



Quarterly Bond Market Overview

December 31, 2025

Economic Overview

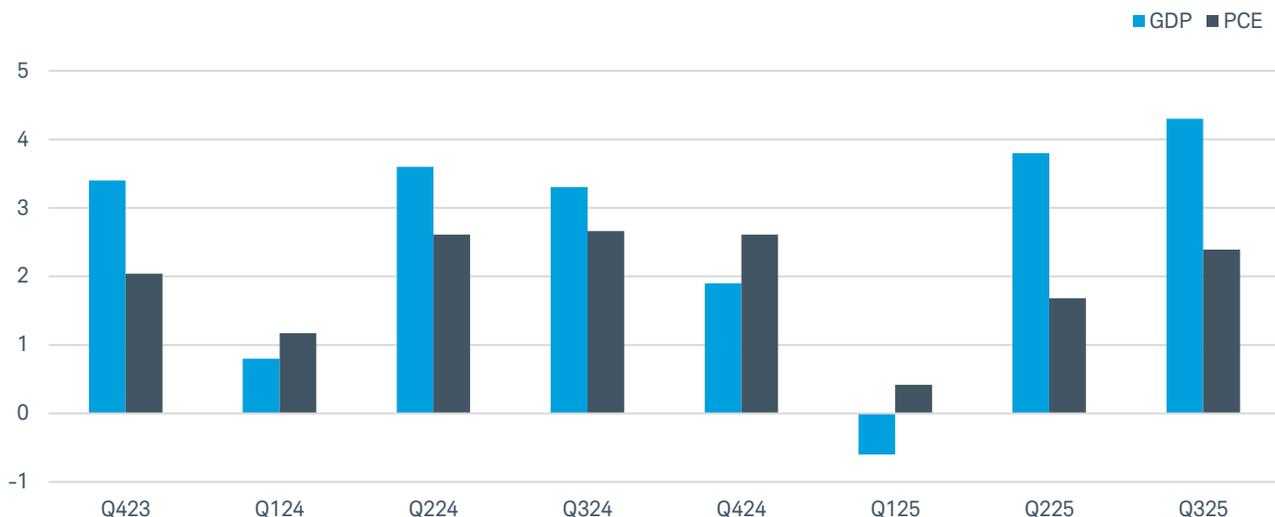
Brian Ferry, Senior Portfolio Manager

The fourth quarter narrative centered on the federal government shutdown and the lack of timely economic data for policy makers and market participants. Bond buyers had to rely on non-traditional, soft-data indicators- such as surveys or companies earning releases - to get the pulse of the U.S. economy. The federal government officially shut down from October 1 to November 12; however, months of economic data were lost, or significantly diluted. Even in these less-than-ideal conditions, important decisions still needed to be made, including those with significant impact, such as those made by the Federal Reserve (the Fed).

The Federal Open Market Committee (FOMC) held two meetings in the fourth quarter, cutting rates by 25 basis points (bps) in both October and December due to concerns over rising unemployment and slowing job gains. The committee also acknowledged inflation remains elevated and has recently edged higher. Another notable development at the October meeting was the Fed’s announcement that it would stop shrinking its balance sheet on December 1, 2025. Fed Chair Jay Powell commented on the decision, “there’s not a lot of benefit to more balance sheet runoff”, and also noted the final decision on the composition of the balance sheet had not yet been made. The combination of rate cuts and a stabilized balance sheet positioned the Fed in a significantly more accommodative stance at the end of December compared to the beginning of the quarter.

The biggest surprise in the fourth quarter, based on the limited data available, was the acceleration in third quarter GDP. The market expected growth of 3.30%, but the release came in at a staggering 4.30%. The strength in the economy was led by the consumer and an upturn in exports. U.S. consumers experienced healthy income gains last quarter which fueled their willingness to spend despite concerns over inflation, tariffs, and the government shutdown.

