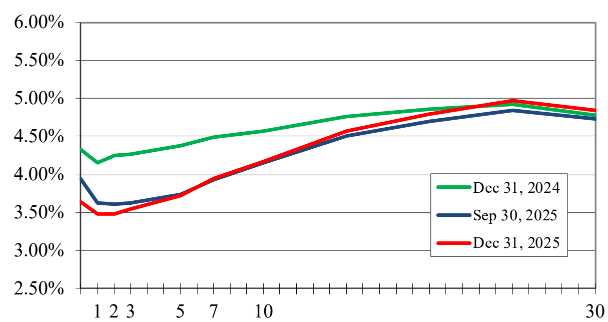
Baird Advisors
Fixed Income Market Commentary
2025 Review and 2026 Outlook

2025 Bond Market Review

Treasury yields declined across the curve in 2025 with the lone exception being the 30 yr, which rose 7 bps. The largest yield declines were among shorter maturities as shown in the -76 bps drop in the 2y year maturity. The 10yr fell -41 bps. The steepening trend, underway for the past 2.5 years, continued as the slope of 2s10s yields finished at +69 bps, 35 bps steeper for the year and 179 bps steeper since mid-2023 (peak curve inversion). The first half of the year was shaped by the policy actions of the new Trump administration and Republican-controlled Congress. The tariff rollout on Liberation Day in April, the government spending curbs targeted by the Department of Government Efficiency (DOGE) as well as the framework construction for spending and tax cuts (including extending 2017's TCJA) that ultimately became the One Big Beautiful Bill Act (OBBBA) shaped the first half of the year. The high threatened tariffs and resulting retaliation, in particular, stoked yield and spread volatility in 1H '25 as the announced +20-percentage point hike in tariffs was the largest increase since the Smoot Hawley Tariff Act in 1930. The second half of the year was marked by the longest Federal government closure (43 days) on record, increased scrutiny by investors regarding the substantial growth in AI-infrastructure borrowing and spending, a renewed focus to achieve peace deals for the wars in Ukraine and Gaza, and lower actual tariff rates than initially feared. The federal government closure caused delays and distortions of US economic data.

The Fed, for its part, remained on hold for 1H '25 by keeping its policy rate at 4.25-4.50%. Core PCE inflation's first reading in January of 2.8% YoY contributed to market concerns that the gradual decline of inflation back to the Fed's 2% target had stalled. Labor market strength continued in the first half of the year as US non-farm payroll growth averaged +182K per month. This strength coupled with uncertainty regarding inflationary impacts of US trade and fiscal policy shaped the Fed's unanimous "wait and see" approach on the Fed Funds rate. However, by July, divisions within the Fed began to emerge as two governors dissented in favor of lowering rates on slower US growth, softer labor markets and less than expected inflation from tariffs. Expectations for resumed Fed rate cuts increased over late summer and culminated in the Fed cutting 25 bps in September to 4-4.25% as US non-farm payrolls showed notable cooling in labor with just +11k avg monthly jobs over June-Aug period. Despite "distorted data", to use Fed Chair Powell's phrase, from the Federal government closure, the Fed had enough information to make additional ¼ point cuts in October and December, which took the policy rate to 3.50-3.75% at year end. The Fed also introduced Treasury Bill purchases as part of the Reserve Management Purchase Program (RMP) to ease pressure on short-term funding rates.

Treasury Yields



Maturity	12/31/24	9/30/25	12/31/25	Q4 Chg	YTD Chg
3 Mo	4.33%	3.95%	3.64%	-0.31%	-0.69%
1	4.16%	3.63%	3.48%	-0.15%	-0.68%
2	4.24%	3.61%	3.48%	-0.13%	-0.76%
3	4.28%	3.62%	3.54%	-0.08%	-0.74%
5	4.38%	3.74%	3.73%	-0.01%	-0.65%
7	4.48%	3.93%	3.94%	0.01%	-0.54%
10	4.58%	4.15%	4.17%	0.02%	-0.41%
20	4.86%	4.71%	4.80%	0.09%	-0.06%
30	4.78%	4.73%	4.85%	0.12%	0.07%

Volatile Spread in 1H '25 Followed by Docile Spreads in 2H '25

Spreads compressed for most sectors in 2025 as the theme of attractive all-in income overwhelmed concerns of tight spreads. IG Corporate OAS began the year at a historically narrow spread of +80 before ultimately reaching +119 at the apex of concerns regarding tariffs with the "Liberation Day" announcement of punitive tariff rates in early April. Ultimately spreads declined through mid-year to +83 by June 30. The second half of 2025 featured low volatility as Corporate OAS remained in a 13-bps range to finish the year at +78, -2 bps tighter for 2025. The period from late May through year end marked the longest stretch below +90 bps OAS for the IG Corporate Index since the mid-1990s. Compelling absolute yields attracted insurers, including annuity providers, foreigners and asset managers and resulted in tight spreads despite heavy gross supply. Agy RMBS and CMBS also tightened for the year with the bulk of Agy RMBS' move occurring in Q4. Emerging Markets finished the year particularly strong, tightening -54 bps in Q4 to finish the year at +326 bps, -67 bps tighter for the year.

