Market Update

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October 2025

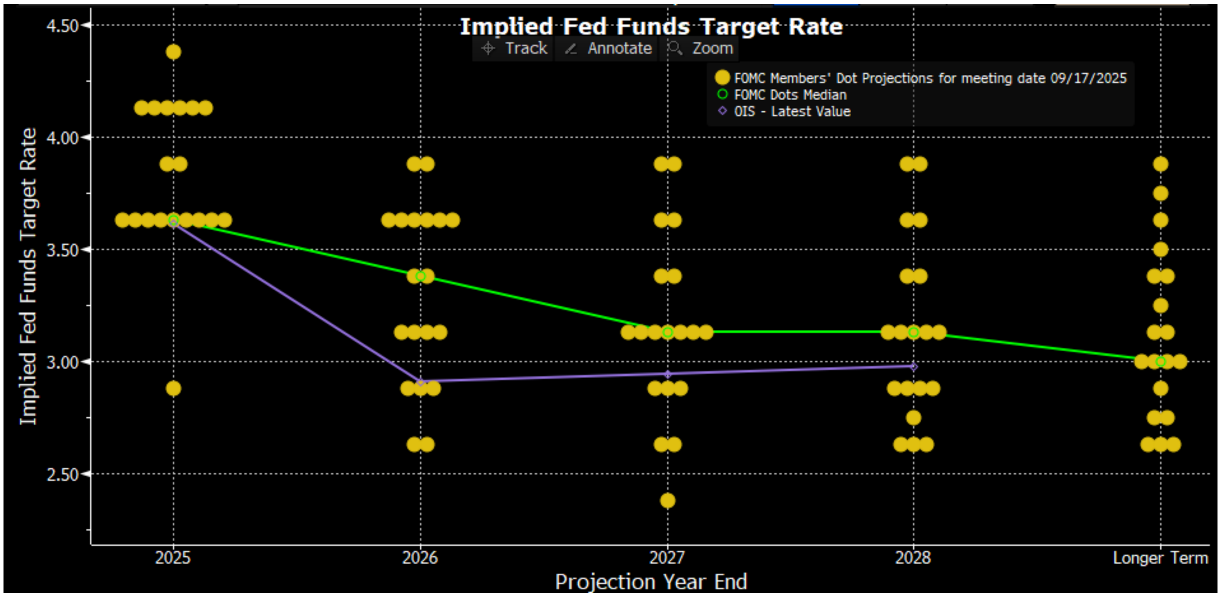
September's data releases delivered a round of upside surprises, underscoring the economy's consumer-driven resilience. August retail sales rose 0.6% month-over-month, significantly higher than expectations, led by strength in online (+2%) and apparel stores amid back-to-school demand. The result pushed sales from June through August 4.5% higher year-over-year, defying concerns over a cooling labor market and sticky prices. The Atlanta Fed's GDPNow model now tracks Q3 2025 GDP growth at 3.8%, reflecting solid industrial output and front-loaded trade activity ahead of tariff implementation. Still, that optimism differs from consensus forecasts below 2%, as economists brace for softer hiring, potential tariff disruptions, and elevated policy uncertainty.

The path forward on the government shutdown remains uncertain. Each week of closure is expected to shave roughly 0.1–0.2 percentage points from GDP growth, with prolonged disruption posing broader confidence risks. A protracted standoff could dampen spending momentum, as evidenced during the 2018-19 shutdown, when the University of Michigan Consumer Sentiment Index fell 7% after more than 30 days of gridlock.

Inflation edged higher in September's data releases. CPI rose 2.9% year over year through August, the fastest pace since January and up from 2.7% in July. Upward momentum and broad-based pricing pressures continue to challenge expectations for an imminent disinflation, keeping real yields contained and the policy debate active. Headline PCE inflation also ticked up to 2.9%, with housing services and other sticky categories remaining elevated. The uptick, coupled with renewed tariff discussions, suggests underlying pressures that could extend the Fed's path to target. Cleveland Fed nowcasts for September and October indicate both CPI and PCE will remain elevated.

The government shutdown delayed the September jobs report, leaving a key data void. Proxy indicators point to a deteriorating labor backdrop. ADP private payrolls fell by 32k, with leisure and hospitality posting the sharpest declines. The Chicago Fed's models imply unemployment rising to 4.34%, consistent with a gradual cooling rather than a sharp downturn.

As expected, the FOMC delivered a 25 bps rate cut, with Chair Powell characterizing the change as "risk management" move amid growing downside risks. Chair Powell cited slower growth, weaker job gains, and still-elevated inflation near 2.7%, noting "downside risk is now a reality." The September 2025 Dot Plot projects the Fed funds rate settling in the mid-3% range by 2026. Vice Chair Jefferson highlighted that tariff effects on inflation and growth will likely intensify into year-end. FOMC materials from the September meeting maintain a cautious tone, projecting real GDP growth of 2.5% for 2025 while preserving flexibility for further policy adjustment. We anticipate the FOMC to continue its path by cutting another 25 bps at the October and December meetings, especially given the unknown with jobs outlook.



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Product Views

Rates: Short-term Treasuries (one year and in) moved lower on dovish Fed signals and rising labor market concerns. Two-year yields are down roughly 2 bps over the past month, while 10-year yields have declined about 6 bps, leaving the 2s10s curve only 4 bps flatter.

Swapped Treasuries continue to look cheap relative to T-bills, as the premium to hold longer-dated maturities remains wide versus the market's FOMC expectations. On an outright duration basis, our view remains that the front and intermediate parts of the curve offer the best value.

Credit: Credit spreads remain largely unchanged both month-over-month. High yield has been the best-performing asset year-to-date (7.34%), while investment grade (IG) returns followed closely at 7.19%. While fundamentals remain strong, we don't believe current valuations justify moving down in credit quality. We continue to emphasize that if the economy slows, spreads have meaningful room to widen, particularly given their current position in the bottom decile relative to long-term history, even amid resilient corporate fundamentals.

Securitized: Nominal MBS and OAS spreads have compressed over the past month, consistent with our outlook. Year-to-date, MBS has returned 7.15% versus 7.19% for IG credit. While we are less constructive on MBS following the recent tightening, we continue to favor it over credit given the uncertain outlook for the economy.

We also see value in select non-agency RMBS and equipment ABS, which have participated less in the broader tightening across credit and securitized markets. Our focus remains on diligent, case-by-case assessment and rigorous ongoing monitoring.