

VANDERBILT *Ave.* ASSET MANAGEMENT

4th Quarter 2025

As it prepares to enter a new year the U.S. **economy** is facing challenges. Vanderbilt Avenue Asset Management is forecasting slowing growth bordering on a recession. Inflation pressures will continue and inflation will prove to be sticky in moving down to the Federal Reserve’s objective of 2%. As a result, the Fed will be in a difficult position trying to formulate monetary policy in a stagflation environment.

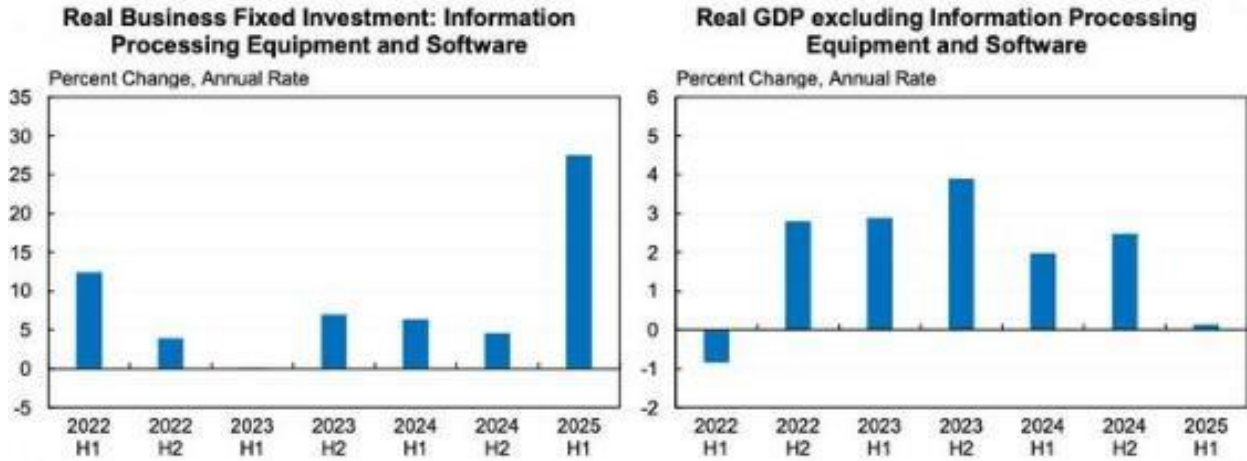
Approximately two-thirds of U.S. GDP comes from the **consumer sector**. Consumers are struggling given recent weakness in the labor market and rising prices for consumer goods. Tariffs are a regressive tax on consumers and will be even more of a factor next year. Consumer loan delinquencies have risen sharply since Covid. Credit card balances are subject to an interest rate of approximately 20%. The “pay later” option for consumers will only worsen the delinquencies. The affordability issue targets specific sectors of consumer goods in contrast to the overall inflation rate. Due largely to tariffs, such goods as coffee, bananas, apparel and furnishings have seen significant price increases. For some of these items the administration recently rolled back tariff rates. Housing is another sector where affordability is an issue. In the South and West housing prices have recently seen declines; however, in the Midwest and Northeast housing prices have continued to climb. This is partially due to the availability of less land and more restrictive zoning regulations. Job growth has been narrowly based. Half of job growth the last two years has been in healthcare, education and government. In addition, Fed Chair Powell recently said the labor data could be drastically overstating recent hiring by up to 60,000 jobs a month. The average monthly job growth since April is 40,000. If correct, this results in a loss of 20,000 jobs per month since April. Another continuing headwind to growth is commercial real estate. Remote work has continued to cause a large vacancy of office space. Companies are leasing less and there is an increasing trend of repurposing office space to residential use. Due to tariffs, wide swings in inventories and net exports have had an abnormally large impact on GDP data.

	<u>Q2 2025</u>	<u>Q1 2025</u>
Line 1 Real GDP	3.8%	-0.6%
2 Personal Consumption	2.5%	0.6%
3 Private Investment	-13.8%	23.3%
4 Change in inventories (USD bn)	-\$18.3	\$172.0
5 Net Exports		
6 Exports	-1.8%	0.2%
7 Imports	-29.3%	38.0%
8 Contributions to percent change in real GDP		
9 Personal Consumption	1.68%	0.42%
10 Gross Private Domestic Investment	-2.66%	3.79%
11 Change in Private Inventories	-3.44%	2.58%
12 Net Exports	4.83%	-4.68%
13 Exports	-0.20%	0.02%
14 Imports	5.03%	-4.70%
15 Final Sales to Private Domestic Purchasers	2.90%	1.90%

Inventories: Q1 ramp up pre-tariffs; Q2 inventory runs down with tariffs in effect (Line 4).