Option-Adjusted Spreads (in bps)

	12/31/24	9/30/25	12/31/25	Q4 Chg	YTD Chg
U.S. Aggregate Index*	32	28	27	-1	-5
U.S. Agency (non-mortgage)	12	10	11	1	-1
Mortgage and ABS Sectors					
U.S. Agency RMBS (Pass-throughs)*	34	31	22	-9	-12
U.S. Agency CMBS	35	31	33	2	-2
U.S. Non-Agency CMBS	127	121	120	-1	-7
Asset-Backed Securities	44	49	52	3	8
Corporate Sectors					
U.S. Investment Grade	80	74	78	4	-2
Industrial	78	72	76	4	-2
Utility	82	81	85	4	3
Financial Institutions	82	74	78	4	-4
Non-Corporate Credit	55	43	45	2	-10
U.S. High Yield Corporates	287	267	266	-1	-21
Emerging Market Debt	393	380	326	-54	-67

Source: Bloomberg Indices
**U.S. Aggregate Index and U.S. Agency RMBS spreads in 2024 have been adjusted to incorporate Bloomberg's most recent prepayment model, which was updated on 1/24/2025*
(Bloomberg updates the prepayment model on an annual basis which impacts the sector OAS).

Robust Nominal and Excess Returns Across Fixed Income in 2025

The Agg Index total return was 7.30%, its largest calendar year return since 2020. The annualized trailing 3-year Agg Index return now stands at 4.65%. Agy RMBS was a notable outperformer in 2025, driven by positive supply/demand dynamics and lower rate volatility. Low organic net supply due to subdued housing market activity was absorbed as demand came in multiple forms including purchases by GSEs, mortgage REITS, and money managers seeing inflows. This demand was also more than enough to offset continued runoff of the Fed's mortgage portfolio at the tune of ~$15bln/month. The MOVE index, measuring implied Treasury rate volatility, fell from ~100 bps to ~60 bps, lowest since 2021, further supporting Agy RMBS excess returns for this volatility-sensitive sector. The sector finished up 8.58% with +1.71% of excess return for the year with the lion's share of that excess return produced in Q4 (+0.65%). The second half of 2025 produced the strongest Agy RMBS excess returns for any six-month stretch since 2011. CMBS (+17 bps) and ABS (+16 bps) produced similar excess returns in Q4 but CMBS (+1.03%) outperformed ABS (+0.55%) in excess return for the year. IG Corporates produced +1.19% of excess return for the year driven in large part by strong spread income "carry" from the sector. The IG Corporate Market continued to digest outsized debt issuance from AI hyperscalers, particularly in October and November. HY Corporate and EM Debt led major sectors in excess return for the year, producing +2.60% and +7.14%, respectively. Municipal Bonds, which substantially underperformed in early 2025, finished strong in Q4 (+1.56%), but lagged most sectors YTD with a 4.16% return.

Total Returns of Selected Bloomberg Indices and Subsectors

	MTD Total Return	MTD Excess Return	3 Mo Total Return	3 Mo Excess Return	YTD Total Return	YTD Excess Return	Effective Duration (years)
U.S. Aggregate Index	-0.15%	0.18%	1.10%	0.16%	7.30%	0.78%	5.98
U.S. Gov't/Credit Index	-0.27%	0.09%	0.90%	-0.01%	6.88%	0.47%	6.15
U.S. Intermediate Gov't/Credit Index	0.09%	0.06%	1.20%	0.04%	6.97%	0.43%	3.74
U.S. 1-3 Yr. Gov't/Credit Index	0.34%	0.01%	1.16%	0.02%	5.35%	0.20%	1.85
U.S. Treasury	-0.33%	0.00%	0.90%	0.00%	6.32%	0.00%	5.88
U.S. Agency (Non-Mortgage)	0.05%	-0.02%	1.17%	0.08%	6.11%	0.31%	3.30
U.S. Agency RMBS (Pass-Throughs)	0.21%	0.47%	1.71%	0.69%	8.58%	1.71%	5.63
CMBS (Commercial Mortgage Backed Securities)	0.12%	0.08%	1.34%	0.17%	7.75%	1.03%	3.87
ABS (Asset-Backed Securities)	0.30%	0.12%	1.25%	0.16%	5.93%	0.55%	2.85
U.S. Corporate Investment Grade	-0.20%	0.26%	0.84%	-0.04%	7.77%	1.19%	6.83
U.S. High Yield Corporates	0.57%	0.40%	1.31%	0.16%	8.62%	2.60%	2.77
Emerging Market Debt	1.26%	1.43%	4.72%	3.68%	13.64%	7.14%	4.97
Municipal Bond Index	0.09%	N/A	1.56%	N/A	4.25%	N/A	6.74
Taxable Municipal Bond: Agg Eligible	-0.56%	0.25%	1.26%	0.51%	7.75%	0.76%	9.11
TIPS (Treasury Inflation Protected Securities)	-0.40%	0.00%	0.13%	0.00%	7.01%	0.00%	6.50

*Excess return represents the return of a spread sector versus a like-duration U.S. Treasury.

