Market and Economic Review

Client Communication for the Second Quarter 2025

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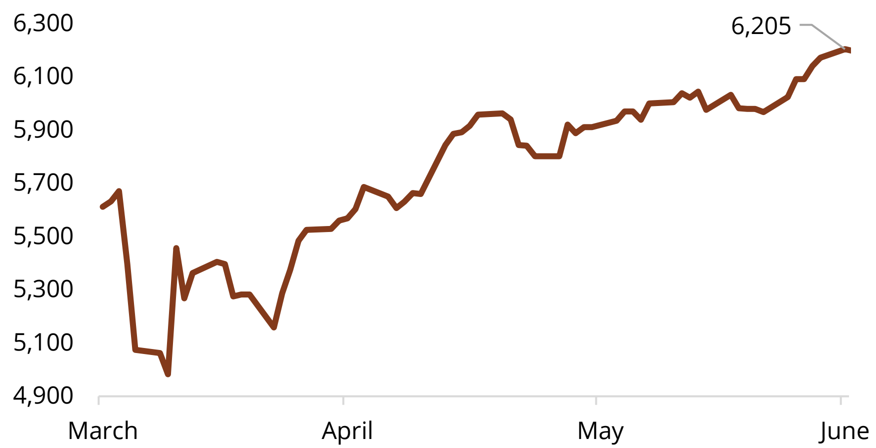
2Q 2025 – Snap Back

Summary of the Second Quarter

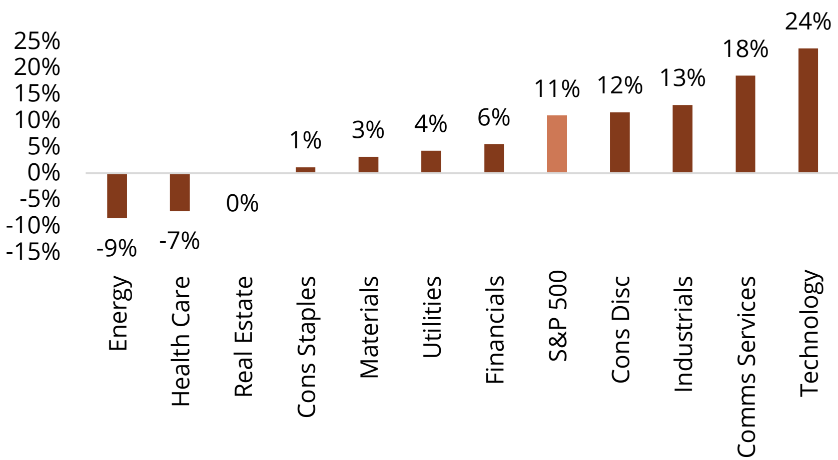
The second quarter started with a sharp move down on the "Liberation Day" tariff announcements but rebounded after the reciprocal tariffs were put on a 90-day pause.

Stocks continued to move higher despite a variety of concerns including trade policy uncertainty, volatile interest rates, and increased geopolitical risk. By the end of the quarter, the S&P 500 closed at a fresh all-time high.

S&P 500 - Second Quarter



S&P 500 Sectors - 2Q Performance



Sector Snapshot

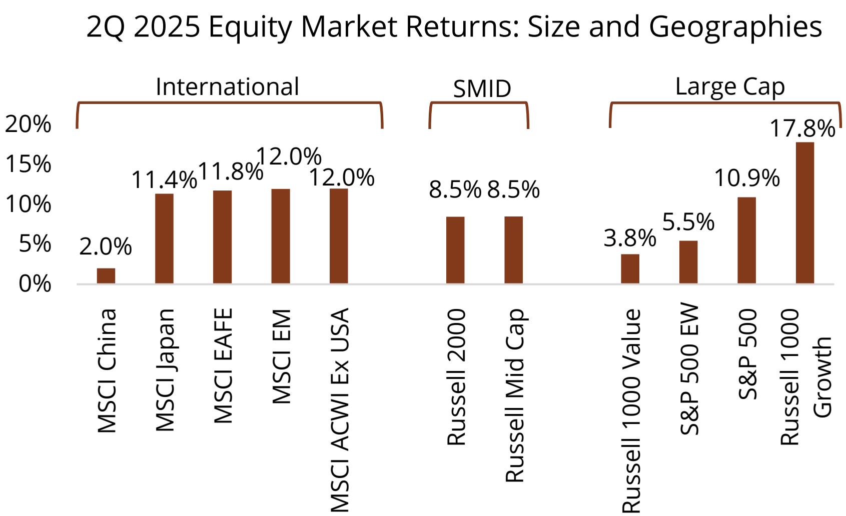
Performance across sectors was generally positive with eight of the eleven producing positive returns, four of which outpaced the S&P 500 during the quarter.

Technology and Communication Services were the strongest sectors during the quarter, reversing the weakness they experienced in the first quarter.

The Energy sector came under pressure as fears of a tariff-induced global economic slowdown sent crude oil prices lower. The Health Care sector was another notable laggard as questions arose regarding Federal medical spending.

Sources: FactSet, Morningstar Direct

A Familiar Story

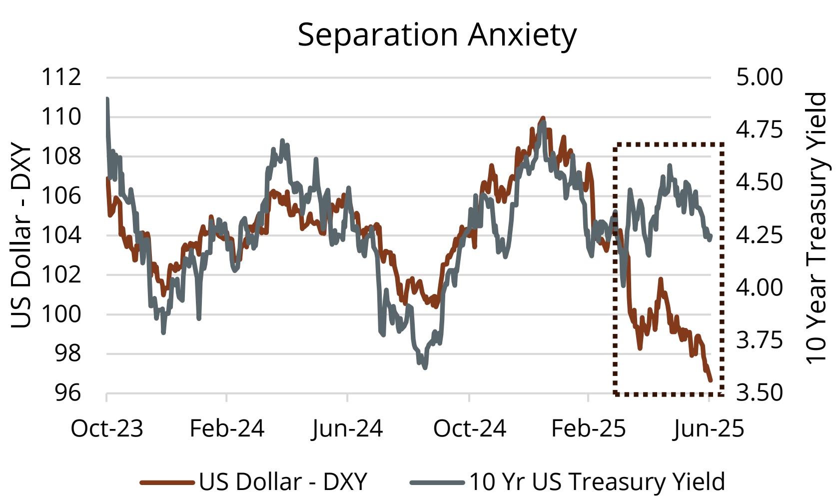


Broad-based Strength

While it was a challenging quarter from a headline perspective, global equity markets produced solid returns in the second quarter.

