Well, we met the new sheriff, but we are still deciding if we like him

Our new Federal Reserve Chairman, Kevin Warsh has conducted his second speech in his new role. Similar to the statement published after the first meeting, his speech was short and to the point. The Fed will remain laser focused on returning the inflation rate (Core PCE) to its 2% target, while remaining vigilant regarding the unemployment rate. Forward guidance will be and, thus far, has been less transparent than what was provided by the prior regime. Market reaction has not been Fed-friendly. Market participants are more closely monitoring economic data, as desired by the Fed, but the interpretation and follow-though implications for the unfavorable yield curve move over that past 30 days are more about market acceptance of this new way of conducting monetary policy.

Monetary Policy: At their September 15-16 meeting, the Federal Reserve raised the Fed Funds Target Rate 25 basis points to 3.75%–4.00%. The decision was unanimous without dissent. This was in line with market expectations amid elevated uncertainty related to the Iran War, improving labor market conditions, firm inflation readings and upside risks to the inflation outlook from energy prices. Within the Summary of Economic Projections (SEP), the median Fed Funds rate projection for year end 2026 was raised from 3.8% to 4.1%, adding one more hike in the near-term. The projection sees rates steady in 2027 before gradually declining in 2028 and beyond. Expected 2026 GDP growth was raised from 2.2% to 2.3%. Year end 2026 unemployment was nudged lower, from 4.3% to 4.1%, and Core PCE inflation was raised slightly, from 3.3% to 3.4%.

Chairman Warsh began his tenure at the Fed amid market uncertainty around his views on the economy and interest rates. At the June FOMC meeting his comments were received as hawkish. At the July meeting, investors interpreted his answers in the Q&A session as dovish, undermining his credibility as an inflation fighter. Throughout August and September, the economic data generally supported the view of an economy with solid growth, low unemployment and elevated, sticky inflation. In the months leading up to the September meeting, public comments from Federal Reserve governors and regional bank presidents became increasingly hawkish, downgrading labor market concerns with an increasing focus on inflation. At the annual Jackson Hole Economic Policy Symposium in late August, Warsh delivered a clearly hawkish speech, including suggesting that policy rates were not restrictive and that the Fed may have work to do to contain inflation. As the September meeting drew near, futures markets were pricing in a very high probability of a hike, and the Fed delivered 25 basis points with the SEP pointing to another hike in 2026. Market concerns around Warsh's independence and commitment to the inflation mandate have mostly been relieved.

Oil, Inflation, and Interest Rates – It Takes Three to Tango

The war in the Middle East is creating an inflationary shock primarily through higher energy costs. Disruptions to shipping through the Strait of Hormuz have pushed up not only energy prices but shipping and insurance costs as well. Prior to the war, roughly one-fifth of global oil and gas consumption was shipped through the straight. At those shipping volumes, even temporary interruptions can have meaningful impacts on energy costs and inflation worldwide.

Attacks on energy infrastructure across the region (and in Russia stemming from their war with Ukraine) have also created a refining crunch. Resulting higher fuel costs, particularly diesel, increase costs for trucking, shipping, agriculture, airlines, manufacturing, chemicals, metals, and other energy-intensive industries. Ultimately, businesses will pass these higher costs to customers, creating broader price increases in food, manufactured goods, construction, and services.

On the demand side, a prolonged energy shock would likely slow economic growth. Consumers are left with less disposable income while businesses may reduce investment and hiring. However, thus far, the broad economy remains resilient with Real GDP growing in the mid-2% area, modestly above potential. As a result, unemployment remains low, at potential, within a low hire/low fire regime. Higher trending interest rates do not appear to have slowed the economy yet, but that impact takes time.

This puts the Fed in a bind because higher interest rates can restrain demand to help fight inflation but cannot directly increase energy supplies. The longer energy prices remain elevated, the greater the risk that the energy shock develops into more persistent inflation. Fixed income markets appear to expect a tougher inflation flight than the Fed's SEP indicates, now pricing in three to four 25 basis point hikes through 2027. This is a dramatic change from the beginning of the year, at which time futures markets were pricing in around 2 cuts by year end 2027. The +161 bps move in the year-end 2027 expected Fed Funds rates mostly explains the +122 bps year-to-date rise in the ten-year Treasury yield and +80 bps year-to-date rise in the 30-year.