2026 Outlook

The year ahead begins with investors continuing to earn attractive income as shown by the yield on the U.S. Aggregate Index at 4.32%. Appealing roll-down benefits from a steeper yield curve should enhance returns and incentivize investors to extend from cash-like holdings. However, investors also recognize some of the uncertainties that lie ahead. The Fed begins 2026 as a body divided with three of the twelve voting members dissenting in recent meetings, expressing differing views on the two-sided risk of the Fed's dual mandate of full employment and stable prices. In its recently released Summary of Economic Projections (SEP) the Fed raised its real GDP forecasts while also lowering its Core PCE inflation estimate. The Fed noted that its policy rate is "within a range of plausible estimates of neutral", potentially setting the stage for a pause to see how the 75 bps of 2H'25 rate cuts as well as fiscal policy stimulus from tax cuts impact the economy. President Trump has signaled his desire for lower rates and is expected to announce a new Fed Chair candidate in advance of Chair Powell's term ending in May. Signs point toward a continued steepening of the Treasury yield curve. Fiscal policy will be shaped by the large Federal deficit, fiscal stimulus associated with the OBBBA, the re-shoring associated with Trump's tariff policy and the looming mid-term elections. Republicans begin the year with control of all three branches of Federal government. Mid-term elections have historically ushered in changes to party control and have also been harbingers of financial market volatility. That environment calls for a focus on prudent risk management. Investments in lower quality holdings offer investors additional income to start the year but tight spreads also provide little insulation against a spread widening event. 2026 will reward investors focused on risk management as continued AI investment adds to the uncertainty regarding the duration and strength of this economic cycle. Paying attention to what is not owned or underweighted could be as important – if not more so - than focusing on what is owned or overweighted.

Disclosures

Information in this document regarding market or economic trends, or the factors influencing historical or future performance, reflects the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose. This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. *Past performance is not a guarantee of future results.*

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk, and liquidity risk. In a rising interest rate environment, the value of fixed- income securities generally decline and conversely, in a falling interest rate environment, the value of fixed-income securities generally increase. High yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield.

Treasury yields are the interest rates that the U.S. government pays to borrow money for varying periods of time.

Option-adjusted spread is the difference between the yield of a security that pays fixed interest payments and the current U.S. Treasury rates, which represents the rate of return on a risk-free investment.

The Bloomberg U.S. Aggregate Bond Index is an index comprised of approximately 6000 publicly traded bonds including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

The Bloomberg Government/Credit Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt.

The Bloomberg Intermediate U.S. Government/Credit Bond Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between one and ten years.

The Bloomberg 1-3 Year U.S. Government/Credit Bond Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between zero and three years.

The Bloomberg U.S. Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint of at least one year but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double- counting. Securities in the Index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. The U.S. Treasury Index was launched on January 1, 1973.

U.S. Agency: This index is the U.S. Agency component of the U.S. Government/Credit index. Publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities). The largest issues are Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLB). The index includes both callable and non-callable agency securities.

U.S Corporate – Investment Grade: This index is the Corporate component of the U.S. Credit index. It includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

CMBS (Commercial Mortgage-Backed Securities): This index is the CMBS component of the U.S. Aggregate index. The Bloomberg CMBS ERISA-Eligible Index is the ERISA-eligible component of the Bloomberg CMBS Index. This index, which includes investment grade securities that are ERISA eligible under the underwriter's exemption, is the only CMBS sector that is included in the U.S. Aggregate Index.

MBS (Mortgage-Backed Securities): This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.

ABS (Asset-Backed Securities): This index is the ABS component of the U.S. Aggregate index. The ABS index has three subsectors: credit and charge cards, autos, and utility. The index includes pass-through, bullet, and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. The Manufactured Housing sector was removed as of January 1, 2008, and the Home Equity Loan sector was removed as of October 1, 2009.

Corporate High Yield: The Bloomberg U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

Emerging Market: Bloomberg uses a fixed list of countries defined as emerging markets countries for index inclusion purposes that is based on World Bank Income group definitions (Low/Middle), IMF country classifications (Non-Advanced Economies), and other advanced economies that may be less accessible or investable for global debt investors.

The Bloomberg Municipal Bond Index is a broad-based, total-return index. The bonds are all investment-grade, tax-exempt, and fixed-rate securities with long-term maturities (greater than 2 years). They are selected from issues larger than $50 million.

The Bloomberg TIPS Index consists of Treasury Inflation Protected Securities (TIPS). TIPS are securities whose principal is tied to the Consumer Price Index. TIPS pay interest semi-annually, based on the fixed rate applied to the adjusted principal.

Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.

This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. Indices are unmanaged and are not available for direct investment.