International markets continued their strength through the second quarter benefiting from both a pause in tariffs and a weaker US dollar.

Within US equity markets, a familiar story re-emerged as growth outpaced value, and large caps outpaced mid and small cap stocks.



Sell America?

Higher interest rates normally result in a strengthening currency, however, the US dollar has decoupled from Treasury rates as the trade war continues.

This decoupling is a rare dynamic that is typically seen in Emerging Markets during debt and currency crises. This divergence brought into question whether this is the beginning of a "Sell America" trade by foreign holders of US assets.

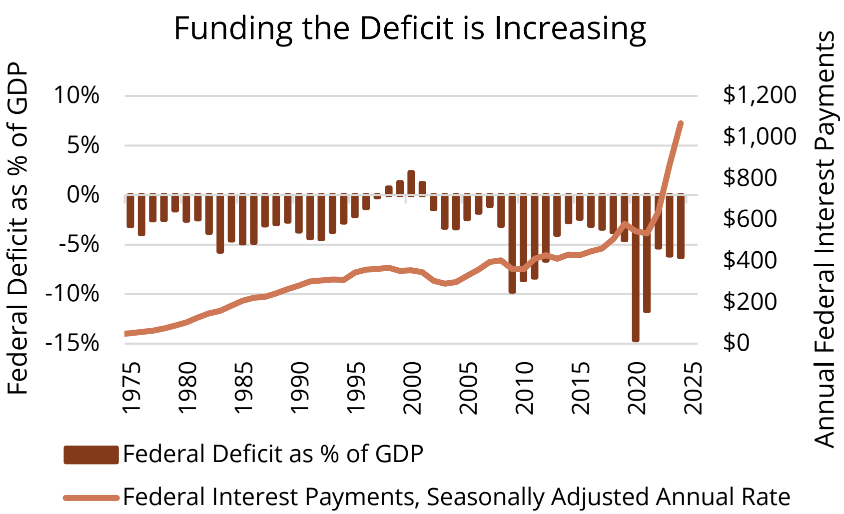
Source: Morningstar Direct, FactSet, Madison Investments

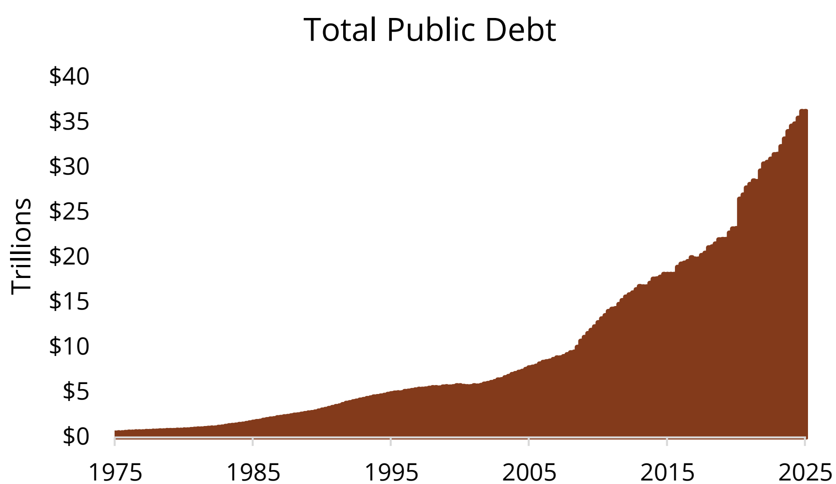
One Big Beautiful Bill

Fiscal Policy

During the second quarter markets began to anticipate the passage of the "One Big Beautiful Bill" with equity markets moving higher but fixed income markets showing signs of skepticism.

Longer term interest rates at higher levels indicate that fixed income markets seem to be more concerned about the higher levels of debt along with no signs of curbing spending in Washington. This is something we will continue to monitor closely.





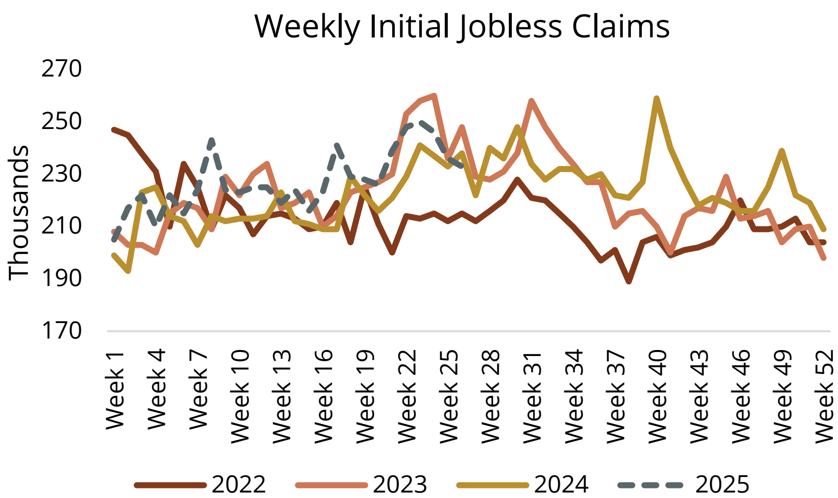
Is this Sustainable?

The Federal debt is now above $35 trillion and the cost to service this debt on an annual basis has surpassed $1 trillion.