Gross Domestic Product (GDP) and Personal Consumption Expenditures (PCE)



Source: Bloomberg as of 12/31/2025

Geopolitical risks were still at-large throughout the fourth quarter and have recently elevated with the recent actions in Venezuela. President Trump and the administration hinted this was not the final act by the U.S. in the Western Hemisphere and there could be more to follow. The initial market reaction was limited but the number of increasing conflicts happening concurrently we believe risks unforeseen consequences with the sheer number of players involved. In our view, the so-called "resetting" of the global order does not occur without associated risks.

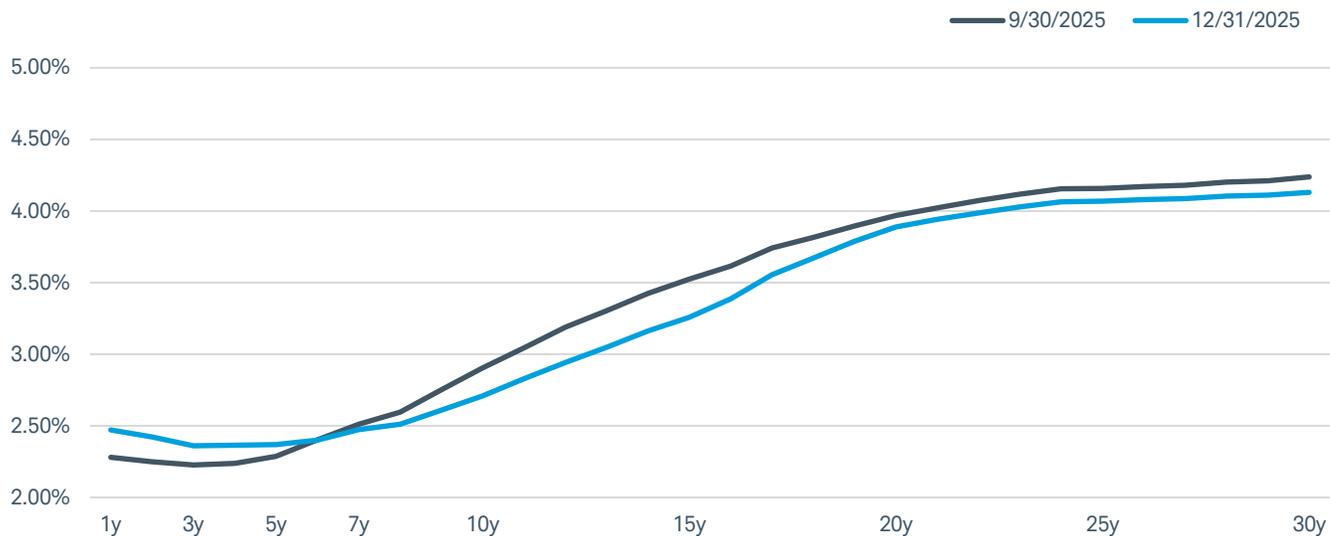
Tax-Exempt Market

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

Municipal (muni) bonds closed the year on strong footing, outperforming U.S. Treasuries and other taxable fixed-income sectors for a second straight quarter. The market showed surprising resilience in the face of a historically long federal government shutdown and heightened uncertainty due to delayed economic data releases. The period was highlighted by a flatter tax-exempt yield curve, elevated new-issue supply, persistent investor demand, and stable credit fundamentals. The Bloomberg Municipal Bond Index returned 1.56% during the fourth quarter, outperforming Treasuries by 66 bps, investment grade corporate bonds by 73 bps and taxable municipal bonds by 19 bps. Despite the Bloomberg Municipal Bond Index ending June with a year-to-date loss of -0.35%, the rally during the last 6 months of the year boosted the full year 2025 total return to 4.25%.

The tax-exempt yield curve continued the aggressive flattening move that began in late August. Two-year AAA yields rose 18 bps to 2.42% during the quarter and 5-year yields increased 8 bps to 2.37%. Ten-year yields declined 19 bps to 2.71%, and 30-year yields moved lower by 11 bps to 4.11%. This led the 2-year to 10-year (2s10s) slope to flatten by 37 bps to end December at +29 bps, notably flatter than +69 bps 2s10s slope in the Treasury curve. The 10-year to 30-year (10s30s) slope continues to hold near multi-year highs, steepening +9 bps during the quarter to +142 bps (two-times steeper than the 10s30s Treasury curve).

