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June 30, 2025

Second Quarter Fixed Income Letter to Clients

The U.S. fixed income markets remained cautious during the second quarter of 2025. While economic data pointed to a gradually slowing economy, markets remained alert to shifting Federal Reserve policy signals. Core inflation continued its deceleration, with the Personal Consumption Expenditures (PCE) index easing closer to the Fed's 2% target. Headline CPI hovered between 2.3% and 2.6% year-over-year, allowing the federal reserve to maintain its patient stance on rate cuts. The Fed left rates unchanged, holding the federal funds target range at 4.75%–5.00%. Market expectations began to coalesce around a single rate cut in the latter half of 2025, as Chair Powell emphasized a "data-dependent" outlook. Real GDP growth moderated to an annualized pace of approximately 1.2% in Q2, reflecting softness in consumer spending, reduced inventory accumulation, and slowing corporate investment. Labor markets remained resilient but showed signs of normalization, with unemployment ticking up slightly to 4.1%.

Tax-free municipal bonds delivered modest but stable performance, and continued to offer a compelling investment opportunity, particularly for tax-sensitive investors. The supply-demand imbalance remains a key theme, with new issuance constrained while demand has remained strong. This technical backdrop has provided price support and helped municipal bonds outperform relative to other fixed-income assets. Credit fundamentals in the municipal sector remain robust. State and local governments have maintained strong reserve balances, and overall credit ratings remain favorable, with 48 states holding an AA rating or higher. The market continues to benefit from historically low default rates and the essential-service nature of many municipal bond issuers.

The Bloomberg Municipal Bond Index returned +1.2% in Q2 2025, outperforming taxable counterparts on a tax-adjusted basis. Intermediate and long-term municipal bonds (10+ years) led the way, benefiting from rate stability and strong demand.

The U.S. Treasury yield curve remained modestly inverted, with 2-year yields ending the quarter near 4.55% and 10-year yields at 4.35%. Investment-grade corporate spreads widened slightly, reflecting some risk aversion amid earnings pressure and tighter lending conditions.

We remain constructive on bonds heading into the second half of 2025. Specifically, we continue to focus on laddered portfolios composed of short and intermediate-term bonds. As broader economic momentum slows and the Fed moves cautiously, municipals stand well-positioned to deliver durable after-tax income and relative performance. Investors with a long-term view should consider maintaining or increasing allocations, particularly in high-quality strategies.

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Fixed Income Portfolio Manager