Federal Reserve Chairman Jerome Powell is often questioned about the Federal deficit and overall size of the debt that the US Federal Government carries and provides what we believe to be a reasonable answer, suggesting that the level of debt is sustainable, but the trajectory is not.

Sources: Federal Reserve Bank of St. Louis, Factset, Madison Investments

Labor Market & Economy



Is the Pessimism Warranted?

Throughout the first half of this year, consumer surveys such as the Conference Board and the University of Michigan have suggested that the labor market was softening.

Despite this perceived weakness and pessimism, labor market data has been resilient. Over the past year, the unemployment rate has fluctuated in a tight range of 4.0%-4.2%, with June's rate falling to 4.1%, below the 4.3% that was anticipated.

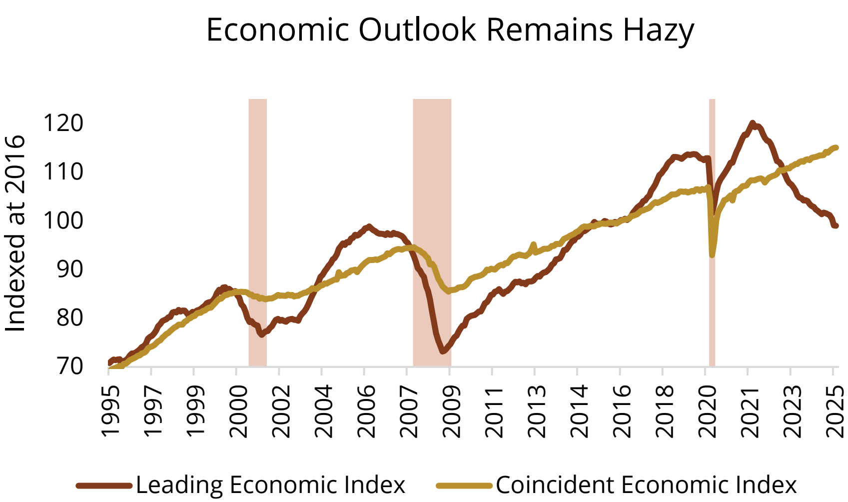
In the second quarter, initial jobless claims began to drift higher, however, if they continue to moderate through the second half of the year, it would be a similar pattern to what was observed in the previous two years.

Economic Outlook Remains Hazy

The disconnect in the data isn't exclusive to employment numbers as economic indicators are also sending mixed messages.

The Leading Economic Index comprised of ten indicators has been flashing warning signs since the end of 2021, while the four component Coincident Economic Index continues to make consecutive highs.

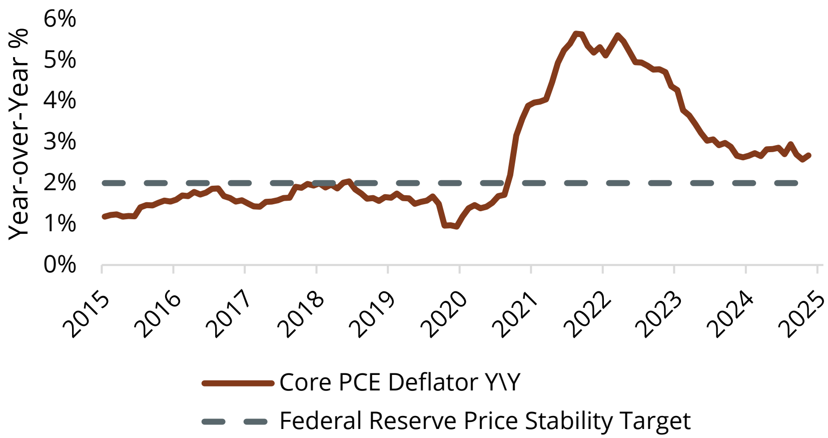
Economic activity is also bifurcated between the manufacturing sector, which has remained in contraction for much of the last two and a half years, while activity in the Service sector, moderating as of late, has remained in expansion.



Sources: Factset, Madison Investments

Taking the Wait and See Approach

Inflation Remains Stubbornly Above Target

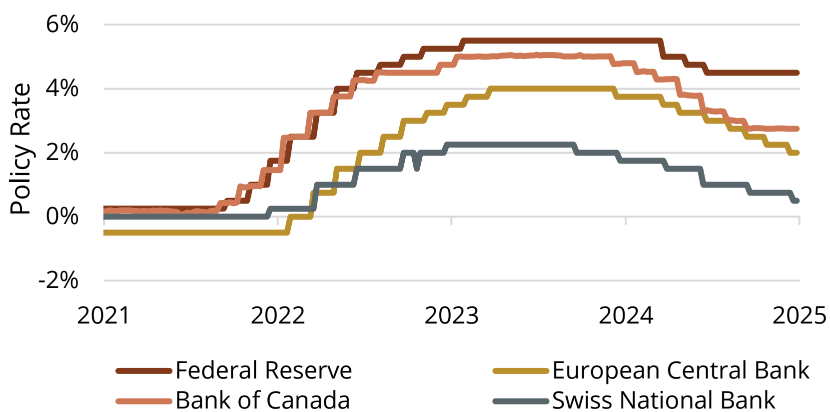


Inflation Remains Elevated

After declining through mid-2024, inflation has been bouncing around 2.7% for the last year. Although some believe that tariffs could cause a temporary bump to inflation rates, we have not seen evidence of inflation moving higher due to tariffs.

Tariff policy, however, is not firmly in place. We will get more news about tariff levels during the third quarter and will continue to monitor how inflation responds.

Central Bank Policy Rates



Global Central Bank Policy

Central banks around the globe have cut their policy rates as inflation has moderated and they work to counteract potential economic fallout from trade policy with the United States.

The Federal Reserve (Fed) has remained on the sidelines for the first half of this year, taking a "wait and see" approach to potential inflationary pressures from tariffs, before making adjustments to monetary policy.

Despite this hesitancy, interest rate markets are anticipating two interest rate cuts from the Fed in the second half of this year, consistent with the Fed's latest Summary of Economic Projections.

