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The fourth quarter of 2025 marked the return of a more normal upward-sloping bond yield curve, which steepened after the Federal Reserve lowered short-term interest rates by 25 basis points at each of its October and December meetings. This brought the total Fed easing in this rate cycle to 1.75%, which began in the third quarter of 2024 and took a nine-month hiatus from December 2024 to September 2025. The 10-year yield barely budged in the quarter, ending at 4.2%, down from 4.6% at the start of the year.

Fed easing in 2025 set the stage for the best full year taxable bond returns since 2020. Still, fixed income investors had to endure a bond market revolt in April over concerns that the Trump administration's fiscal deficit, tariff, and immigration policies would impact US growth and inflation. The Bloomberg Aggregate Bond Index and the Bloomberg Municipal Bond Index returned 1% and 2% in the quarter, and had annual returns of 7% and 4%, respectively. Meanwhile, the stock market continued its strong performance, with the S&P 500 index rising 3% in the quarter and 18% for the year, driven primarily by mega cap technology and AI infrastructure companies.

The unemployment rate rose modestly in 2025, up 0.5 percentage points to 4.6% as of November 2025, and the 12-month US CPI chain-weighted inflation rate came in at 2.6% in November 2025, the same level as the December 2024 report. President Trump's tariffs likely delayed a decline in inflation in 2025 and affected business inflation expectations; however, according to earnings reports, business inflation expectations have moderated substantially for the coming year and could provide a disinflationary tailwind.

The Fed's easing cycle is now mature but not complete, and it usually does not end without the Federal Funds Rate equaling or dropping below the rate of inflation, which remains about 1% below today's Funds Rate. In Fed Chairman Powell's recent press conference, he remarked that "we are on the high side of the normal neutral rate now...with tariff effects likely to flow through in early 2026 along with softer employment

despite lower immigration and improvements in productivity." This all lines up with more easing ahead.

We believe the economic backdrop looks good for bonds. However, policy questions remain as the end of Powell's term looms in May. President Trump insists that the next Chair cut interest rates more aggressively. An activist Fed chairman, directly supporting the executive branch, certainly isn't the first choice of most market participants, and could keep longer-term interest rates higher than they otherwise would be. Recently, though, lower short- and intermediate-term interest rates have provided some relief to the housing market through lower mortgage rates. Housing starts and existing home sales have been in a recession-type slump since 2022.

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Interest rates are not the only policy expected to ease in 2026. The government has embarked on regulatory easing, which will likely affect fixed income markets in the coming years. In December, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) announced that they were rescinding interagency guidance on leveraged lending for banks. The loan guidance was issued in 2013 in response to the significant bank portfolio losses during the Great Financial Crisis. This policy change will likely clear the way for banks to more effectively compete with non-bank lenders, enabling them to make more loans to small businesses. While this is positive for small businesses, it may lead to weaker lending practices and greater credit risk for bond market investors.

Despite all the concerns early in the year about government policy, Riverbridge remained disciplined in our fixed income approach. We continue to make our investment choices with an eye toward long-term value and understanding risks, supporting our clients' stability and income needs.

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