Bloomberg AAA Tax Exempt Yield Curve



Source: Bloomberg as of 12/31/2025

This twist in the curve led longer-duration munis to outperform once again, with the Bloomberg 15-year Municipal Index returning 2.84% during the fourth quarter, while the Bloomberg 5-year Municipal Index posted a return of 0.50%. For the full year, the Bloomberg 10-year Municipal Index was the best performing area of the market with a total return of 5.92%; the Bloomberg Long Municipal Index was the weakest area of the market, returning 1.95% for the year.

The move lower in yields outside of 10 years led to outperformance in lower-coupon bonds, with 4% coupons outperforming 5% coupons by 82 bps during the period¹. This is typically the case given the convexity profile of 4% coupons and the higher representation of that coupon structure on longer term maturities.

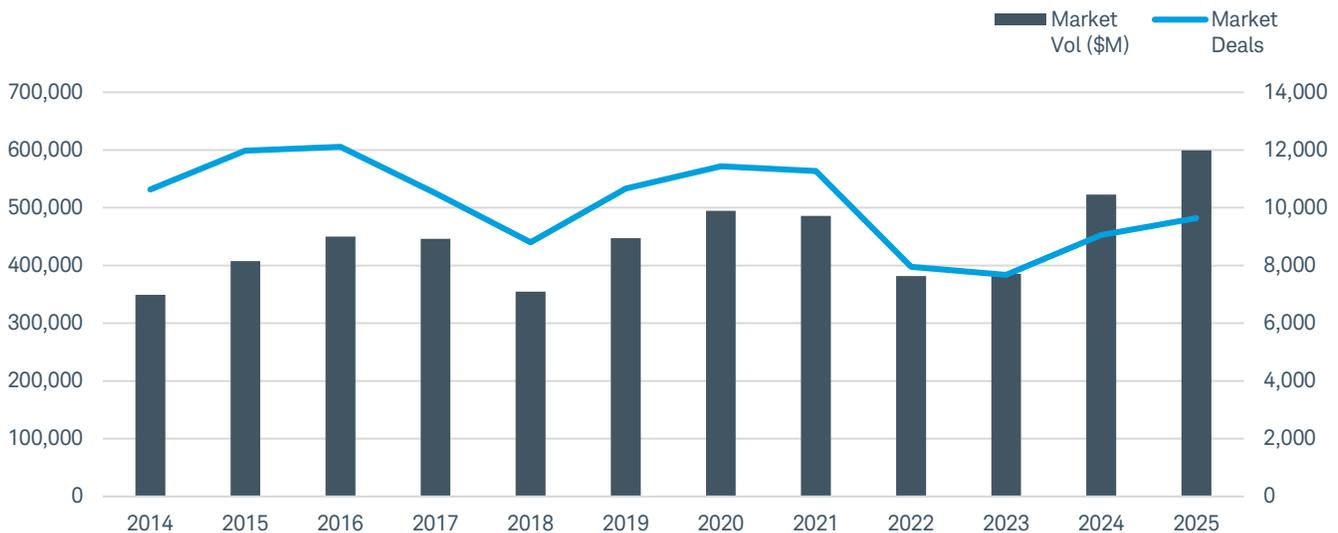
Quality trends were generally stable during the quarter, although we did see a general moderation in the elevated number of upgrades to downgrades, which has been the theme over the last few years. The State of Illinois was upgraded by Moody's to 'A2' from 'A3', reflecting improvement in the State's financial metrics. Fitch revised the outlook for the Los Angeles Department of Water & Power to Stable from Negative based on lowered expectations that the system would face "materially significant financial liability" related to last January's Palisades wildfire. The City of Philadelphia PA saw its general obligation rating, and the ratings of its school district and water & sewer funds, upgraded by Moody's as well.

S&P changed its outlook on the City of Chicago IL's 'BBB' rating from Stable to Negative after the Mayor proposed a budget that included no structural fixes to their projected funding gaps. Moody's took the Chicago Public Schools District's 'Ba1' rating to Stable from Positive on a weakening revenue outlook and elevated expenses. The City of New Orleans LA saw its ratings placed on review for downgrade by both Moody's and S&P due to budget and cash flow issues that required the City to borrow to make employee payroll.