Sources: Factset, Madison Investments

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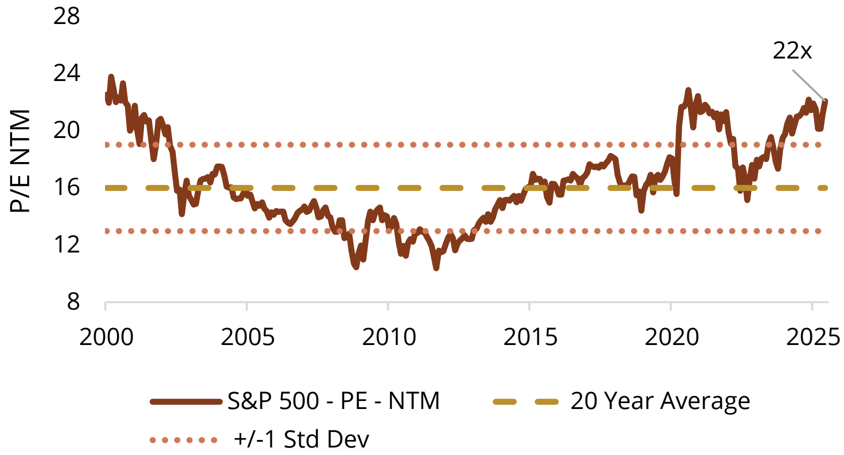
S&P 500 P/E NTM

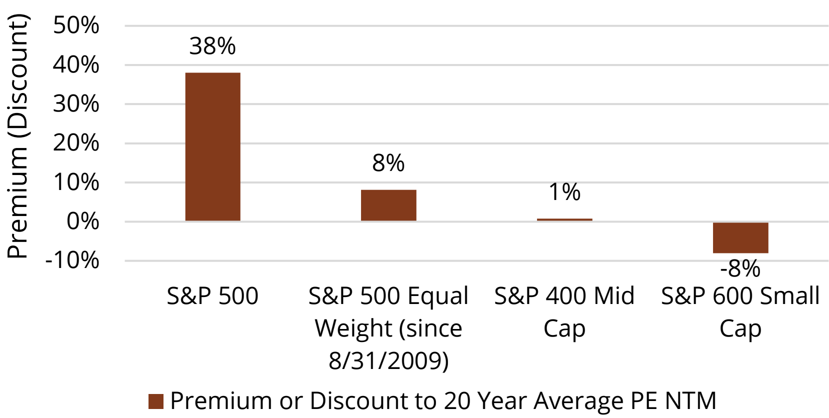


(Top Left) With new highs reached at the end of the quarter, the S&P 500 is once again trading at a premium valuation of 22x next twelve-month (NTM) earnings.

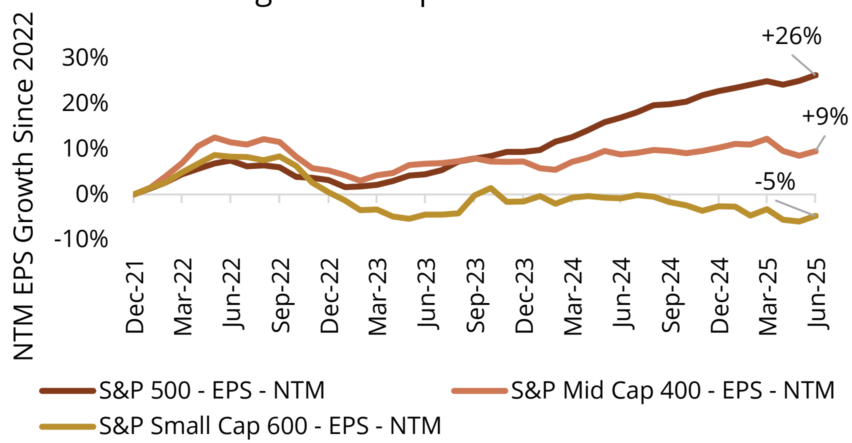
(Bottom Left) We find it encouraging that not all valuations are stretched. While the market-cap weighted S&P 500 is trading at a 38% premium to it's 20-year average, the same 500 companies on an equal weighted basis are trading at a more reasonable premium of 8%. Moving down the market cap spectrum, mid caps ended the quarter roughly in line with their historical average and small caps trade at a discount to their 20-year average.

(Bottom Right) While valuations of large cap stocks appear full, it is partially deserved due to their robust earnings growth, earnings estimates are 26% higher than they were at the beginning of 2022, while mid cap earnings are up +9%, and small cap earnings are actually 5% lower.

Not All Valuations are Stretched



Earnings Backdrop Remains Bifurcated



Sources: Factset, Piper Sandler, Madison Investments

Fixed Income Executive Summary

Market Summary (2Q25)

- Interest rate volatility continued during the second quarter as the incumbent administration advanced initiatives including tariff policies, the fiscal budget, and immigration reform.
- GDP declined -0.50% during the first quarter, although the year-over-year change was 2.0%. According to economists, there is a 35% chance of recession during the next 12 months.
- The Fed held their policy rate steady, awaiting more data specific to employment trends and possible inflation stemming from U.S. tariffs.
- Treasury yields finished the quarter mixed with the 2-year, 5-year, and 10-year maturities shifting by -0.16% to 3.72%, -0.15% to 3.80%, and 0.02% to 4.23%, respectively.
- During the quarter, A-rated corporate bond spreads declined 7 basis points (bps) while BBB-rated spreads decreased by 9 bps. The average spread on corporate bonds fell 8 bps to 78 bps.

Matters Madison Fixed Income Are Monitoring

- We anticipate the economy will continue to slow in the coming quarters as consumers and businesses adapt to the changing domestic and global environments. The effect tariffs may have on consumption will take months to decipher, although higher import prices can be expected. While it's unclear whether businesses will increase prices consumer pay, the impact of tariffs is apt to affect consumer behavior and/or corporate earnings.
- The Federal Reserve is likely to lower rates in September should the unemployment rate move towards 4.5% with inflation remaining at or below current levels. We anticipate rates will trend lower with short rates shifting downward more so than longer rates. A steeper yield curve may provide opportunities for investors to extend maturities and lock-in yield.
- Congressional efforts are determining federal spending and tax regulation, both of which have the potential to propel economic growth. These plans may necessitate incremental Treasury issuance and amplify interest rate volatility.

