Confluence INVESTMENT MANAGEMENT

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Destruction and Creativity

- Policy changes in Washington are taking place at a pace and scale greater than the modern historical cadence.
- The bond market has offsetting forces at play that are combining to create stability; however, this isn't necessarily the case in other countries, including those in Europe.
- Tariffs are a significant issue, though it's difficult to foresee their ultimate effect on inflation and economic growth. For now, bond yields are well above our expectations for inflation.
- Corporate spreads have widened with the broad "risk off" mentality but remain tight relative to history. MBS have performed well and remain attractive.
- We suggest a slightly shorter duration posture with an even-weight allocation to Treasurys.

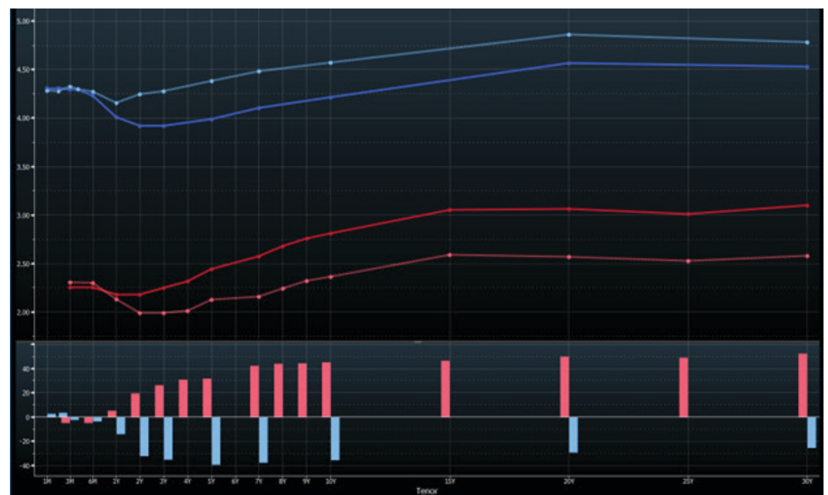
Joseph Schumpeter was an Austrian economist who worked on concepts relating to market equilibrium and how cycles of innovation could disrupt the status quo. In a capitalistic system, he referred to the process as "Creative Destruction," a term that is often applied today to circumstances where existing structures are eliminated, by design or circumstance, and are replaced with new ones. If what's new is more efficient, then the ascension from the ashes could be considered creative.

Unconventional changes in Washington policy are unfolding at a faster pace and with greater impact than what the markets, economy, and society are accustomed to. And it's an open debate, or perhaps just a difference of opinion, as to whether those changes are part of a cycle of creative destruction…or one of just plain destruction. Furthermore, the changes certainly aren't limited to domestic economics or governance as foreign policy is also being abruptly reshaped, affecting both friends and foes of the United States.

Given this changing environment, financial market volatility has risen in 2025 as investors attempt to discern the magnitude and timing of policy changes. Treasury yields in the United States have been generally stable thus far and are oftentimes caught between opposing forces. For example, tariffs could cause inflation, which would pressure rates higher. On the other hand, tariffs could also cause a recession, which would pressure rates lower. In Europe, the view on policy effects has been more clear, propelling interest rates definitively upward, as political leaders have concluded that spending more on defense is needed, even if it creates large budget deficits.

Our first chart compares the yield curves of the United States (blue) with Germany (red) and displays maturities ranging from one-month bills to 30-year bonds. The lighter lines show interest rates at the beginning of the year, while the darker, bolder lines depict recent rates. The bars in the lower section show the change in yields, and we can see that longer-maturity German rates have risen by almost 50 bps so far in 2025, while US rates have declined by around 25 bps. Most of the increase in German rates happened rapidly after the government announced large increases to defense spending, along with a proposal that these expenditures would be excluded from deficit spending limitations. German bond prices fell in anticipation of rising future supply.

