

2nd Quarter 2025

Vanderbilt Avenue Asset Management (VAAM) forecasts that the labor market will weaken. Both Initial and particularly Continuing Jobless Claims are above Covid era levels. Continuing Jobless Claims are at 3-year highs and considerably above the levels experienced in the two years leading up to the pandemic, pointing to the sluggish nature of finding employment in the current economic environment. The Jobless payments data released by BLS has not kept up with weekly Jobless Claims data, but we expect that if this trend in claims continues, it will eventually catch up with the BLS and in turn compel a data dependent Fed to act. VAAM forecasts that the Federal Reserve will remain in wait-and-see mode and monitor incoming data regarding formulating **monetary policy**. The Fed will not react to just one data point but will want to see a pattern in the data when formulating monetary policy. The uncertainty and volatility in both policy making and the financial markets makes the Fed's job even more difficult. We have been in a disinflation (slowing inflation gains) environment for several years as the core PCE has declined from a 5.6% increase to the current 2.7% rate. Tariffs, fiscal and deportation policies are inflationary that will cause upward price pressure in the second half of the year. The Fed will wait to see which of their dual objectives is adversely impacted. Either a weaker labor market causing slowing economic growth or a pivot from disinflation to inflation (inflation rising at an increasing rate). A potential major problem in the stagflation scenario is slowing growth and higher inflation occurring at the same time. This poses a unique challenge for the Fed forcing them to reconcile a goal of low, stable inflation and to sustain a healthy labor market and growing economy. If forced to choose, we think the Fed will address slowing growth first. We forecast a rate cut later in the second half of the year. Any move by the Executive branch to threaten the Fed's independence in formulating monetary policy will be viewed very negatively by the financial markets.

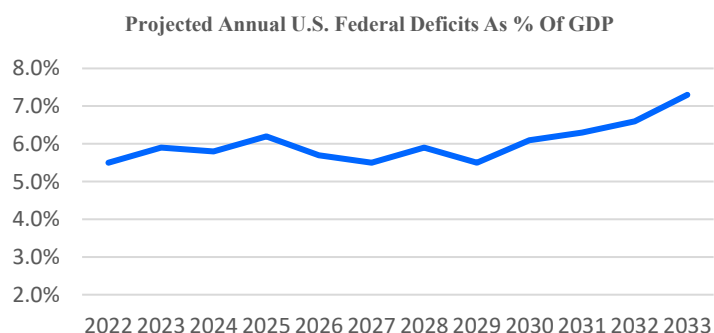


In the wake of a weaker labor market real GDP growth will remain sluggish and the odds of a recession have increased. The core PCE inflation gauge (the Fed's primary benchmark on inflation that excludes food and energy) is currently 2.7% year-over-year. While this is above the Fed's objective, it reflects disinflation from a 5.6% rate a couple of years ago. VAAM is forecasting that inflationary pressures will increase. An environment of stagflation reflecting slowing growth along with increased inflationary pressures is less than an ideal environment for corporate profits. Federal Reserve monetary policy will remain in a wait-and-see posture as to how the economic data evolve from some policies at crosscurrents. For example, tariffs are a regressive tax paid by consumers versus proposed tax legislation giving some consumers tax cuts. The

Fed could be faced with having to address slowing growth or renewed inflation pressures (or potentially at the same time). Heightened uncertainty and volatility will continue to place a cloud over consumer spending (approximately 70% of GDP) and corporate hiring and capex.

Tariffs have caused consumer and business sentiment surveys to significantly decline. Consumers have become more cautious in their spending and businesses are facing margin pressure as costs rise in a slowing growth environment. The timing, magnitude and transitory nature of these tariffs is not clear. This is due to the uncertainty and volatility in policy making. As higher tariff costs get passed on to the consumer, inflation pressures will increase in the second half of the year. Tariffs are both inflationary and impede economic growth. Tariff barriers are used extensively by both China and the EU-two of our largest trading partners. Non-tariff concessions are very difficult to achieve even in prolonged negotiations let alone the abbreviated “arrangements” currently being negotiated. These arrangements are not formal trade agreements which can take months to finalize. The objective of significantly increasing manufacturing jobs will be difficult as companies will be hesitant to commit significant time and resources to rearranging their supply chains. The current tariff controversy does not consider the trade surplus for services the U.S. runs. Although the trade deficit for goods is significantly larger, the U.S. trade surplus for services is \$300 billion. In the short-term tariffs can raise inflation expectations (something that would get the Fed’s attention). However, long-term expectations could remain anchored if the Fed is seen as credible in their targeting of the 2% PCE inflation objective. Should a universal 10% tariff be the result (and the tit-for-tat reciprocal tariffs eliminated), this would still represent a tariff level 4-5 times the previous level. Tariffs will result in fewer goods at higher prices versus more goods at lower prices.