Imports: Q1 increase to build inventories pre-tariff; Q2 large decline in imports as tariffs take effect (Line 7).

Investment in information processing equipment and software is 4% of GDP, but it was responsible for 92% of GDP growth in the first half of 2025. Excluding these items, GDP only grew at an annual rate of 0.10%!



Inflationary pressures will intensify next year, making it difficult for the Fed to achieve their inflation objective of 2%. Both the tariffs and deportations are anti-growth and inflationary. The core PCE (the Fed’s preferred measure of inflation) is 2.8% over the last 12 months. This measure has been in a 2.5%-3% range since early 2024. Tariffs have increased by 7-8 times what they were earlier in the year. The consumer will ultimately pay most of these tariffs in the form of higher prices. Most of these price increases will occur next year. In addition, deportations will cause labor shortages in some sectors (agriculture, construction and healthcare), placing upward pressure on wages. The Supreme Court should issue their ruling on the tariff issue sometime in the first half of the year. Should the Court rule that most of the tariffs are unconstitutional, there will be added confusion regarding the procedures for reimbursements to be made to the companies that paid the tariff cost.

The **Federal Reserve** faces several challenges going into the new year. The Fed’s dual mandates of low, stable inflation and a healthy labor market are in tension due to the stagflation environment we have outlined. There are implications for the new Fed chair if he tries to lower rates too much in line with what the Trump administration wants. Lowering short rates too much could be counterproductive causing further inflationary pressures and higher long-term rates. Given sluggish GDP growth and weakness in the labor market, we think the Fed will elect to support the labor market with one to two additional rate cuts in 2026. This could especially be true if the Federal Reserve staff is correct regarding the labor market weakness the government data has not yet reported. Should inflation pressures heighten, the Fed could be forced to adopt a more restrictive monetary policy. A new Fed chair will find differing opinions regarding monetary policy amongst the policy making members that will make it difficult to forge a consensus. Indeed, some Fed members might dissent on Trump’s lower rates to indicate they are independent and will protect the Fed’s independence. Sometime in the first half of next year the Supreme Court will issue their ruling regarding how much independence agency heads have vis-à-vis the President. The expectation is the Court will carve out the continuation of independence for the Federal Reserve. Should the Court rule otherwise, it would be a shock to the financial system with adverse consequences for the U.S. dollar, bond and stock markets.