US and German Sovereign Yield Curves



(Source: Bloomberg)

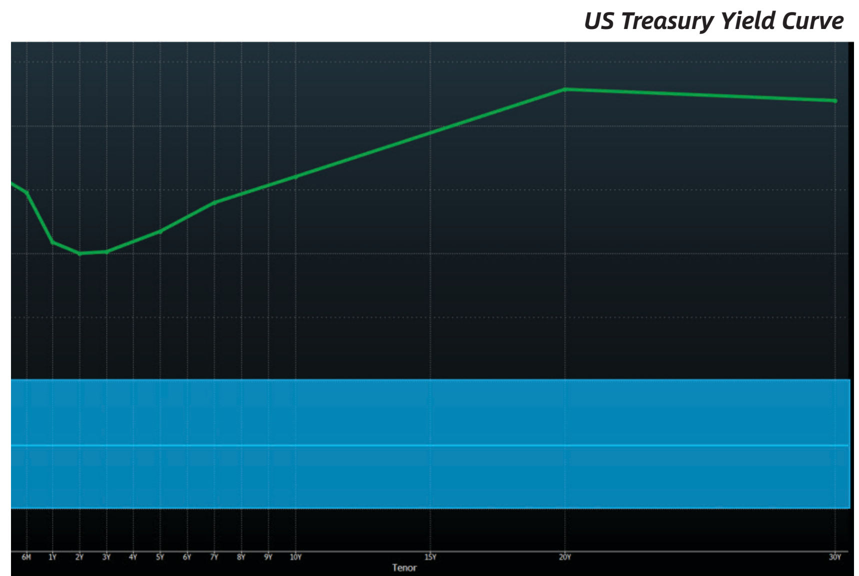
Also noteworthy is the changing shape of the sovereign yield curves, which reflect not just the supply and demand of government debt, but also investor expectations. The German yield curve is gaining slope, taking on a more normalized shape. This change may reflect rising expectations of higher growth as European defense spending stimulates economies and pressures inflation upward. The flattening US curve may reflect a rising possibility of slower economic growth, which could offset some of the inflation caused by tariffs.

There's an old saw that financial markets can handle bad news; it's uncertainty that isn't dealt with very well. Due to the policy changes unfolding in Washington, that rule is alive and well in the markets. Fortunately, an age-old tool for addressing market risk also remains intact: incorporating bonds as part of core allocations. Bonds have lower volatility than many other asset classes, including equities and commodities, and their correlation to riskier investments tends to decline, or even turn negative, during times of high uncertainty and turmoil. So, while the environment is full of change, and it's difficult to know if creativity will emerge from destruction, the good news is that some time-tested investment strategies remain useful. Risk control and diversification may have rising investment utility in a world where US policy changes are dramatically affecting economies, societies, markets, and geopolitical relationships.

Treasury Sector

Rapid policy changes in Washington are creating change across the financial markets, although the Treasury market environment has been relatively stable, at least so far. As 2025 began, the inverted yield curve of 2024 had largely given way to a more normally shaped curve, beyond short maturities. This shift reflected market expectations that a recession was unlikely, while lower inflation would allow the Fed to ease short-term rates down. In recent weeks, that thesis has been questioned, and the curve has flattened a bit, reflecting a higher possibility of recession. At the same time, investors have less consensus on what the Fed may do, given the uncertainty of how tariffs may affect not just growth, but also inflation.

US Treasury Yield Curve



(Sources: Bloomberg, Confluence)

From our perch, we see a wide range of possible outcomes with regard to tariffs and their ultimate effect on the economy, markets, and society. That said, when we look at the Treasury yield curve, (green line), we see rates are well above our expectation of where inflation is likely to settle (shaded blue area). We recognize that the range of our expectations for inflation is fairly wide (3.0-3.5%), but it reflects the uncertainty effect that tariffs and other policies coming out of Washington could have. Fortunately, even with this high level of uncertainty, yields across a wide range of maturities are much higher than the inflation levels we anticipate, indicating a positive real yield. Our preference remains in intermediate maturities, where investors can limit exposure to high levels of interest rate risk in longer maturities, while avoiding the reinvestment risk in shorter maturities caused by the Fed's easing. With this intermediate maturity posture, we suggest an even-weight exposure to the Treasury sector.

Corporate Sector

Corporate Investment-Grade Spreads, 10 years ending March 2025

(Sources: Bloomberg, Confluence)

When the Fed began to tighten in 2022, corporate spreads widened significantly, peaking in the latter half of that year. Since then, the general trend has been for spreads to tighten. Investors were pleased to learn that credit fundamentals remained intact, even as interest rates rose. In addition, the view toward corporate credit continued to improve as the likelihood of a recession declined. This set the stage for spreads to move well below their long-term average, which is illustrated by the red horizontal line on the chart. However, corporate spreads widened in the first quarter of 2025, responding to tariffs and the uncertainty related to economic growth, inflation, and geopolitical events. Declining and volatile equity markets fostered a "risk off" mentality, which manifested in widening spreads in the corporate sector. *Despite the recent widening, spreads remain below the long-term average and we continue to suggest an underweight exposure.* In order to become more constructive on the sector, we would prefer to see conditions tilt more in favor of lenders as opposed to borrowers in the form of spread widening. Caution toward the corporate sector may prove to be particularly important until we have better clarity on how particular industries are affected by tariffs and trade.