In terms of credit performance, the Bloomberg Municipal BAA Index outperformed the Bloomberg Municipal AAA Index by 20 bps during the quarter, although that excess return can be primarily attributed to the longer duration, lower average coupon, and the additional carry from excess yield; however, the direction of investment grade credit spreads during the quarter was generally neutral. High-yield municipals did see notable underperformance versus investment-grade bonds as idiosyncratic credit concerns dented returns. The Bloomberg Municipal Bond High Yield Index underperformed the Bloomberg Municipal AAA Index by 42 bps during the quarter, bringing the full year underperformance to 179 bps. This underperformance was primarily felt during the second half of the year and can be attributed to notable spread widening in the Transportation and Tobacco sectors.

Technical trends across the market were supportive, despite a continuation of the elevated new-issue backdrop. The supply of new bonds totaled \$145 billion during the quarter, a decline of 11% from the third quarter but a 15% increase from the fourth quarter of 2024. That volume brought the full calendar year supply total to a record \$599 billion according to Bloomberg, eclipsing the previous record of \$523 billion set in 2024. The supply was absorbed well primarily due to reinvestment demand from coupon and maturity payments, as well as significant flows of new money into the market. According to LSEG Lipper, inflows to municipal bond funds totaled approximately \$51 billion in 2025, with ETFs attracting two-thirds of those dollars.

Annual Municipal Issuance Totals



Source: Bloomberg as of 12/31/2025

The positive demand backdrop helped the municipal market outperform taxable during the second half of the year, which flowed through in the form of tighter relative valuations. Municipal-to-Treasury yield ratios on 10-year and 30-year bonds fell to 65% and 86%, respectively, during the quarter, which is somewhat rich from a historical perspective although certainly not out of the norm for a typical fourth quarter. The front end of the curve did manage to cheapen up, with 2-year ratios rising from 63% at the end of September to close out the year at a 6-month high of 70%.²

Looking ahead, in our view the combination of easier monetary policy, strong technicals, and stable credit conditions positions municipals favorably as we enter 2026. That said, there are a number of dynamic themes that will be guiding investors over the coming quarters, not the least of which are uncertainties around the leadership structure and monetary policy intentions of the Fed, geopolitical tensions, and the outlook for tariffs and international trade. With many underwriting firms projecting another year of record issuance, with many estimates more than \$600 billion, investor confidence will be a key input for the stability of the municipal bond market and its prospects for additional relative outperformance.

Taxable Market

Brian Ferry, Senior Portfolio Manager

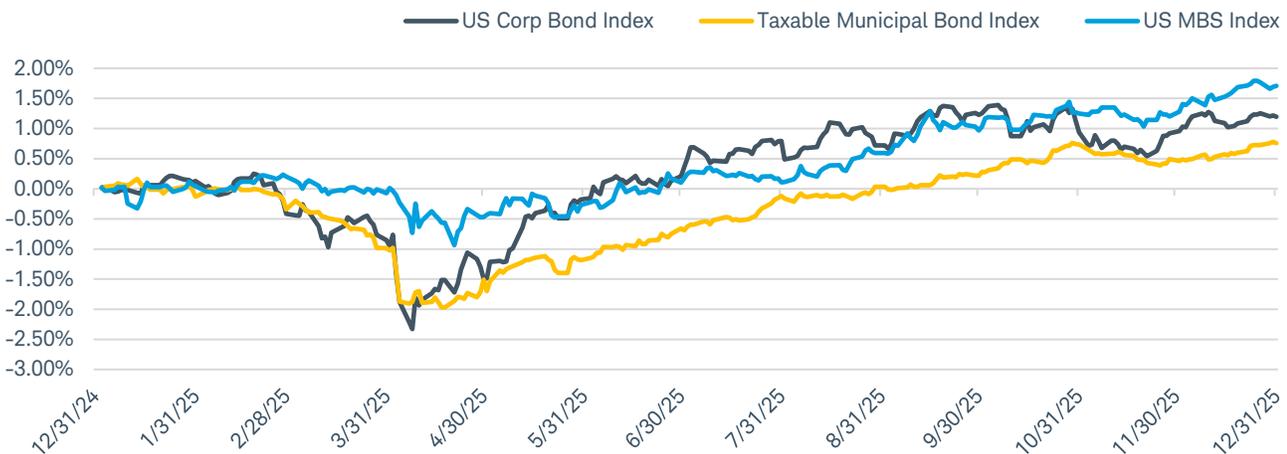
The fixed income market continued to perform well through year-end. The broad measure of the market, the Bloomberg U.S. Aggregate Bond Index, had a total return of 1.10% in the fourth quarter, which added to the year-to-date gains to finish with a total return of 7.30% in 2025. The additional gains were fueled by the above-mentioned 50 bps of rate cuts in the front end of the yield curve a tightening in certain spread sectors.

