



### 3rd Quarter 2025

**Vanderbilt Avenue Asset Management's economic outlook** is for weakening in real GDP growth. Continued labor market weakness will negatively impact consumer spending. Consumer and business sentiment surveys indicate that the uncertainties surrounding Trump's policies are having a negative impact on spending, investment and hiring. Recent data show further signs of weakness in the labor market. The August monthly payrolls report came in much weaker than expected. Over the last four months there has been an average of 27,000 monthly jobs created versus an average of 167,000 monthly jobs added last year. This was before the Bureau of Labor Statistics released their annual revision of minus 911,000 jobs revised downward for the 12 months through March. This revision was much greater than forecast. While recent second quarter real GDP came in at 3.8% annualized, underlying consumer spending was weaker. The consumer sector grew at 2.5%. Inflation is forecast to not meet the Fed's 2% objective any time soon. Between the Fed's dual mandates of maximizing employment with low and stable prices we believe the Fed will move to protect the labor market. The economic setting is increasingly one of stagflation-slows growth with increased inflation pressure. Whether the slowing economy tips into recession could very well depend on the Supreme Court. If the Court rules that a good portion of Trump's tariffs are unconstitutional, this would be tantamount to a tax reduction and promote economic growth. Should the court find that most of the tariffs can remain, this will represent the equivalent of a regressive tax increase on the consumer that will retard growth.

Prior to Trump's tariffs the average tariff rate was 2.5%. The best estimate now is this average rate will be approximately 17%-18%. This is a seven-fold rise that will, for the most part, ultimately be passed on to the consumer in the form of higher prices. It is estimated that consumers will eventually absorb up to 70% of the tariff cost. Consumer sentiment surveys have declined significantly. This has somewhat offset the growth stimulus from the accelerated depreciation provision for tax purposes in the recently enacted tax and spending bill. The result is fewer goods at higher prices versus previously more goods at lower prices. It is questionable to what meaningful extent domestic manufacturing will grow due to the tariff policy. Depending on the Supreme Court's tariff decision, fiscal policy may have to contend again with a \$2 trillion deficit and resultant higher debt level. As tariffs move through the inventory pipeline consumers will increasingly be hit with higher prices. There is also a secondary effect as domestic producers raise their prices to these higher levels. Deportation policy will also raise the cost of labor as businesses must hire replacements at higher wages. Businesses report they are beginning to run through inventory they stockpiled before Trump's tariffs and are starting to pass on their higher costs to customers. Recent price increases have been broad based. Core PCE (the Fed's preferred gauge of inflation) rose 2.9% over the last 12 months, an increase from the 2.6% rate last spring.

The prospect of firm inflation and a softening labor market creates a quandary for the **Federal Reserve**. Between their dual mandates of maximum employment and low and stable prices, the Fed will continue to lower the fed funds rate to support an increasingly fragile labor market. The Federal Reserve cut the fed funds rate 25 basis points at the September meeting, and we forecast it will become more aggressive in their monetary easing for the foreseeable future. The Fed would like to keep consumer inflation expectations grounded. However, expectations have recently risen to 4.6%. The pace and magnitude of the rate reductions will not match President Trump's call for a 3% reduction in the fed funds rate as the Fed keeps a wary outlook on inflation pressures. Due to the uncertainties we have outlined, the Fed said it is difficult to make an accurate economic forecast and they will remain data dependent when formulating future monetary policy. Federal Reserve independence in formulating monetary policy free from political

interference is critical. Should the Supreme Court grant President Trump the ability to infringe on the Fed's independence, this would have negative consequences for the markets. In addition, there may be a selloff in the US dollar-the key reserve currency in the world.

Given these **uncertainties**, this raises the issue of what could go wrong in the investment markets. Areas of concern would include the growth of private credit and private equity. These are often securities from leveraged companies that could see an erosion of their cash flow in an economic slowdown or recession. The relative illiquidity of these instruments could result in significant price corrections. The growth of bitcoin and recent lessening of regulatory oversight is a concern. The recent rise of meme stocks that do not trade on fundamentals but rather comments on social media. The increased popularity of single stock ETFs that offer returns of 2x-3x the underlying stock's movement. Investors are using increased financial leverage. It would be one thing if markets were at levels to compensate for these uncertainties. However, they are not. For example, price/earnings ratios are well above historic norms and credit quality spreads are narrow vis-a-vis high yield debt securities. All of these factors have the potential to make market correction more severe.