Source: Madison, Bloomberg, ICE Global Indices

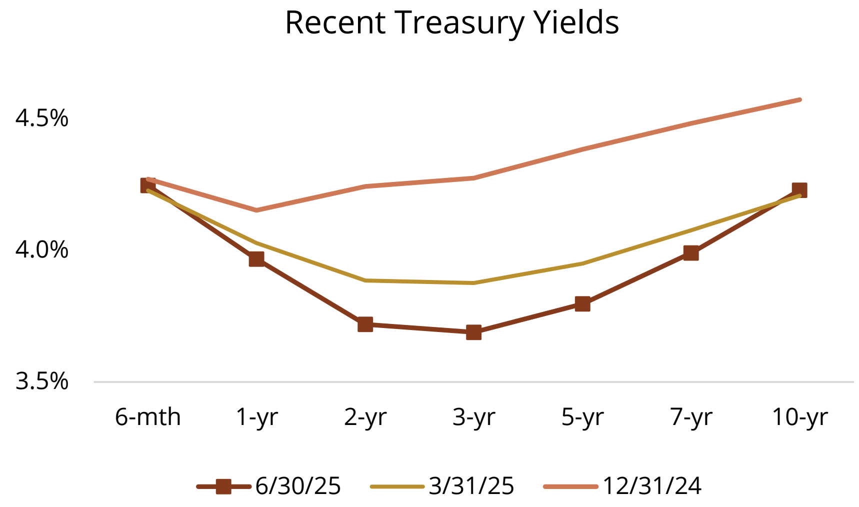
2Q 2025 – Fixed Income Attribution

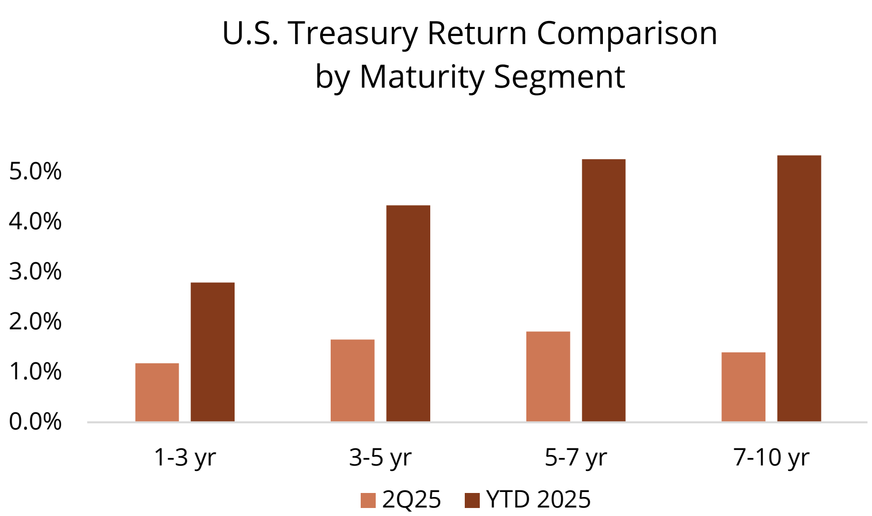
Madison INVESTMENTS

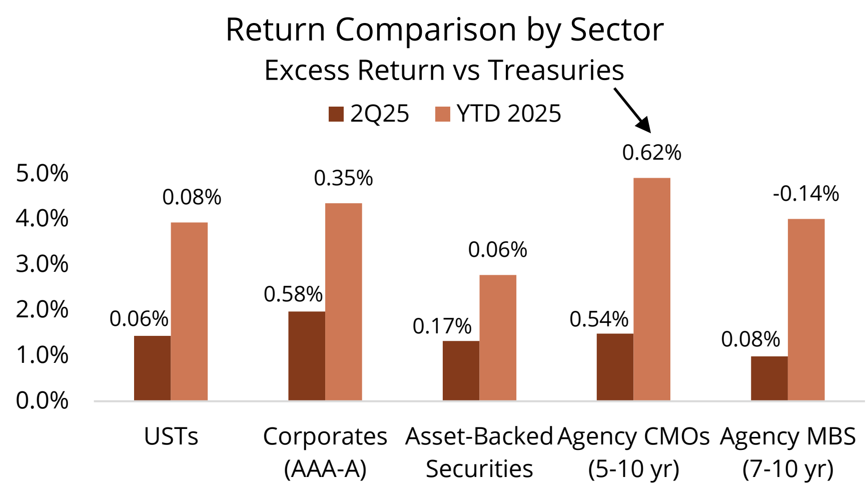
Attribution Comments

The Bloomberg Intermediate Government/Credit index posted a 1.67% return during the second quarter, extending the year-to-date gain to 4.13%. Price return accounted about half of the total return, reflecting the downward shift in rates and stable credit spreads. Bonds maturing between 3 and 7 years benefited the most as the yield curve changed shape.

During the quarter, corporate bonds and agency collateralized mortgage obligations provided the most excess return (against comparable maturity Treasuries), mainly due to yield advantage and slightly lower risk premiums. Excess returns for Agency MBS have been lower because of prepayment concerns caused by falling interest rates.





