



December 18, 2025

RSW's 2026 Investment Outlook

"From 1990's Powerhouse to Today's Warning Signal"

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Many of the economic challenges we have highlighted in recent commentaries are still very much with us. Households continue to feel squeezed, credit remains tight, auto delinquencies are climbing, and commercial real estate remains under pressure. Parts of the private-credit market that flourished when rates were near zero are now discovering that refinancing in today's environment is about as realistic as swinging a samurai sword to hack down the size of the national debt.

So, what does all this mean for bond yields? Does slower growth automatically point to lower rates ahead? Not so fast! Before jumping to conclusions, it helps to step back and look at the full picture: the who, what, where, why, and how. To do that, we need to look east.

Shogun Strategy

While most headlines and market participants remain fixated on whether the Federal Reserve cuts rates by another quarter point, a more under-appreciated story is unfolding in Japan. Recently, Japanese policymakers announced a roughly \$135 billion stimulus package, one of the largest in years. This is notable not just for its size, but because officials in Tokyo rarely deploy large stimulus without careful deliberation.

Historically, its policymakers tend to act early when they sense the global cycle turning. That does not mean a crisis is imminent. It does, however, suggest that their officials are detecting that risks are building beneath the surface.

When the Rising Sun Was Rising

If you were managing money in the 1990s, Japan was impossible to ignore. Its manufacturing prowess dominated global markets, its corporations set the standard, and every data released out of Tokyo moved sentiment. It genuinely felt as though the third largest economy was on track to become the world's economic engine.

Instead, the country slid into decades of deflation, stagnation, and ultra-low interest rates. Today, Japan is back in the spotlight but not as a model for future growth. Maybe it would be better understood as an early-warning signal for itself, the global economy, and the United States.

Double-Edged Blade

After decades of near-zero or even negative interest rates, Japanese Government bond (JGB) yields are finally rising again. No, this is not evidence that the economy has escaped stagnation or is returning to its former powerhouse status. What ails Japan is a double-edged blade of troubles.

Their challenges are not just limited to its growth potential, but front and center are risks of spiraling inflation and diminished levels of liquidity. Years of central-bank control (or more bluntly, manipulation) have reduced trading depth as fluctuations in bond prices were tamped down. Just a small downward shift in demand for their debt can lead to outsized moves in yields.

When there's no longer "Yen" for the Yen

That appears to be where we are today! Liquidity is drying-up, rates are rising, and the fallout doesn't seem to be contained within Japan. As Japanese yields rise and liquidity tightens, the world's cheapest and most reliable funding source is no longer quite so cheap or quite so reliable. For years, investors engaged in the "Yen Carry Trade", where monies were borrowed in yen to invest in higher-yielding assets abroad, particularly U.S. Treasury securities.

This worked beautifully for years, right up to the time that it didn't. As funding costs rise and volatility increases, investors are unwinding those trades. Yen-denominated loans are being repaid, and U.S. Treasuries are being sold to raise cash.

What can look like a U.S.-driven rise in yields is being partially driven by a broader deleveraging process tied directly to Japan's shifting policy and changing interest rate environment. Against this backdrop, investors in Japanese debt are demanding greater compensation for risk, including liquidity risk. When liquidity becomes a concern in one of the world's largest bond markets, the ripple effects tend to extend beyond their homeland.

This can partially explain why longer-maturity U.S. government bond yields have risen since the Fed's first rate cut in September 2024. While the overnight federal funds rate has been slashed by 175 basis points since then, the 10-year Treasury yield has risen by 49 basis points (source: Bloomberg).

Liquidity, Volatility, and the "Yips"

Japan isn't the only source of near-term nerves. The U.S. Treasury bond market may also be experiencing a touch of the "yips" (a highly technical term) as the Fed continues cutting rates while inflation remains above target. When liquidity is thinner, whether in Japan's bond market or globally, investors become more sensitive to uncertainty. Small surprises can produce big moves. But looking further out, the picture changes.

Why the Dragon's Stress May Push U.S. Yields Lower

Looking beyond early 2026, as inflation cools and Japan's pressures ease, or if concerns grow around Japan's debt sustainability, the dynamic discussed herein could reverse. History shows that when investors become anxious about Japan's outlook, capital tends to move toward safety, not risk. Simply put, this means that Japan's strain should, in the end, create great demand for U.S. Treasuries, even if Japanese yields are rising.

It's also worth noting that the Federal Reserve is unlikely to tolerate a disorderly spike in long-term yields. If rates rise too far, too fast, the Fed has both the tools and the precedent to step in. This isn't a judgement that they should act, just an acknowledgment that maintaining financial stability has always been part of the Fed's mandate, whether communicated or not.

