CONGRESS
ASSET MANAGEMENT COMPANY

Fixed Income Outlook

| 4Q25

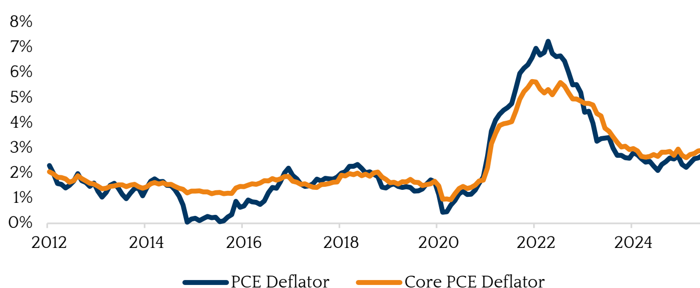
Key Takeaways:

1. **The Federal Reserve cut rates by 25 bps amid weaker employment and rising inflation.**
2. **The Treasury yield curve remains in an unusual "U" shape, expected to gradually normalize into a steeper curve.**
3. **Credit spreads remain tight, keeping Corporate bonds "rich," and they have outperformed Treasuries YTD on strong demand for yield.**
4. **Portfolio strategy remains balanced between Corporates and Treasuries, focused on high-quality, investment-grade bonds for liquidity and protection.**

Interest rates fell across the U.S. Treasury yield curve over the third quarter, with the short end seeing more pronounced declines. The Federal Reserve Open Market Committee (the Fed) chose to cut rates by 25 basis points despite conflicting economic indicators as employment softened unexpectedly and inflation ticked higher. Overall, the yield curve retained its odd-looking "U" shape that has persisted for some time. Bond performance remained positive, with Corporate bonds enduring as sought after issues.

Growing weakness in employment over the quarter prompted the Fed to cut short-term interest rates by 25 basis points. In a recent address, Chairman Jerome Powell said, "In the near term, risks to inflation are tilted to the upside, and risks to employment to the downside—a challenging situation." Markets cheered the cut, but the Fed made it evident that future actions will be dependent on macroeconomic developments.

Figure 1 **YoY Personal Consumption Expenditures Price Indices 2012-2025**

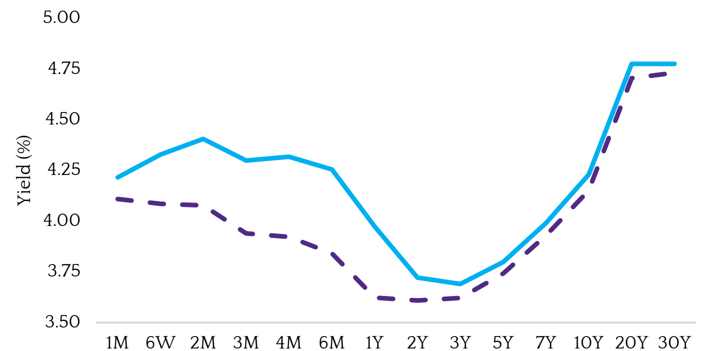


Source: Bloomberg as of 9/30/2025

The cut was a preemptive action given that the economy is not flashing any immediate warning signs. Generally, the U.S. economy has been sound with good growth, relatively full employment, and middling inflation. While one could point to an unbalanced budget, increasing income inequality, or historically high housing prices, monetary policy shifts alone cannot address those challenges. With intense political pressure being applied to the Fed, it suggests this may have been a move intended to provide relief to Chairman Powell.

The Fed's choice is illuminating in terms of its current philosophical bias. Based on the data, they could have held rates steady or even hiked rates to slow inflation. Instead, they chose to cut interest rates in order to foster growth and employment gains. Equity investors are clearly enjoying the prospect of higher economic growth while fixed income investors are less sanguine due to fears of higher inflation that could erode their buying power.

Figure 2 **U.S. Treasury Yield Curve on June 30, 2025 & September 30, 2025**



Source: Bloomberg as of 9/30/2025

The U.S. Treasury yield curve fell over the quarter but retained its unusual shape. In this continuing oddity, short-term and long-term interest rates are nearly equivalent while medium-term rates are much lower. Short-term rates are largely tied to the Fed funds rate and, for now, prop up this part of the curve. Mid-term rates reflect investor expectations of future Fed cuts and long-term rates signal concerns of inflation in the long run. Many other factors impact interest rates set by markets, but these are key issues currently at play.

Credit spreads, or the additional yield required by investors to compensate for default risk, remained stubbornly tight. This metric shows that Corporate bonds are "rich" and that investors have a seemingly insatiable appetite for yield. We continue to be cautious regarding this asset class, preferring to be selective with purchases. Until spreads become more

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attractive, we are unlikely to expand our overall allocation to Corporate bonds.

Corporate bonds, propelled by the additional yield they carry, outperformed U.S. Government guaranteed issues during the quarter and year-to-date. The margin of outperformance stands as an indicator of the market's unslaked thirst for yield. Overall, this has been a very good period for bonds, driven by falling interest rates and a strong demand for Corporate bonds.

