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In the second quarter of 2025, fixed income markets navigated a turbulent landscape dominated by the White House's shifting tariff policies. When announced in early April, tariffs initially sparked fears of an inflationary recession, driving a sharp selloff in equities and pushing interest rates higher. The 10-year Treasury yield climbed from 4.2% to 4.5% as investors grappled with heightened inflation risks and concerns over reduced foreign investment in U.S. markets. However, a moderation in the administration's stance—highlighted by a U.S.-China agreement to reduce tariffs from 145% to 30% and a 90-day pause on reciprocal tariffs—stabilized markets by mid-quarter. This shift supported a recovery in the S&P 500, which gained 11%, while the Bloomberg Aggregate Bond Index posted a modest 1% return and the 10-year Treasury yield was essentially unchanged over the quarter at 4.2%.

Economic data in the first half of 2025 signaled a slowdown. First-quarter GDP was revised downward to -0.5%, reflecting weaker consumer and business activity. Retail sales growth downshifted from 3-4% in 2024 to around 1% year-to-date in 2025. Housing market activity contracted with home sales, housing permits and home prices declining for the first five months. Labor markets also showed signs of strain, with continuing jobless claims rising to 2 million, the highest since late 2021, according to the Bureau of Labor Statistics. Inflation remained steady over the past two months, but economists warn that tariff pass-through effects could drive prices higher in the coming quarters.

Despite early volatility, fixed income markets demonstrated resilience. The Federal Reserve maintained the Fed Funds rate at 4.25-4.50%, adopting a cautious “wait-and-see” approach to assess tariff impacts. Corporate bond and high-yield spreads narrowed, supported by robust corporate earnings, strong interest coverage, and declining leverage. High-yield default rates rose slightly to 3.8% from 3.5% in 2024, per S&P Global data, but remained near long-term averages. Municipal bond investors welcomed the

preservation of their tax-exempt status in the final U.S. House Budget Bill, avoiding a proposed elimination that could have disrupted demand and pricing. This stability bolstered municipal bond performance, with yields on 10-year AAA-rated municipals holding steady at 3.3%.

While markets stabilized, rising fiscal deficits posed a persistent concern for fixed income investors. The Congressional Budget Office projects deficits of 6-7% of GDP through 2028 from the One Big Beautiful Bill Act (OBBBA). Current federal debt servicing costs are \$1.2 trillion annually against \$5 trillion in government revenue. Increased Treasury issuance to finance these deficits could pressure yields higher, particularly if foreign demand for U.S. debt wanes. Investors remain suspect of the sustainability of the U.S. debt trajectory and its implications for long-term interest rates.

Looking ahead, fixed income markets face an environment shaped by tariff resolutions, fiscal policy, inflation dynamics, and Fed policy. The July 9, 2025, tariff deadline may be a critical point, potentially influencing inflation, growth, and the Fed. And while we anticipate continued policy surprises and interest rate volatility, fixed income investments remain a good value with yields substantially above inflation expectations.

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In a fixed income market rattled by tariff uncertainties and rising yields, Riverbridge remains steadfast in our disciplined approach. We prioritize meticulous security selection and rigorous risk management, focusing on high-quality, income-generating securities in seeking to deliver stability and consistent returns. By tuning out short-term market noise, we strive to help our clients stay on track to achieve their long-term financial objectives.

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