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In Q3 2025, fixed income markets demonstrated resilience amid geopolitical tensions and tariff uncertainties. The Federal Reserve cut its key interest rate by 25 basis points to a 4.0–4.25% range in September—its first reduction in a year—in response to labor market weakness. This bolstered bond returns, with the Bloomberg Aggregate Bond Index up 2% and the Bloomberg Municipal Bond Index up 3%, reflecting strong demand for high-quality, tax-exempt securities. Meanwhile, stocks had a great quarter with the S&P 500 index rising 8%. The Fed now faces a tricky balance of weakening labor markets and persistent inflation. Futures contracts show that markets participants now anticipate two more 25 bps cuts in 2025 and two in 2026, which would leave the Fed Funds rate at 3% by year-end 2026.

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The 10-year Treasury yield ended the quarter at 4.2%, down from a Q3 peak of 4.5% in July. Early-quarter tariff uncertainty, high Treasury issuance, and persistent fiscal deficits in the OBBBA triggered a selloff in long-maturity bonds, briefly pushing yields higher. As tariff-related inflation fears diminished, bond markets stabilized, and yields retreated. The Treasury yield curve flattened (short rate fell more than long rates) as long-term yields remain more sensitive to supply and demand dynamics.

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Economic growth likely rebounded in Q3, driven by robust consumer spending. The Atlanta Fed's GDPNow tracker estimates 3.9% annualized growth, up from 1.25% in the first half of 2025. However, inflation remained sticky, with August core PCE at 2.9% year-over-year, above the Fed's 2% target. Revised employment data highlighted a labor market with significant softness. 2025 job growth is averaging just 125,000 per month, down significantly from 2024's 186,000 per month.

While topline economic growth has been solid, middle-income households are facing rising financial stress, with credit card delinquencies at 12.3% (exceeding the 2009 peak of 11.0%), auto loan delinquencies at 5.0% (near the 2010 peak of 5.3%), and student loan delinquencies at 10.2% (below the 2012 peak of 17.1% but up sharply from 2024). The end of pandemic-era forbearance programs and higher borrowing costs exacerbated these trends as much of the credit weakness is among younger households. However, high-income households and corporates, in general, showed resilience. Despite the high-profile defaults of Tricolor and First Brands, Leveraged Loan and High-Yield corporate defaults remain only slightly elevated at 4% compared to long-term averages (near 3%), according to JPM.

After the quarter ended, on October 1, a government shutdown halted non-essential services, likely furloughing thousands of federal workers. Historically, shutdowns have been a drag on GDP growth and may suggest potential economic drag in Q4, increasing recession risks and demand for bonds. The shutdown will likely also delay key data releases, including September's employment report, which may heighten market volatility and cloud the economic outlook.

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