

Great clients!

Yes, we have them and they ask great questions! It's an honor to work on behalf of the smartest clients for various reasons. We thought all our clients may benefit from reading a few of their questions and a brief summary of our reply.

Q: When will the Fed stop their quantitative tightening program?

A: The Federal Reserve resumed quantitative easing (QE) (the buying of longer maturity Treasuries and Agency-Backed Mortgage-Backed Securities (MBS) in the open market) during the market convulsions of the pandemic shutdown on March 15, 2020. Initially the Fed pledged to buy \$500 billion in Treasuries and \$200 billion in MBS, but quickly shifted to open-ended, unlimited purchases. By the time QE ended on March 10, 2022, the Fed had more than doubled its Treasuries and MBS holdings to \$8.5 trillion, for a total expansion of \$4.4 trillion. Months later, on May 4, 2022, the Fed published a plan for quantitative tightening (QT) that outlined a start date of June 1, 2022, a gradual ramp up period (3 months), and a long-term pace of balance sheet reduction of \$60 billion per month for Treasuries and \$35 billion per month for MBS. One might reasonably assume that the macroeconomic effects of reducing the balance sheet (QT) would be equal, but in the opposite direction, of balance sheet expansion (QE). However, this is not the case due to the way the structure of the two programs as well as the macroeconomic context in which they occurred. QE was a surprise announcement during a market crisis with an open-ended and unlimited mandate. On the other hand, QT was announced ahead of implementation (not a surprise) after normal market function had resumed and confidence had been restored. The QE program bought long maturity debt in the open market while the QT program merely allows debt held on the balance sheet to mature, and thus, avoids significant selling in the market. The QE program was designed to maximize its financially accommodative impact on the market in the immediate-term while QT was designed to minimize the removal of financial accommodation over the long-term. In July 2022, the Federal Reserve Bank of Atlanta published an article titled "How Many Rate Hikes Does Quantitative Tightening Equal?" that assumed \$2.2 trillion in passive roll-off of nominal Treasury securities over three years. To date, the Fed has closely adhered to those assumptions having reduced the balance sheet by \$2.3 trillion over three and half years. The article estimated that QT, according to its assumptions, would result in policy tightening equivalent to +29 basis points (bps) of hikes in the federal funds rate in normal times and +74 basis points in turbulent markets. By contrast, the Fed has lowered the rate by 125 bps

since September 2024. Outside of crisis periods and a 0% fed funds rate (the effective lower bound), the Fed prefers to adjust financial conditions using the fed funds rate and can quickly more than offset the effect of QT. Maintaining its practice of well telegraphed, slow-paced QT, the Fed announced a reduction in the pace of QT beginning in June 2024 and again in April 2025. The end of QT will likely be announced at one of the upcoming FOMC meetings. It will be expected and we believe there should be minimal-to-no market impact. Financial markets are focused now on expected future rate cuts with fed fund futures markets anticipating another -125 bps of cuts by late 2026.

Q: Why are corporate bond spreads at historical tight levels?

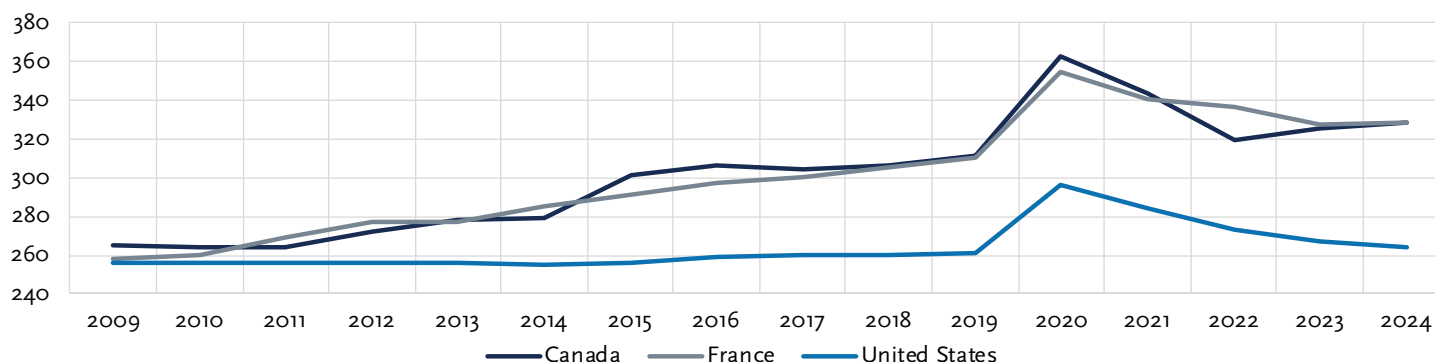
A: Investment grade corporate spreads, the difference in yield between a U.S. Treasury security and a corporate bond of the same duration, are at their tightest level since 1998 at 69 basis points. However, attractive all-in yields continue to drive demand for the asset class. And with the prospect of additional Fed rate cuts on the horizon, money market accounts are becoming less appealing to investors as they look to lock in higher rates for longer by extending duration. At the same time, supply has been flat year over year, and it is slowing due to the government shutdown. In our view, these technical aspects have combined to support tighter spreads. How low will they go? Corporate balance sheets remain strong and the outlook remains favorable for disciplined investors focused on credit selection. We currently remain optimistic that the companies we are invested in will maintain a disciplined approach to their capital structures, their growth plans and acquisition prospects. With default and distressed rates both well below their post Great Financial Crisis (GFC) 2008-09 averages, have investors been lulled into complacency? Maybe, but not our team. Considering that spreads are so tight, in our view, this is not the time to reach for yield. In fact, we are moving up in quality because we believe risk is being mispriced in many instances.