Mortgage-Backed Securities (MBS) Sector

The MBS sector began 2025 with relatively good performance, and we continue to believe there are unique opportunities in this sector. Legacy low-rate mortgages that were underwritten during the pandemic remain in securitized mortgage pools, creating numerous low-coupon MBS that represent a meaningful proportion of the overall MBS market. Because the low-rate mortgage holders have little incentive to refinance or pay off mortgages early, the prepayment rates on the low-coupon MBS are low and their duration profiles have been extended. The combination of higher interest rates and longer duration has caused many low-coupon MBS to trade at substantial discounts to par. These conditions create an unusual opportunity to invest in MBS. Most of the time, MBS investors face significant interest rate risk. If rates decline, prepayment rates rise and investors are forced to reinvest more principal at lower yields. At the same time, MBS can be harmed by rising rates, which cause prepayments to decline and force investors to remain invested in lower yields, even when rates are higher. We believe the current circumstances lower the negative consequences of both conditions. MBS trading at deep discounts to par will benefit from lower interest rates because refinancing increases principal payments, which take place at par. On the other hand, duration extension will probably be less severe if rates rise because much of the extension has already happened.

30-year Fixed Rate MBS OAS, 10 years ending March 2025

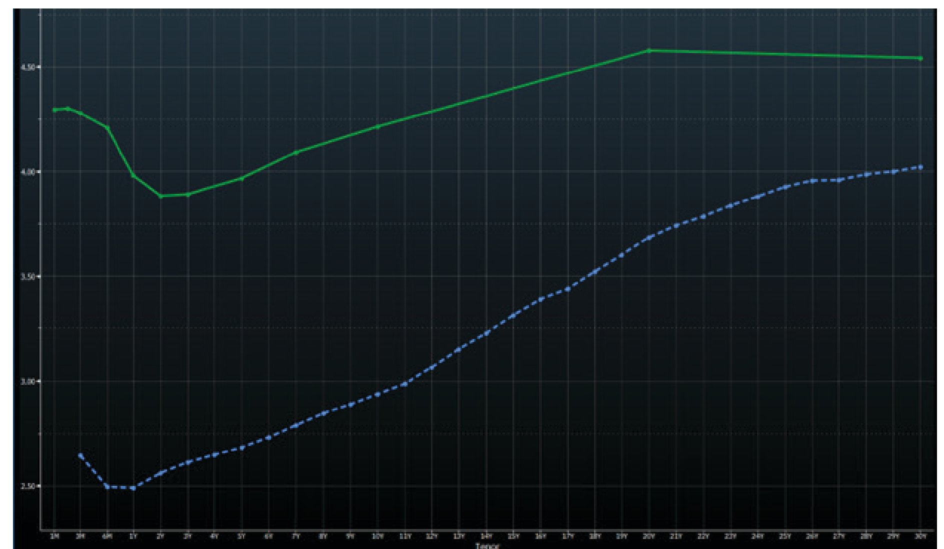
(Sources: Bloomberg, Confluence)

MBS spreads have tightened so far in 2025, moving roughly in line with the longer-term average (red line) after having spent the last couple of years at much wider levels. From here, the sector is no longer cheap, but we believe the circumstances are unusually favorable and risk is lower than average. *Accordingly, we continue to favor an overweight exposure to the MBS sector.*

Municipal Bond Sector

In contrast to the US Treasury yield curve, which is currently inverted within two years of maturity, the municipal yield curve is positively sloped across all maturities beyond one year. However, much like US investment-grade corporates, returns on municipal bonds have been pressured thus far this year owing to uncertainties regarding SALT provisions in the proposed budget as it wends its way through Congress, as well as changing fiscal policies that may affect future funding of infrastructure projects, which disproportionately affect revenue bonds. With their recent weakness, municipal bonds now trade at tax-equivalent yields (for those in the highest federal income tax bracket) that are attractive relative to Treasurys – a shift compared to a year ago when they were priced to perfection. In this environment, we find that general obligation bonds hold attraction versus revenue bonds, given the fiscal health of most state and local governments with their historically strong balance sheets, stable tax support, and plentiful rainy day funds.

Municipal Yield Curve



(Source: Bloomberg)

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