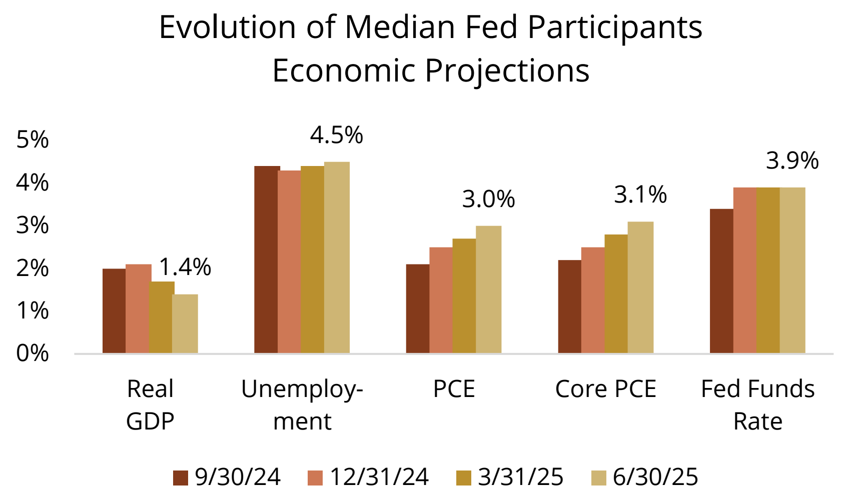


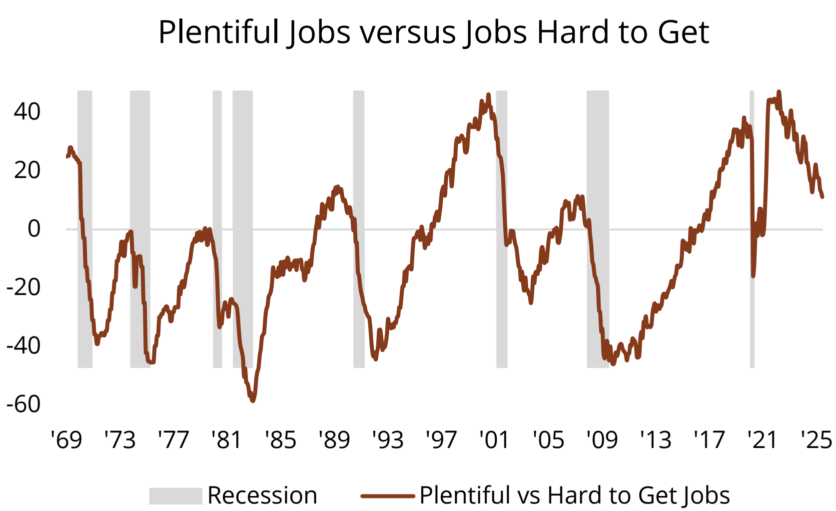
Source: Madison, Bloomberg, ICE Global Indices

Macro Commentary

The Fed Projects Slower Growth and Prolonged Inflation

In June, Fed officials released their revised Summary of Economic Projections which revealed the central bank's expectation for slower growth, increased unemployment, and higher inflation. The potential impact of U.S. tariff policy likely influenced the estimates, especially their outlook for inflation as gauged by the Personal Consumption Expenditures (PCE) index. There's an expectation businesses will raise prices to recover a portion of the higher import costs. The Fed continues to project two 25 bps rate cuts this year.





Source: Madison, Bloomberg

Early Indications of Labor Market Weakness

Households participating in the Conference Board's Consumer Confidence survey indicated jobs opportunities have become less plentiful and are becoming harder to get. As shown at left, the number of plentiful versus hard-to-get jobs tends to become negative prior to economic downturns.

Most industries have expanded their workforces this year, except for the Federal government and the Professional and Business Services industry. In the coming months, U.S. immigration policies could result in labor shortages within the farming, construction, and leisure/hospitality industries. Although we do not foresee a recession, we expect slower economic growth will lead to increased layoffs in the coming quarters.

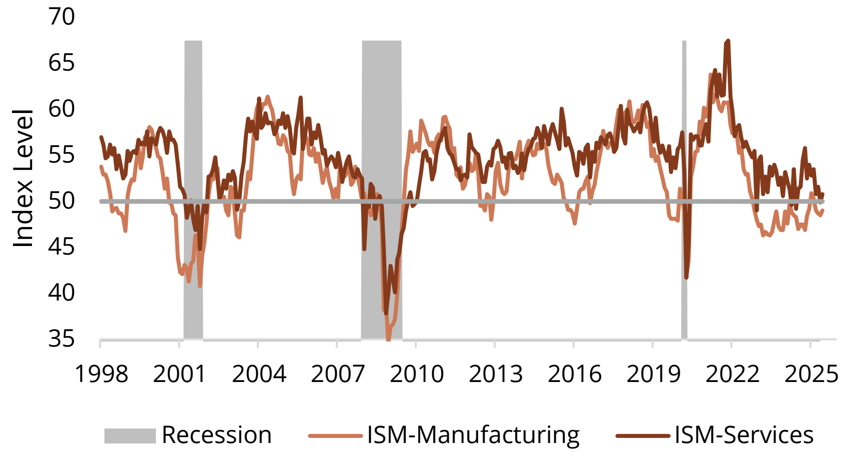
Macro Commentary

The Service Sector Appears To Be Contracting

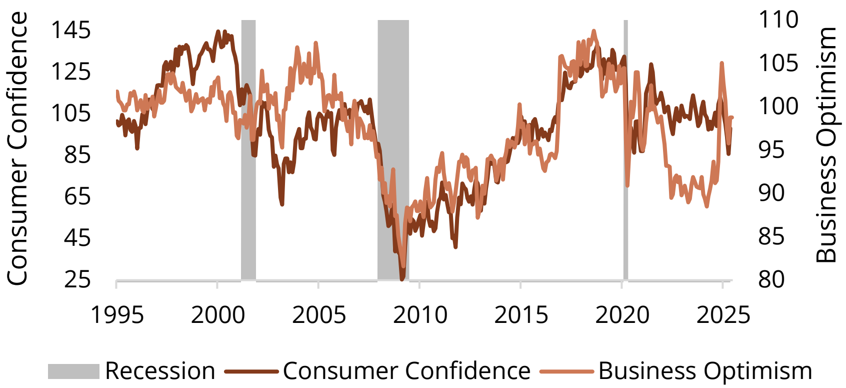
In May, the Institute for Supply Management (ISM) reported contraction within both the manufacturing and services sectors. A reading below 50 for either index indicates an economic decline within the sector. The manufacturing sector showed signs of expansion early this year as businesses procured inputs in advance of tariff enactment, although the uptick was short-lived as tariffs took effect.