The corporate bond market weathered periods of turbulence in the fourth quarter to finish mostly unchanged from the start of the quarter. The option-adjusted spread of the Bloomberg U.S. Corporate Bond Index widened from 73 bps at the start of the quarter up to 77 bps at the end of December. The investment grade (IG) corporate bond market underperformed like-duration U.S. Treasury bonds by 4 bps for the quarter. The option adjusted spread (OAS) of the index traded in a fairly narrow range of 47 bps throughout the year and finished 3 bps lower on the year. For the year, IG corporates have outperformed Treasuries by 119 bps. Issuance surged to the upside in the fourth quarter led by deals from technology giants such as Meta, Amazon, and Alphabet. Issuance in the fourth quarter was \$359 billion, a 46% increase from the same period last year. For the year, issuance stood at \$1.77 trillion - an increase of 9% from 2024 and the second biggest year on record.

The taxable municipal market fared better than their corporate peers in the fourth quarter. The Bloomberg Taxable Municipal Index outperformed like duration Treasury bonds by 50 bps in the fourth quarter. The index saw its first monthly decline compared to its benchmark since April, occurring in November, but it still managed to outperform for the quarter. The index outperformed by 76 bps for the year. Issuance for the quarter came in at \$18 billion, an increase of 90% from the same time period last year. Issuance was driven largely by healthcare entities. Issuance for the year was \$54 billion, a 35% increase from 2024.

The Bloomberg U.S. Mortgage-Backed Securities (MBS) Index outperformed like duration Treasury bond by 68 bps in the fourth quarter and by 171 bps for 2025. All coupons within the MBS stack outperformed in 2025. Mortgages with coupons just below par performed the best, followed by deep discounts and lastly premium coupon bonds. Gross issuance for the year increased due to a pickup in refinance activity, however, net issuance fell due to home affordability challenges and limited price appreciation.

Excess Returns of Corporate, Taxable Municipal and MBS markets



Source: Bloomberg as of 12/31/25



Jason D. Diefenthaler

Managing Director, Head of Active Taxable and Municipal Strategies

Jason Diefenthaler is a Managing Director and Head of Active Taxable and Municipal Strategies for Schwab Asset Management. In this role, he is responsible for developing, managing, and implementing Schwab Asset Management’s active taxable and tax-exempt fixed income investment strategies, including separately managed accounts, actively managed mutual funds, and exchange-traded funds (ETFs). Mr. Diefenthaler also leads the portfolio management team for the Wasmer Schroeder® Strategies and is responsible for day-to-day co-management of active fixed income Schwab Funds® and Schwab 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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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.

1 Source: Bloomberg Municipal Bond: 4% <= Coupon < 5% Index -, Bloomberg Municipal Bond: 5% <= Coupon < 6% Index, 4th quarter returns

2 Source: Bloomberg BVAL AAA Muni Yield % of Treasury 10, 30, and 2 years as referenced

Disclosures

Mortgage-backed securities (MBS) may be more sensitive to interest rate changes than other fixed income investments. They are subject to extension risk, where borrowers extend the duration of their mortgages as interest rates rise, and prepayment risk, where borrowers pay off their mortgages earlier as interest rates fall. These risks may reduce returns.

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