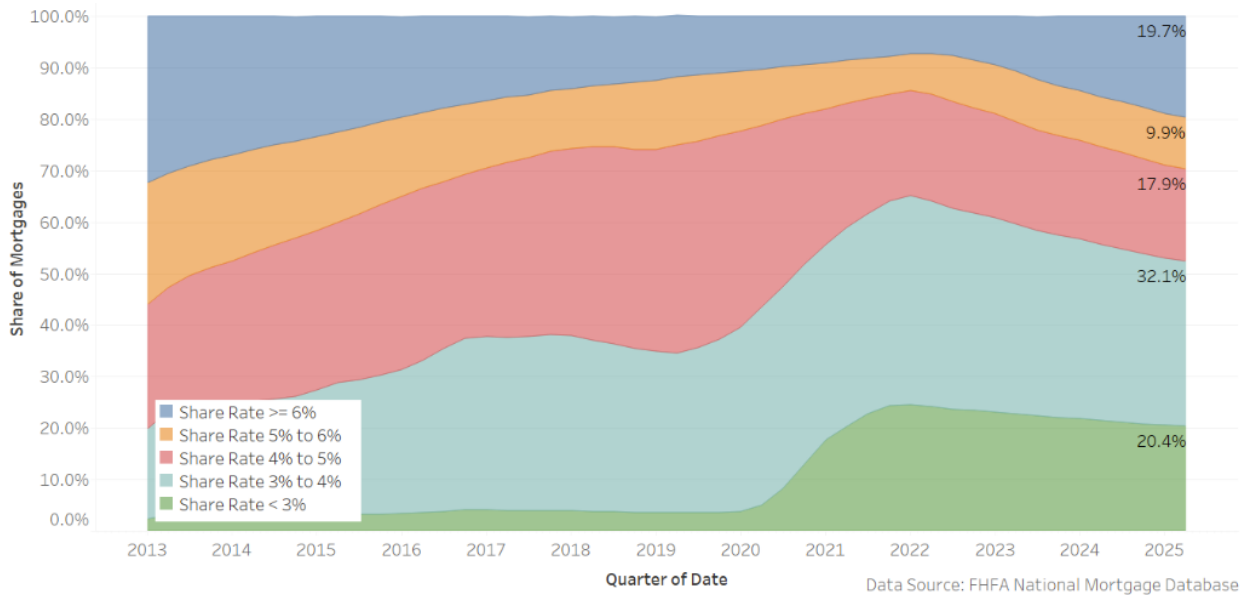
Fixed Income Summary

The treasury yield curve became steeper during the fourth quarter, pivoting around the 10-year treasury rate, with the 30-year treasury yield increasing from 4.73% at the start of the quarter to 4.84% at the end, and the 2-year treasury yield decreasing from 3.61% at the start of the quarter to 3.47% at the end. The combined movements in opposite directions resulted in the 2-year to 30-year curve steepening by 0.25% from 1.12% at the start of the quarter to 1.37% at the end. This reshaping of the treasury curve resulted in outperformance of short-term securities as they increased in price, and an asymmetrically greater underperformance in long-term securities whose prices declined. The directionally disparate rate movements occurred as the Federal Reserve cut the Fed funds rate by .25% in each of their last three meetings and began a program of purchasing short-term treasuries in December to maintain an ample supply of reserves on an ongoing basis, after judging that reserve balances had declined below the necessary ample threshold.

Vanderbilt believes that the recent backup in long-term treasuries may be short lived, when we consider that the Fed’s decision to cut rates was driven by a need to bolster a weakening labor market. Especially as the unemployment rate continues to climb, reaching 4.6% even after 150 basis points of interest rate cuts that began in 2024. Risk of an economic slowdown remains, which should put downward pressure on long-term rates. As a result of our expectation for a decrease in interest rates across the curve, your portfolio’s duration is longer than the benchmark.

Housing

Fed rate cuts should have resulted in easing mortgage rates for consumers, but due to the steepening of the treasury curve, whereby long-term rates remained elevated even as short-term rates declined, mortgage borrowing rates are still well above 6%. As a result, most of the housing market remains locked-in and ineligible for refinancing. Eighty percent of outstanding mortgage debt has a sub-6% borrowing rate, creating a lock-in effect for homeowners which keeps housing supply down, while demand increases, resulting in elevated prices at still unaffordable rates.



New construction inventory has alleviated some of the supply shortfalls, and builders offer interest rate incentives to lessen the cost burden of buying a home, but affordability remains tight as neither prices nor interest rates have had a pronounced decrease.

Meager incentives for homeowners to sell homes have resulted in low prepayment levels on mortgage-backed securities that are collateralized by mortgage debt. Vanderbilt purchased mortgage-backed securities in your portfolio at a discount with the base case assumption that prepayments will remain low. If mortgage rates start to decrease, leading to increased prepayments, these securities will benefit as they will receive principal back at par at a faster rate than assumed at time of purchase.

Treasury Inflation Protected Securities

The administration's tariff and immigration policies have resulted in consumer inflation concerns. As a hedge against inflation, Vanderbilt has allocated a portion of your portfolio to Treasury Inflation Protected Securities. TIPS perform better than nominal treasuries when either actual inflation is elevated or when inflation expectations as measured by breakeven rates rise. In the fourth quarter, as more clarity surrounding tariff policies took hold and inflationary indicators such as hourly earnings remained subdued, inflation expectations measured by breakeven rates diminished. Likewise, actual inflation, although still well above the Federal Reserve's 2% target, did not increase as much as was feared. As a result, the TIPS underperformed their nominal treasury counterparts. Vanderbilt still likes these securities as they provide an inflation hedge to a fixed income portfolio in uncertain times.



Corporate Bonds

Corporate bonds continue to be resilient, as evidenced by strong fundamentals and positive earnings surprises. Interest coverage ratios that measure companies' ability to pay interest on outstanding debt using their EBITDA (earnings before interest taxes depreciation and amortization) have remained stable, and still above pre-pandemic levels. Likewise, gross leverage levels which measure companies' debt

divided by EBITDA have not increased in the last few quarters. Corporate earnings continue to move along at a healthy pace, with about 85% of companies exceeding their estimates, yielding the best results since 2021. The solid fundamentals coupled with strong earnings have resulted in tight valuations for corporate bonds.