We do not yet know the final shape and details of the tax legislation that will impact **fiscal policy**. As a share of GDP, the deficit will grow from 6.4% last year to 8% in a decade. Never has the U.S. had such large deficits for so long. The current deficit at approximately \$2 trillion and growing will result in higher debt levels thereby putting upward pressure on inflation and interest rates. The wider deficits and debt levels could keep pressure on the Fed for a tighter monetary policy due to the inflationary pressures. This would have an impact on mortgages, car loans, consumer credit cards and capex funding for companies. There is no significant new stimulus in the proposed legislation. Renewing the 2017 legislation that is set to expire simply maintains the status quo. More stimulative measures in the proposed legislation would have to include a further reduction in the corporate tax rate from 21% to 15% as well as making permanent the full expense of capex for tax purposes. Nearly 14% of what the U.S. spends goes toward interest payments on the debt. This is more than what is spent on defense. Proposed fiscal policy will be inflationary and impede economic growth.



Current **immigration** and deportation policies will prove inflationary and an impediment to growth as the cost to replace workers will increase. Deregulation on the surface appears to be a clear winner-productivity enhancement, anti-inflationary and a stimulus to growth. However, so far, the results have lagged, perhaps

because some of the proposed changes require Congressional approval. Geo-political tensions have risen with the possibility of further upward pressure on some commodity prices.

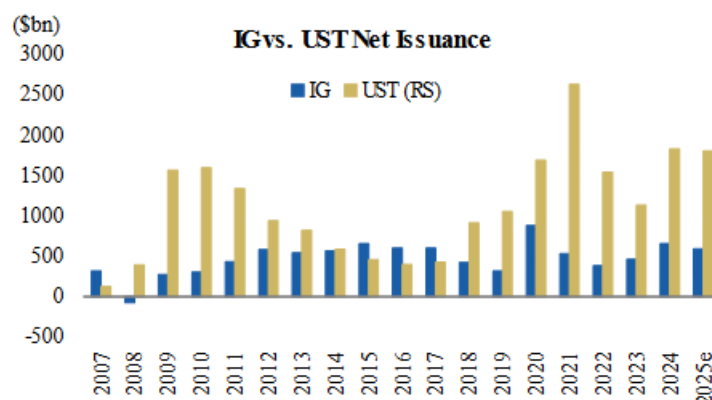
Doubts have risen regarding the role of the **U.S. dollar** (USD) as the world's reserve currency. The USD has declined approximately 10% since the start of the year against a basket of the world's major currencies. Countries have been less willing to hold the USD partially due to the ill will created by the U.S. tariff policies. The swelling deficits and resultant growing debt levels have caused nervousness. The USD could see pressure as interest rates spread between the Federal Reserve and other major central banks are likely to narrow. The recent ratings downgrade by Moody's below top rated Aaa for U.S. Treasury securities highlights the concerns of higher debt levels. VAAM believes the USD will remain the world's reserve currency. Attributes include no other market having the depth and liquidity of U.S. Treasury securities, an independent judiciary and the U.S. legal system. Some further decline in the dollar is possible but its reserve status will be maintained.

2nd Quarter 2025 Fixed Income Summary

Whereas the first quarter of 2025 was dominated by interest rates decreasing evenly across the yield curve, the second quarter was highlighted by a steepening in the yield curve, whereby short rates declined, and the long end increased. The second quarter ended with the 2-year treasury dropping down to 3.72%, while the 10-year treasury increased to 4.23%. The slope of the 2-year to 10-year treasuries went from 0.32% at the start of the quarter to 0.51% at the end; even more exaggerated, the slope of the 2-year to 30-year treasuries went from 0.69% at the start of the quarter to 1.05% at the end.

Much of the magnitude of interest rates relative to one another has been driven by expectations of future interest rate cuts by the Federal Reserve. At the end of 2024, futures markets were pricing in less than two 25 basis point cuts in rates for 2025. But as economic data during the first quarter pointed to a slowdown, markets started to price in three interest rate cuts—a total of 75 basis points. However, the second quarter challenged economic slowdown uncertainties with even greater uncertainties surrounding tariff effects on inflation. This created a new roadblock for the Fed, resulting in an expectation of fewer interest rate cuts by the Fed in 2025, and an increase in interest rates at the long end of the yield curve.