The recent services sector decline is likely due to depleted bank balances for many households and a grim employment outlook for many unemployed workers. Although a headwind for growth, a decline in the price of services could lower the overall inflation rate.

Manufacturing and Services Have Slowed



Consumers and Businesses Are Less Positive Likely Due to Prevailing Uncertainties



Consumers and Businesses Suggest Caution

According to the Conference Board, consumer confidence continues to decline, a trend that began in late 2024. Lingering effects of prolonged inflation, weakening employment conditions, and concerns stemming from federal government rhetoric have all contributed towards the drop in confidence.

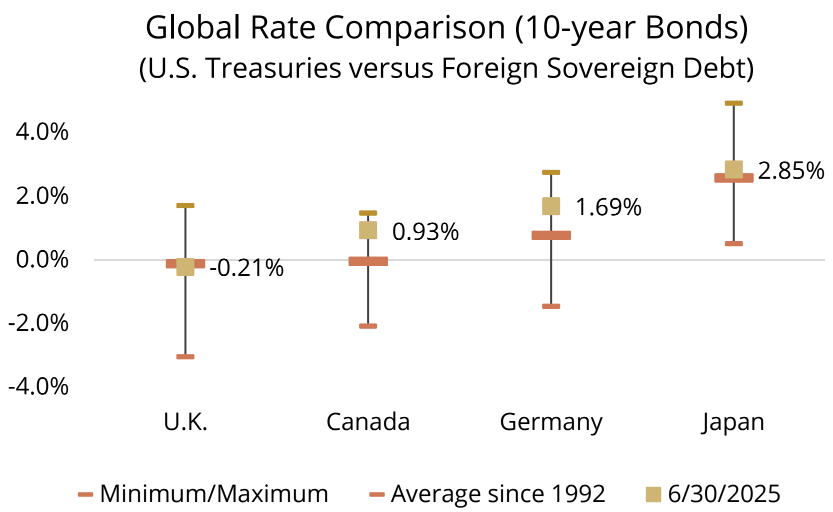
Similarly, the National Association of Independent Business (NFIB) reports that although companies have positive outlooks for general business conditions, they have mounting concerns about sales and earnings given rising costs. We believe most business entities will successfully adapt to these near-term challenges.

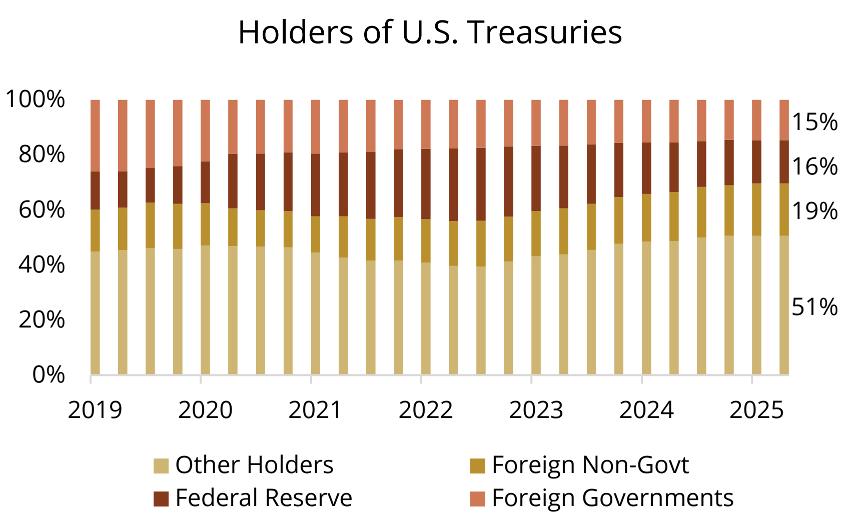
Source: Madison, Bloomberg

Asset Class (Governments)

The Differential Between U.S. and Foreign Rates Exceeds the Long-term Average

U.S. Treasury rates currently exceed comparable rates on foreign sovereign debt by an amount greater than the long-term average. In part, this is due to foreign central banks lowering their respective policy rates while the Fed has remained on hold. Generally, a higher rate differential attracts foreign capital causing the U.S. dollar to rise in value versus other currencies. The opposite has happened this year with the dollar depreciating more than 10% against a basket of foreign currencies. Even though U.S. economic prospects surpass most countries, our nation’s tariff policies along with other uncertainties have decreased flows into U.S. assets.





Source: Madison, Bloomberg

Non-Government Investors Hold the Most Treasuries

This year U.S. interest rates have been impacted by policy uncertainties, the ratings downgrade of Treasury debt, and the forthcoming budget bill which may necessitate significant Treasury issuance. As shown at left, “Other Holders” now hold 51% of outstanding Treasury debt, up from 40% in 2022. In large part, this is attributable to higher yields as the Fed aggressively raised rates to combat inflation.

Investor demand for Treasuries is likely to ebb and flow, depending upon the absolute level of yields and appetite to position riskier assets. We believe rates on longer Treasuries will move downward less so than shorter maturities when the Fed cuts rates again. A steeper yield curve may present an opportunity to position longer dated assets at favorable levels.