Q: How bad is our national debt problem?

A: It's not good, but we are in better shape than most countries. When people hear the term "national debt" they automatically think of U.S. debt, but perhaps there is a better way to look at national debt. We think the better metric is a country's ratio of Gross Domestic Product (GDP) to combined government and private debt, or total debt.

The Bank Credit Analyst (BCA) publication provided an insightful statistic on this topic. From 2009, forward, Canada's total debt to GDP has surged to 315 percent while France's is at 325 percent. By comparison U.S. total debt is at 250 percent or, more importantly, the same level as 2009. Put another way, aside from the pandemic hump,

The US Total Debt Ratio is Unchanged for Almost Two Decades!



Source: International Monetary Fund as of 9.30.25

the U.S. total debt to GDP is essentially unchanged from pre-GFC levels. The composition of the U.S. total debt is what has changed. While the private sector has deleveraged, the government debt ratio has risen from 70 percent to its current level of 110 percent. The increase in U.S. government debt is what concerns many people; however, debt sustainability depends on the combination of government and private sector debt. Because, just as the government can 'crowd out' the private sector, the private sector can also crowd out the government. The less private sector debt there is, the more opportunity there is for government debt to be put to productive use. A country's debt reaches its limit when there is no more productive use for it – when the marginal return drops below the cost of the debt. And for this we must look at the total debt ratio. What's the point? We believe there are many dirtier shirts than the U.S. when it comes to the debt math.

Monetary Policy:

Q: Are we unknowingly amid a Fed change of policy? Is the Fed moving away from the 2% inflation target?

A: Without a doubt the Fed is in the middle of an internal tug-of-war. Given the Fed's dual mandate of low unemployment and low inflation, which is more important? Possibly the Fed, after trying to increase inflation from below 2% in 2008 in an effort to prevent the far more dangerous phenomenon of deflation, has allowed inflation to move above its 2% target. Perhaps, but slightly higher inflation works well with our disciplined investment process. In our view, as higher inflation expectations get priced into the bond market, long yields must adjust higher. Why are we less concerned about this than other bond investors? We have never been long-duration investors. Our corporate focused investment style naturally lends itself to a 4–7 year duration target. And we like corporate bonds for the higher income they provide and the alpha they can potentially deliver when coupled with the seasoned group of credit analysts on our team.

Investment Grade Corporate and High Yield Bond Outlook:

With both investment grade and high yield spreads continuing to sit at historically tight levels, we are hard pressed to present a compelling argument for valuations to go tighter from here. In fact, we see a level of complacency in the market that is pricing in a strong likelihood of the Fed threading a needle when it comes to balancing rate cuts, inflation, and growth (without a full complement of economic data due to the government shutdown). As a result, we think credit selection is important in this market, and our preference is to lean into higher quality while carefully reallocating exposure from tight spread credit toward higher-yielding opportunities.

Investment Grade Bond Third Quarter Performance:

The Fed cut the target fed funds rate by 25 basis points (bps) to 4.00–4.25% as widely expected at their September 17th meeting amid growing concerns over downside risks to employment. Interest rates were mixed in September with front-end yields mostly unchanged while longer maturity yields fell. The Bloomberg Aggregate Index returned +1.09% in September and currently an impressive +6.13% year-to-date. The 2-year Treasury yield ended September at 3.61%, unchanged in the month. The 10-year Treasury yield ended

September at 4.15%, 7 bps lower while the 30-year Treasury yield ended the month at 4.73%, 19 bps lower.

High Yield Bond Third Quarter Performance:

High yield fixed income bonds had a return of +2.5% in the third quarter. High yield spreads started the quarter at 284 bps and ended at 280 bps, as markets grappled with the potential impacts of trade policy headlines on the global economy. The quarterly return was comprised of +1.6% from income and +0.9% from changes in price. Beta rallied during the quarter with BBs underperforming at +2.1%, single-Bs mirrored the broader market at +2.3% and CCCs outperformed at +3.2%. High yield bond data is representative of the U.S. High Yield Corporate Bond Index which is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG).

One Final Question

Q: What are your thoughts on political issues.

A: As fiduciaries for our clients, we have a responsibility, taken exceedingly seriously, not to get caught up in politics but rather be students of various policies that are being considered or implemented by political parties. After working as a team for nearly 25 years, it is not to say we don't have our individual opinions, we do, but we stay levelheaded and grounded when it comes to implementation of strategies to address the changing landscape. One thing we do know through our market experience is that rash investment decisions are never good decisions. We look out over the horizon, prepare for the worst and hope for the best of investment climates. As you would rely on, we believe we are well positioned to withstand the current policy volatility in your portfolios.

If you have any questions on strategy, performance, or business development, please do not hesitate to contact us.

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Past performance is not a guarantee of future results. Adtrax 8486752.1