

MADISON INVESTMENTS' INSURANCE SOLUTIONS

December 31, 2025 | Separately Managed Account Investment Strategy Letter

YIELDS REMAIN RANGE-BOUND AS MARKETS SCALE BACK FED RATE CUT EXPECTATIONS

Wrapping up 2025, the fourth quarter proved a resilient close to a year defined by policy volatility and economic adaptation. U.S. investment-grade markets benefited from a dovish Federal Reserve pivot, moderating inflation pressures, and tariff-driven revenue boosts, though lingering uncertainties capped upside. These dynamics supported a modest Treasury rally, credit spread compression, and agency MBS outperformance, allowing portfolios to harvest income while navigating risks. Strategic overweights in quality sectors delivered solid returns, but tight valuations now warrant caution heading into 2026.

Economically, Q4 data painted a picture of steady, if unspectacular, growth amid tariff headwinds. Real GDP expanded at an initial estimate of 3.0% annualized, buoyed by resilient consumer spending despite a government shutdown's temporary drag, which shaved about 1 percentage point from growth. Full-year 2025 GDP settled around 1.9%, down from 2.0% projections but above earlier slowdown fears. Inflation eased modestly, with CPI at 2.7% in November, though core measures held near 2.6%, reflecting lingering tariff passthrough effects. Unemployment ticked up to 4.6% by November—the highest since 2021—signaling labor market cooling, with monthly job gains averaging 130,000. Looking forward we see sub-trend growth persisting into 2026 at 1.9%, with unemployment averaging 4.5%.

Politically, the Trump administration's tariff regime solidified as a dominant force. Effective rates climbed toward 18-20% by year-end, up from 2.5% pre-2025, generating over \$236 billion in revenue—more than 250% above prior years—and narrowing the trade deficit by 17% year-to-date. The One Big Beautiful Bill, passed mid-year, provided fiscal stimulus estimated at 0.4% GDP boost for 2026, offsetting some tariff drags. However, ballooning deficits—projected at 6.9% of GDP by 2027—fueled term premium concerns, pressuring longer-dated bonds.

Market movements aligned with this backdrop. U.S. Treasury yields dipped modestly, with the 10-year ending around 4.15%, down 5 basis points (bps) from Q3's close, amid Fed easing and softer data. The curve continued steepening, with the 2-year falling 15 bps to 3.53% while the 30-year rose slightly to 4.83%, reflecting fiscal risks. Total returns for the Bloomberg U.S. Treasury Index were positive at 1.2% for Q4, supported by the Fed's third 25 bps cut in December to 3.5%-3.75%. Projections for 2026 suggest just 50 bps more easing, tempering aggressive bets.

Investment-grade (IG) credit spreads tightened further, with the Bloomberg Corporate IG Index's option-adjusted spread (OAS) narrowing 16 bps to 74 bps—near 1998 lows—driven by robust fundamentals like 8% S&P 500 earnings growth and low defaults. However, tight valuations limited excess returns, with sectors like utilities outperforming on AI demand. The IG index returned 1.5% for Q4.

Agency MBS provided a standout haven, with spreads compressing 10 bps to around 28 bps over Treasuries, fueled by low volatility, constrained supply (\$109 billion issuance in June, down year-over-year), and strong demand from banks and REITs. The Bloomberg U.S. MBS Index gained 1.8%, outpacing corporates, as mortgage rates held above 6.5%.



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The Bloomberg Intermediate Government/Credit Index returned approximately 1.3% in Q4, benefiting from its 4.5-year duration and coupon income amid flattening pressures. Overall, 2025's 7.5% IG bond returns underscored fixed income's appeal, but with tariffs embedding structural inflation (up 1 percentage point potential drag) and deficits looming, our 2026 outlook emphasizes high-quality, shorter-duration holdings and MBS for resilience. Yields at 4.5-5% offer a buffer, yet policy risks demand vigilant rebalancing.

Don Miller

Bill Fain

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DISCLOSURES

In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Bloomberg U.S. Intermediate Government/Credit Bond Index measures the performance of United States dollar-denominated United States Treasuries, government-related and investment-grade United States corporate securities that have a remaining maturity of greater than or equal to one year and less than 10 years.

The Bloomberg U.S. Corporate Bond Index is an unmanaged market-value-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more.

The Bloomberg US Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage.

The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The S&P 500® is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another. Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve) and flat. Yield curve strategies involve positioning a portfolio to capitalize on expected changes.

A basis point is one hundredth of a percent.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. Duration measures how long it takes, in years, for an investor to be repaid the bond's price by the bond's total cash flows.

High yield bonds are considered lower-quality instruments known as "junk bonds". Such bonds entail greater risks than those found in higher-rated securities.

Option-adjusted spread (OAS) is the yield spread of a bond over a risk-free rate, usually a similar maturity Treasury, adjusted for the bond's embedded options. It reflects the additional return investors require to compensate for the risks and potential changes in cash flows due to options such as a bond's callability.

Consumer Price Index (CPI) measures changes in the price level of a weighted average market basket of consumer goods and services purchased by households. Producer Price Index (PPI) is a measure of the average changes in selling prices received by domestic producers of goods and services.

The federal funds rate is the target interest rate range set by the Federal Open Market Committee (FOMC) for banks to lend or borrow excess reserves overnight. It influences monetary and financial conditions, short-term interest rates, and the stock market.

Upon request, Madison may furnish to the client or institution a list of all security recommendations made within the past year. Madison-860030-2026-01-06