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RSW's Q3 2025 Fixed Income Newsletter

Will AI's Thirst for Power Spark Federal Reserve Shenanigans?

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RSW's second quarter commentary, "From Storm to Tranquility," forecasted that yields should continue to work their way lower and they certainly did! In fact, after the 10-year U.S. Treasury Note reached its high-water mark of 4.50%, yields dropped precipitously to RSW's intermediate term target low yield of 4.00%.

Headlines during the third quarter lacked the same punch as the second period, which afforded fixed income investors an opportunity to experience a relatively smooth ride. With the past being just that, "the past," it's time to focus on what lies ahead. Despite all the handwringing caused by the weaker employment data and the over-hyped speculation of what the size of Federal Reserve Chairman Powell's next mistake will be, broad measures of economic health continued to surprise to the upside.

While second quarter U.S. GDP was revised higher by 50 basis points to 3.80%, the estimate for the third quarter's growth rate (*source: Atlanta Fed*) is projected to stand tall at 3.30%. We at RSW believe this trend will continue with GDP continuing to produce above trend results. So, while some market participants may be breathing a sigh of relief that yields have subsided, a heightened level of changes in bond prices may still lie ahead.

Aside from strengthening economic activity, mounting inflationary pressures are more concerning. To begin, over the coming quarter the Federal Reserve's target inflation rate of 2.00% should prove to be elusive. August's CPI reading came in at 3.20% year-over-year, with core inflation running hot at 2.90%. While the increases in the cost of shelter and services have been important contributors serving to push inflation higher, it's the rise in the cost of electricity that's truly shocking.

The Juice Ain't Free

Contrary to the opinion of many AI users, the rise of AI and increasing electricity demand isn't free. It's showing up in everyone's monthly bills as utilities are pushed to deliver more with less. Data centers and electric vehicle (EV) owners plugging-in to the grid are leading the charge to drive a surge in energy demand. With the combination of new data centers coming online and the existing needs of the AI driven economy, global management consulting firm McKinsey is projecting that AI related power consumption may double by 2030.

The proliferation of EVs, which now account for 12% of 2025 sales (*source: JD Power*) is also putting a strain on resources. During peak residential charging hours, some states (i.e CA and TX) have reported double digit increases in load demand (*source: American Public Power Association*).

Unfortunately, surging demand is only half the conundrum. The ugly cousin is a shortage of available supply. With fewer power plants and an aging grid, in many ways it is a "Scotty, I need more power" moment. The supply shortage has also been exacerbated as several states have retired gas and coal power plants to comply



with environmental regulations. The variability and more limited generating capabilities from solar and wind alternative energy sources simply cannot keep pace with the current and expected rampant demand.

According to the U.S. Energy Information Administration, because of this supply-to-demand imbalance, 47 states have seen electricity rate hikes in 2025. The top five with the largest year-to-date increases are as follows: California: +8.20%, Texas: +7.40%, New York: +6.10%, Florida: +5.60%, Illinois: +5.30%.

Energy Builds for Rates to Rise

The fourth quarter could prove to be more difficult than the third period as market yields are likely to rise. This projection is underpinned by several persistent factors, including robust economic activity, sticky inflationary pressures, higher energy prices, a growing supply of government debt issued to cover federal deficits, and a softening demand for U.S. Treasury debt from foreign buyers. How high can yields go? Should the 10-year U.S. Treasury yield remain above 4.00%, our conviction strengthens, thus creating a pathway for rates to exceed 4.50% in Q4.

Higher Yields can Spark Fed Action

Should our higher rate forecast for 10-year U.S. Treasury yields surpass 4.50%, on their way to 5.00%, it is highly likely that the Federal Reserve will reach into their playbook of financial shenanigans and implement a policy of Yield Curve Control. As a refresher, this is a tool where the Fed purchases vast amounts of longer-maturity U.S. Treasury bonds to cap market rates and ultimately attempt to force yields lower.

Municipal Commentary

During the third quarter, municipal bond prices saw a strong rebound, outperforming U.S. Treasury bonds over the same period. Notably, yields on 10-year "AAA"-rated municipal bonds declined by approximately 34 basis points, compared to a more modest 8 basis point decline in yields for comparable U.S. Treasury bonds.

In alignment with our outlook for a potential easing in interest rates during the quarter, we initiated a modest adjustment to lengthen the duration (measure of interest rate sensitivity) of client portfolios. This strategic move allowed us to lock in more attractive yields while also positioning portfolios to benefit from potential price appreciation.

That said, our approach remained measured. While we saw opportunities in the market we also recognized, and continue to believe, that the decline in yields could reverse quickly as we move into the fourth quarter.

The same could be said for our cautious approach to shifting the yield curve positioning of our client portfolios. Despite the yield differential between 5 and 10-year "AAA"-rated bonds and 5 and 15-year "AAA"-rated bond yields near their widest levels in a decade, while enticing, we anticipate holding on to the balance of our shorter-dated bonds.



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Bottom line: A meaningful opportunity is likely to form in the latter part of the period. However, until then, our efforts are focused on stability of principal rather than emphasizing price returns on that principal.

Thank you for your continued trust and confidence in RSW Investments.

Robert S. Waas

Chief Executive Officer/Chief Investment Officer

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