Forecasting the economic road ahead is laden with difficulty. Fiscal policy should be slowing the economy (e.g., tariffs, expiring tax provisions, reduced government spending, etc.), yet Fed models expect growth of over 3% in the third quarter of 2025. The current trends of weakening employment and higher inflation levels seem unlikely to change until the Fed cut is fully absorbed into the economy. With no meaningful impetus for change in the near term, we expect these trends to persist and for the Fed to implement further interest rate cuts. Now that the Fed has chosen their preferred path for action, we would estimate approximately 75 basis points of total cuts ahead.

Over the long run, we expect the shape of the yield curve to normalize and become more upward sloping. Fed cuts should bring down the short end of the curve. And, if unchecked, inflationary pressures should push up the long end. This will not be an immediate or overnight transition, instead it will take multiple quarters to develop.

Our portfolio strategy remains unchanged, with a roughly balanced allocation between Corporate bonds and U.S. Government-guaranteed issues. Corporate bonds are still rich and we prefer to be selective with our purchases in that area. Overall, we focus on purchasing high-quality, investment-grade bonds for our clients' portfolios. Our end game is to build portfolios that offer liquidity, strong credit ratings, and principal protection.

John Beaver, CFA© | Portfolio Manager

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Fixed Income Risks

Credit Risk: The risk that an issuer of a fixed income security will fail to make interest payments or repay principal when due, in whole or in part. Changes in an issuer's financial strength, the market's perception of an issuer's creditworthiness, or in a security's credit rating may affect a security's value. In addition, investments in sovereign debt involves a heightened risk that the issuer responsible for repayment of the debt may be unable or unwilling to pay interest and repay principal when due, and the Strategy may lack recourse against the issuer in the event of default. Investments in sovereign debt are also subject to the risk that the issuer will default independently of its sovereign. Below investment grade securities (high yield/junk bonds) have speculative characteristics, and changes in economic conditions or other circumstances are more likely to impair the ability of issuers of those securities to make principal and interest payments than is the case with issuers of investment grade securities.

Extension Risk: The risk that if interest rates rise, repayments of principal on certain debt securities, including, but not limited to, floating rate loans and mortgage-related securities, may occur at a slower rate than expected and the expected maturity of those securities could lengthen as a result. Securities that are subject to extension risk generally have a greater potential for loss when prevailing interest rates rise, which could cause their values to fall sharply.

Interest Rate Risk: The risk that debt instruments will change in value because of changes in interest rates. The value of an instrument with a longer duration (whether positive or negative) will be more sensitive to changes in interest rates than a similar instrument with a shorter duration. Bonds and other debt instruments typically have a positive duration. The value of a debt instrument with positive duration will generally decline if interest rates increase. Certain other investments, such as interest-only securities and certain derivative instruments, may have a negative duration. The value of instruments with a negative

duration will generally decline if interest rates decrease. Inverse floaters, interest-only and principal-only securities are especially sensitive to interest rate changes, which can affect not only their prices but can also change the income flows and repayment assumptions about those investments.

Prepayment Risk: The risk that the issuer of a debt security, including floating rate loans and mortgage related securities, repays all or a portion of the principal prior to the security's maturity. In times of declining interest rates, there is a greater likelihood that the Strategy's higher yielding securities will be pre-paid with the Strategy being unable to reinvest the proceeds in an investment with as great a yield. Prepayments can therefore result in lower yields to shareholders of the Strategy.

General Market Risk: Economies and financial markets throughout the world are becoming increasingly interconnected, which increases the likelihood that events or conditions in one country or region will adversely impact markets or issuers in other countries or regions. Securities in the Strategy's portfolio may underperform in comparison to securities in the general financial markets, a particular financial market, or other asset classes due to a number of factors, including: inflation (or expectations for inflation); deflation (or expectations for deflation); interest rates; global demand for particular products or resources; natural disasters or events; pandemic diseases; terrorism; regulatory events; other governmental trade or market control programs and related geopolitical events. In addition, the value of the Strategy's investments may be negatively affected by the occurrence of global events such as war, terrorism, environmental disasters, natural disasters or events, country instability, and infectious disease epidemics or pandemics.

Municipal Securities Risk: Investing in various municipal securities may involve risk related to the ability of the municipalities to continue to meet their obligations for the payment of interest and principal when due. A number of municipalities have had significant financial problems recently, and these and other municipalities could, potentially, continue to experience significant financial problems resulting from lower tax revenues and/or decreased aid from state and local governments in the event of an economic downturn. This could decrease the Strategy's income or hurt the ability to preserve liquidity.

U.S. Government and Agency Issuer Risk: Treasury obligations may differ in their interest rates, maturities, times of issuance and other characteristics. Obligations of U.S. Government agencies and authorities are supported by varying degrees of credit but generally are not backed by the full faith and credit of the U.S. Government. No assurance can be given that the U.S. Government will provide financial support to its agencies and authorities if it is not obligated by law to do so.