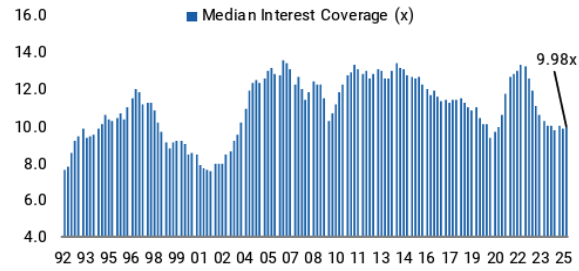
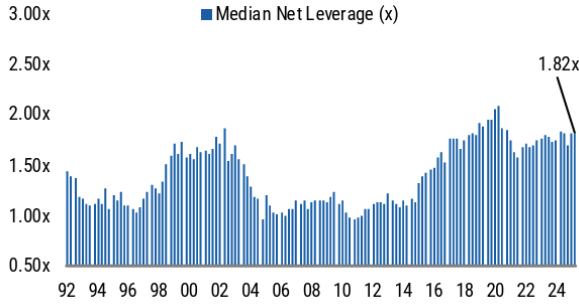
### **3<sup>rd</sup> Quarter 2025 Fixed Income Summary**

During the third quarter, concerns regarding an economic slowdown coupled with inflationary expectations from tariffs led the treasury yield curve to continue a steepening path that had initiated earlier in the year. The spread between the 30-year and 2-year treasury bonds began the quarter at 1.05% and ended the quarter at 1.13%, with the 30-year decreasing by only .04% to 4.73% and the 2-year dropping by .11% to 3.60%. The market is experiencing a bull steepening of the treasury curve as a result of an expectation for continued interest rate cuts by the Federal Reserve to support the weakening labor market and concurrent inflationary expectations from tariff-driven price increases.

As the Fed aims to balance its dual mandate of promoting maximum employment and stable prices in a climate of weakening employment and sticky inflation, we believe that it will continue to carefully cut rates to protect the labor market ahead of insulating against inflation. As a result, we expect the treasury yield curve to continue to steepen as short rates decrease, while longer rates, in response to inflation expectations, stay elevated or decrease at a slower rate. Our yield curve investment strategy in this market environment is to favor an overweight versus the benchmark to securities in the "belly" of the curve, as the return to the belly should outperform the ends on a duration neutral basis in a curve steepening environment.

### **Corporate Bonds**

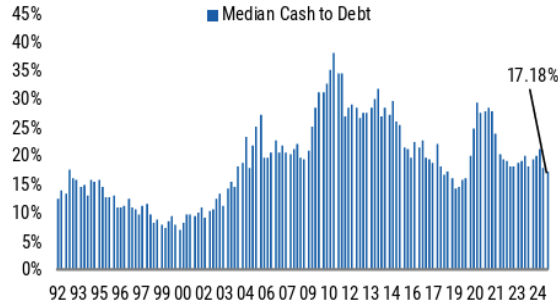
Within investment grade corporates, earnings have been strong with mixed fundamentals (see charts below). While leverage has remained stable in the last two quarters, and interest coverage has improved marginally, cash/debt ratios have decreased for the second quarter in a row. Given all of these fundamentals, corporate bond spreads have continued a tightening path during the quarter. We increased your portfolio's allocation to the corporate bond sector, adding names such as Duke Energy, which had a significant positive earnings surprise and is now trading tighter than its peers.



Source: Bloomberg, FactSet, Morgan Stanley Research

Debt / EBITDA

EBITDA / Interest Expense



## Housing

The housing market continues to remain tight, with low levels of buying and selling, along with limited price movements. The supply of homes for sale is still well below the potential demand, which is curtailed as a result of the lack of affordability due to elevated mortgage rates. We are, however, seeing an opportunity for housing to catch a spark. In the third quarter, the 10-year treasury yield briefly dropped to 4% and the 30-year mortgage rate is now below 6.5%, providing many home sellers with an incentive to move from their locked-in rates. In fact, as rates have decreased, some homeowners have been able to take advantage of the lower rates, as indicated by the Mortgage Bankers Association Refinancing Index, which recorded the highest level of refinancing activity in over 3 years.



A more active housing market could also add to the return of mortgage-backed securities. For government agency MBS that we purchased at deep discount dollar prices, these higher prepayments offer positive return. Since much of the mortgage-backed security universe is unfinanceable, we purchased bonds with low prepayment expectations, that stood to benefit if prepayments increased. Since prepayments on the underlying collateral have been coming in slightly faster than expected by our base case assumptions, these agency MBS bonds that were purchased at a discount have been of benefit to the portfolio.

If the Fed continues its rate cutting path, we expect housing and mortgage-backed securities to benefit. Housing inventory of new homes would increase from new construction, which is aided by lower rates. Additionally, existing homes for sale would rise if mortgage rates decreased, as it would release homeowners from the lock-in effect. More supply would temper housing prices, and lower rates would also offer more affordability to buyers.

### **Treasury Inflation Protected Securities**

During these times when uncertainty driven by tariff legislation and interest rate cuts has an outsized effect on inflation, we allocate a portion of your portfolio to Treasury Inflation Protected Securities (“TIPS”) which provide a hedge against inflation. TIPS valuations, versus nominal treasuries, increase when both actual inflation and inflation expectations as measured by TIPS Breakeven rates increase. In the third quarter, the Consumer Price Index, which indicates actual inflation, remained elevated, and inflation expectations have risen. Returns on TIPS have outperformed nominal treasuries.