The Blade is Already Unsheathed

How can you be so sure the Fed will draw their sword to intervene? **Great question, glad you asked!** The Federal Reserve has shown repeatedly that when financial stability is at risk, it acts. Just last week, it made this clear by cutting rates to a range of 3.50% - 3.75% while simultaneously expanding its balance sheet through Treasury bill purchases. The familiar term "Quantitative Easing" may be absent from the Fed's language, but the mechanics are unmistakable.

What was once called QE is now "reserve management purchases," but the label doesn't matter, the effect is the same. Liquidity is flowing into the system through direct Treasury purchases. Interestingly, this move isn't designed to combat economic or financial stress and it's happening when the rate of inflation is nearly one percentage point higher than their target rate.

Thus, it's a preemptive measure to keep markets orderly amid elevated government borrowing and constrained private demand. The clearest signal came in the Fed's official statement: "the New York Fed's trading desk will buy roughly \$40

billion in Treasury bills starting mid-December, with elevated activity expected for months.” What else can you call this but active intervention.

The Pattern Becomes the Path

The key takeaway is this. Whenever liquidity tightens or long-term yields spike in a way that threatens market functioning, the Fed steps in. Market participants recognize this pattern and increasingly price the reliability of liquidity alongside, and often ahead of, the underlying economic backdrop. Even with these interventions, bond markets may begin to price in renewed inflation risk tied to the Fed’s aggressive response.

It is therefore likely that the 10-year U.S. Treasury yield should push above 4.50% in the early part of the year. After the upward pressure resolves itself, we believe market yields will follow a similar trajectory to our 2025 forecast and path of rates. Specifically, 10-year U.S. Treasury bond yields crested at 4.79% (RSW’s call: 5%) and later declined to a low of 3.95% (RSW’s call: 4%).

For decades, Japan looked like the outlier. Today it looks more like the preview. The rising sun is setting, but not before it’s shining a light on challenges that aren’t just Japan’s anymore. Aging demographics, massive public debt, persistent inflationary pressures, thinning levels of liquidity, fiscal insanity, and limited policy flexibility are themes spreading across the developed world.

While the United States is not Japan, we are wrestling with some of the same structural constraints. Or maybe it is more accurate to say we are not Japan yet...just on a different timeline.

Municipal Bond Commentary

Municipal bonds delivered relatively strong performance this year, as reflected in the broad municipal bond index, which as of this note, posted a total return of approximately 4.03% (before tax considerations). What makes that result particularly notable is the backdrop against which it occurred. This year saw a record level of new municipal bond issuance, with total supply running roughly 32% above the five-year average (source: BOFA).

One useful way to gauge stability in the municipal market is to compare how municipal yields move relative to U.S. Treasury yields. By year-end, the ratio of 10-year AAA-rated municipal bond yields to comparable-maturity U.S. Treasury yields was largely unchanged. This was a clear indication that strong underlying demand absorbed the wave of new supply with ease. Further illustrating investor confidence was the narrow range of yield movements, as 10-year AAA-rated municipal bond yields traded within a range of roughly 119 basis points.

Rising Japanese government bond yields have contributed to a broader global rate reset, which has placed some upward pressure on U.S. Treasury yields. Thus far municipal bond yields have largely resisted the recent move to higher rates. If our forecast proves accurate and 10-year U.S. Treasury yields move above 4.50%, this could create an opportunity to selectively extend average maturity to lock in a higher stream of tax-exempt income.

Against the backdrop described in the body of this note, while we are expecting an uptick in market yield fluctuations, the environment should remain supportive of solid total rates of return. Additionally, a more dynamic market should provide more opportunities to take an active approach.



From a credit standpoint, several areas of the municipal market appear well positioned as we look toward 2026. Large state and local general obligation issues remain attractive where broad tax bases, strong reserve positions, and disciplined budgeting provide flexibility to absorb higher costs. This is particularly true for issuers with manageable pension trajectories and a consistent alignment between recurring revenues and expenditures.

Dedicated tax-backed credits also offer stability. Sales-tax, income-tax, and other special revenue pledges continue to generate reliable cash flow when supported by senior lien structures, conservative additional bonds tests, and solid coverage cushions at the senior lien level. While revenue growth may slow, these protections help limit volatility and remain appropriate in a higher-rate environment.

Essential service systems including water, sewer, and public power continue to rank among the most resilient sectors. Demand for these services is stable, and we favor systems with realistic capital planning, a demonstrated willingness to adjust rates, and coverage metrics that remain solid even as infrastructure investment continues.

With Gratitude

Twenty years ago, RSW was founded with a clear mission: to partner with our clients by providing thoughtful and direct communication, implementing disciplined active management strategies, while maintaining an unwavering focus on risk management and principal protection. Today, as we celebrate our 20th anniversary, that mission continues. We are deeply grateful for our clients' trust and partnership over the years, which have been the cornerstone of our work, and we look forward to continuing to serve you in the years ahead.

Robert S. Waas
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All performance referenced is historical and is no guarantee of future results.