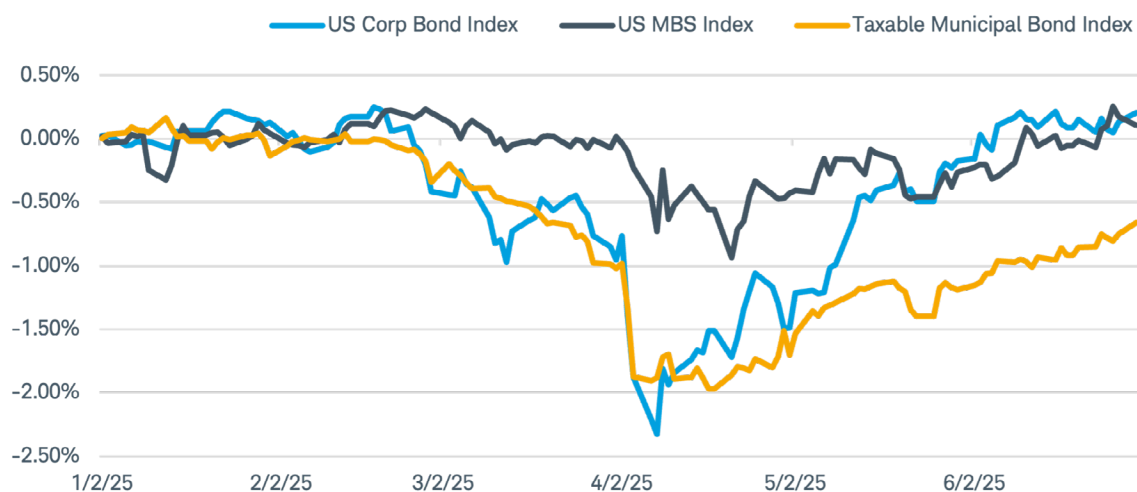
It would almost be unimaginable for fixed income investors to think they would have positive total returns after the first two weeks April, as measured by the Bloomberg Aggregate Bond Index, but that is what happened. The bond market was able to withstand not only inflation fears from tariffs, but also concern over the growing deficit. The yield curve steepened with the 2-year Treasury declining 16 bps, while the 10-year Treasury held steady. Longer-term Treasury rates moved higher by 17-20 bps. All major spreads provided positive total returns and outperformed their Treasury benchmarks in the quarter as well.

The corporate bond market was one of the hardest hit sectors at the start of the quarter on the tariff news. The option-adjusted spread of the Bloomberg US Corporate Bond Index widened from 94 bps at the start of the quarter out to 118 bps within a week. The good news was that it was early in the quarter, and as trade tensions eased, or at least did not escalate, the IG corporate bond market was able to recover and outperform like duration Treasury bonds by 103 bps for the quarter. Issuance was stop and go in April with the uptick in volatility, but once the markets hit calmer waters towards the end of the month it was full speed ahead again. IG companies issued \$410 billion in the second quarter, representing a 14% increase from the same period last year. For the year, issuance stands just under \$1 trillion, or 8% ahead of last year's pace. Credit fundamentals remain strong for the sector.

Despite a rough start, the taxable municipal market, an important sector in our fixed income allocations, was also able to pull out ahead for the quarter, although not to the extent of their corporate peers. The Bloomberg Taxable Municipal Index outperformed like duration Treasury bonds by 34 bps in the second quarter. The underperformance of the sector in the first quarter still leaves the sector in negative relative performance for the year. However, the sector has now shown two consecutive months of outperformance (the first time since Oct/Nov 2024) and, we believe, might be finding its footing. Issuance remains well ahead of last year's pace with \$25 billion coming to market in the first half of the year, an increase of 21% from last year. The fundamental picture is still strong, but there will continue to be a pullback of Federal support that the sector has benefited from over the last several years.

Agency mortgage-backed securities investors were happy to finish in third place for relative performance, since they too finished in positive territory. The Bloomberg U.S. Mortgage Backed Securities (MBS) Index outperformed like duration Treasury bonds by 16 bps in the second quarter, again an impressive performance given the negative 39 bps the index experienced in April. There was a significant development regarding the privatization of Fannie Mac and Freddie Mae when President Trump posted that they would still carry the implicit federal guarantee – which eased concerns in the market and tightened spreads.

Excess Returns of Corporate, Taxable Municipal and MBS markets



Source: Bloomberg as of 6/30/25

**Jason D. Diefenthaler**

Managing Director, Head of Taxable Separate Account and Tax-Exempt 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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