Moving forward, markets will be keenly focused on developments in Iran and the impact on energy prices, the pace of AI investment, and tariffs to form expectations around inflation and interest rates. It is notable that the inflation drivers in this cycle are largely insensitive to interest rates, suggesting that Fed interest rate policy may have to be more aggressive. In the fourth quarter, we expect one-to-two Fed rates hikes. At this point, additional hikes appear likely in 2027; although that prospect could easily change, most likely driven by a resolution of the Iran conflict.

Investment Grade Corporate Bond Outlook: As interest rates have moved higher in 2026, we firmly believe fixed income remains an attractive asset class as investors have opportunities for potential increased income and yields in the future. Corporate spreads remain tight to comparable U.S. Treasury securities, but we expect fundamentals and technical factors to be supportive into 2027. We continue to believe credit selection will be paramount if the focus shifts toward the ability of corporates to navigate macro uncertainty. Based on current market conditions, in our opinion, the securities we hold are well positioned to weather the current market cycle. Capital preservation continues to be our foremost priority followed by seeking to generate income consistent with the strategy's objectives.

High Yield Bond Outlook: Uncertainty in the Middle East and a "good news is bad news" macro environment creates a challenging market to navigate. However, with spreads decently wider and all-in yields a lot higher, we see attractive carry in high yield now. But credit selection will be important, as refinancing risk is on the rise, and a heavy supply calendar will be a broad headwind for the asset class. Our preference is to look for high-quality assets with an eye on a rate-driven rally as we await oil price normalization.

Investment Grade Corporate Bond Third Quarter Performance: September saw interest rates surge on increasing expectations of further Federal Reserve tightening, finishing the month at their highest levels of the year. At their September meeting, the Federal Reserve's decision to raise rates by 25 basis points to 3.75-4.00% came as little surprise given the recent increase in inflation readings tied to the sharp rise in oil prices on the renewed disruptions in the Middle East. The Bloomberg Aggregate Index returned -2.61% in September and now -2.91% year-to-date. The

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2-year Treasury yield ended September at 4.88%, 54 basis points (bps) higher in the month. The 10-year Treasury yield ended September at 5.28%, 53 bps higher, while the 30-year Treasury yield ended the month at 5.62%, 38 bps higher. Corporate bonds slightly underperformed U.S. Treasury securities in the month as corporate demand remained strong on the back of attractive all-in yields.

High Yield Bond Sector Third Quarter Performance: High yield fixed income saw a total return of -1.82% during the quarter, representing the 2nd best performing fixed income asset class behind US Leveraged Loans. High yield spreads widened during the quarter, starting at 279 bps and ending at 324 bps as continued strong economic data created uncertainty surrounding Fed policy, while the continued war in Iran has raised oil prices and further pressured inflation. For the quarter, the -1.82% total return was comprised of +1.65% of coupon and a -3.47% price return. From a quality perspective, Single-Bs again performed the best, returning -1.30%, followed by BBs at -1.86%. CCCs lagged at -3.57%. 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).

The Devil—*and the Performance*—is in the Details (Contributed by Jack Meskunas, Managing Director and Captive Insurance Asset Manager here at Oppenheimer)

Most investors have a fundamental understanding of the need for thorough research when investing in equities. The bond market carries other types of risks affecting bond prices and bond portfolio valuations. Because corporate bonds carry default risk AND interest rate risk, they don't necessarily move in lockstep with changes in interest rates. Additionally, corporate bonds can move up in price when they receive a credit rating increase, and down in price if they are downgraded, regardless of short-term movements in rates. Having a fixed-income manager who conducts thorough fundamental research, rather than relying solely on external credit ratings, may help inform security selection and portfolio risk management.

Volatility across the entire yield curve continues, but we remain very comfortable with our positioning.

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

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