In spite of weakening economic indicators and continued elevated rates, corporate bonds performed well in the second quarter. Unlike previous slowdowns, corporate balance sheets are stronger this time. Also, as the government continues to take on an historical amount of debt, issuing high levels of treasuries that keep rates elevated, new corporate bond issuance has been subdued. As a result, even as rates have increased over the last three years, corporations have maintained a steady level of leverage.



Source: Dealogic, US Treasury, Morgan Stanley
Research forecasts

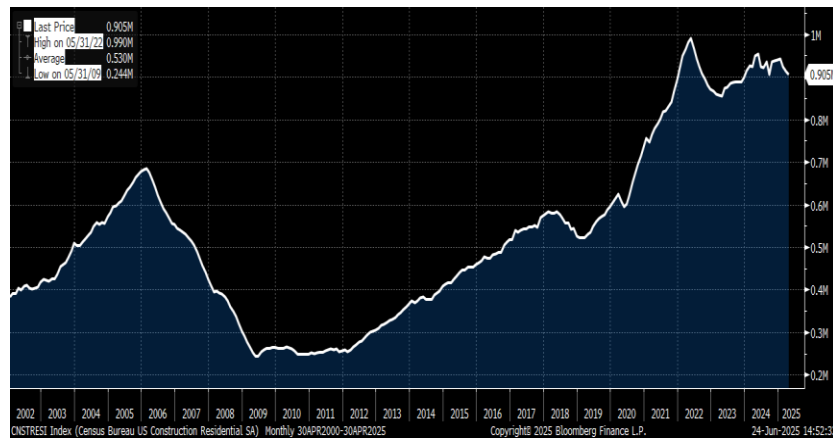
As a result of the strength of corporate balance sheets, when corporate bond spreads did eventually widen during the market volatility incurred from tariff uncertainty in early April, they quickly rebounded to finish the second quarter stronger than they started.

Similar to corporate bonds, agency-rated mortgage-backed securities outperformed similar duration treasuries in the second quarter. Prepayments on mortgage-backed securities remain subdued, resulting from higher prevailing market rates versus fixed locked-in rates from several years ago. Historically, mortgage-backed securities' greatest risk was prepayment volatility: prepayments that were deemed higher than expected for bonds purchased at a premium to par, and prepayments lower than expected for bonds purchased at a discount. However, as we purchase only those bonds that are trading at a discount to par with very low prepayment expectations, any prepayments above those provide a boost to the security's total return.

Even as borrowers hold mortgages at rates below prevailing market rates, many find that they eventually need to sell their homes due to life changes. As a result, we anticipate mortgage-backed prepayments to ramp up over the next year, as the lock-in effect for homeowners begins to wane. This will lead the mortgage-backed securities that we purchased at a deep discount to reap the rewards, as prepayments come in faster than expected.

As movement among homeowners is starting to slowly ramp up, pricing in the housing market is beginning to finally experience a slowdown, both in the price of new and existing homes for sale, and in the levels of rents. The most recent S&P CoreLogic Case-Shiller U.S. National Home Price Index year over year increase was 2.72%, notably below the previous month's year over year level of 3.36%. This slowdown in home price appreciation is a result of an increase in the supply of homes for sale by builders who have been ramping up production in the years after the pandemic and by existing homeowners who are ready to forego their low locked-in mortgage rate.

Census Bureau U.S. Residential Construction Spending



Since prevailing mortgage rates are still close to 7%, however, demand for homes by new buyers remains muted. As a result, the number of days to sell homes is increasing, and in many cases, prices are dropping.

As prices of homes for sale decrease, rental market prices are also lowering. This is exemplified by the continued monthly decrease in the shelter component of the Consumer Price Index. Shelter CPI is comprised of rent and owner's equivalent rent and has decreased from a high of 8.2% in March 2023 to a most recent level of 3.9%. As more multi-family construction becomes available for rent, we expect this shelter CPI to continue to decrease. Since shelter represents roughly one third of CPI, its decrease will facilitate a decrease in the composite CPI index. Lower CPI should provide the Fed with fodder for a rate cut, which should lead to lower mortgage rates, and an incentive for more homeowners with low locked-in mortgage rates to sell their homes, resulting in a slowdown in home price appreciation.

While an eventual slowdown in home price appreciation should lead to slower overall inflation, we are wary of current inflationary pressures coming from tariff and immigration policies. To hedge against inflation, we allocated a portion of your portfolio to Treasury Inflation Protected Securities (TIPS). Unlike nominal treasury securities, the principal of TIPS increases by the level of actual inflation, and their pricing increases by the level of inflation expectations. As a result, unlike other fixed income securities, TIPS perform better in an inflationary environment. In today's uncertain climate, TIPS provide a level of protection to your portfolio against inflation.