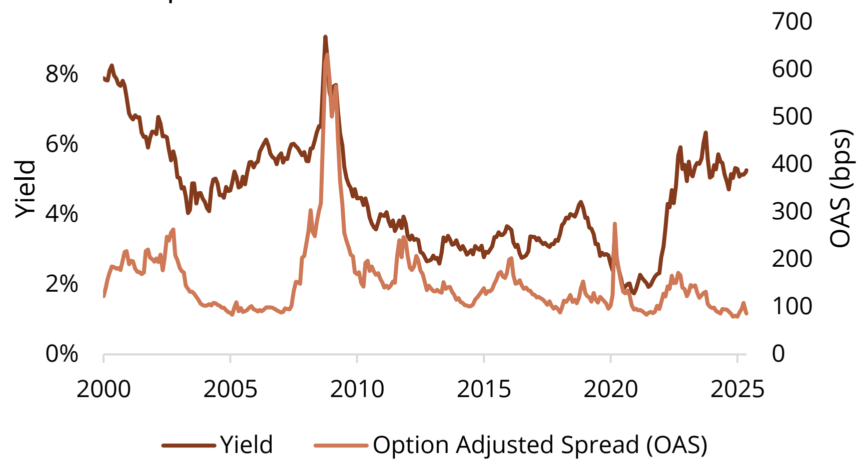
Asset Class (Corporates)

Corporate Bond Yields Appear Attractive

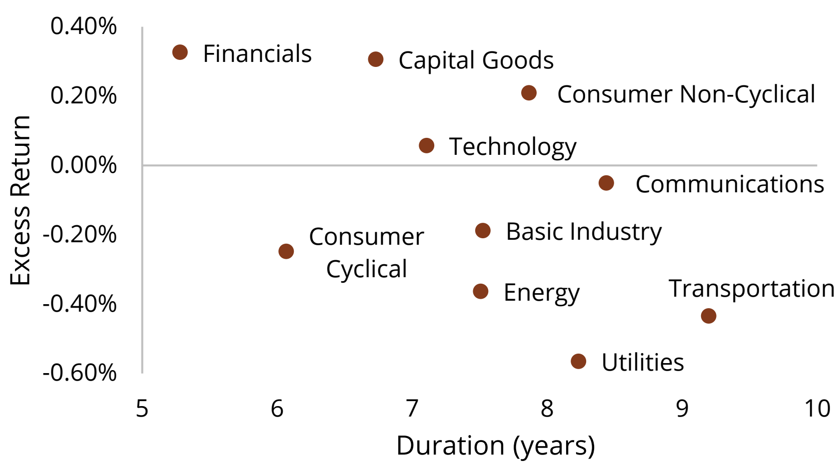
Although credit spreads are nearly 50 bps lower than the long-term median spread, fixed income investors still have an opportunity to lock-in historically favorable yields. A key driver of lower risk premiums has been the strong demand for yield as evidenced in both the secondary and new issue markets.

We believe the opportunity to position today's yields may be short-lived should the Fed accelerate the pace of anticipated rate cuts. A substantial economic downturn could cause risk premiums to gap 50 to 75 bps wider, although we currently view this as a low probability event.

Corporate Bond Yields and Risk Premiums



YTD Excess Returns by Economic Sector



Positive Excess Return Have Been Sector Dependent

Notwithstanding a 5 to 15 bps rise in risk premiums this year, many sectors of the investment grade corporate bond market have generated positive excess returns. *[Excess return is the amount earned above or below a comparable duration Treasury bond.]* In terms of credit spread, sectors less prone to macroeconomic uncertainties fared better than sectors more dependent upon promising economic conditions.

The miniscule change in credit spreads does not fully explain the negative excess returns. Certain sectors such as Utilities, Energy, and Basic Industry have also been negatively impacted by geopolitical issues, volatile global energy prices, and/or wildfires.

Source: Madison, Bloomberg, ICE Global Indices, S&P Capital IQ

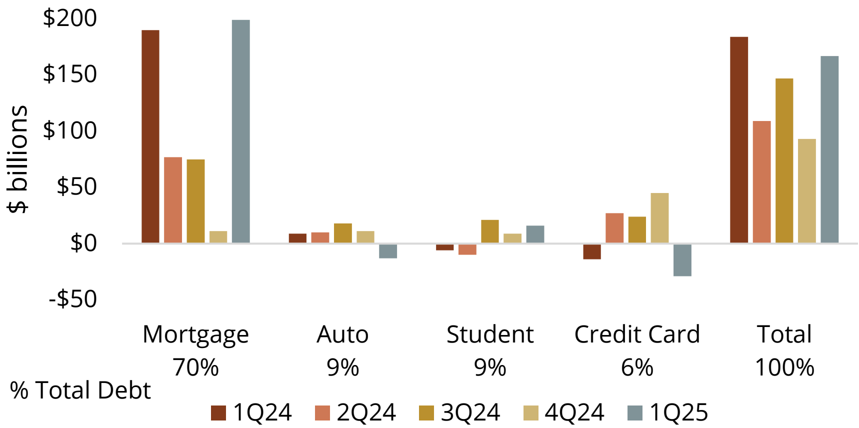
Asset Class (ABS/MBS & High Yield)

Mortgage Lending Picks Up

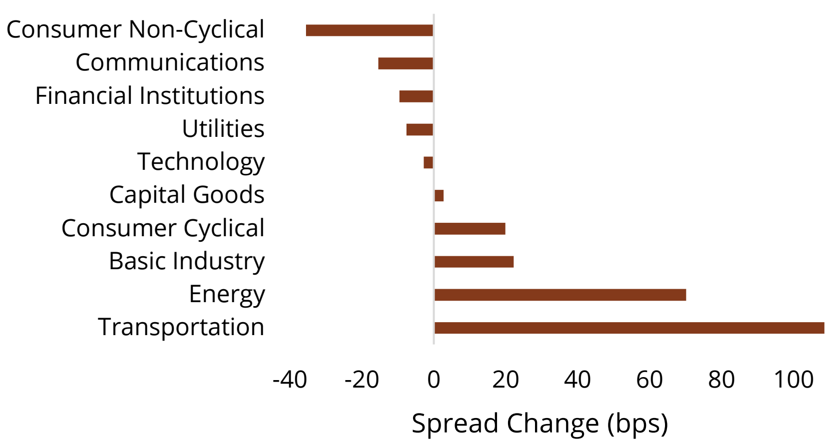
About $200 billion of mortgage debt was issued during the first quarter, thereby increasing the supply of mortgage pools available to investors. Lower interest rate volatility and a steepening yield curve helped MBS outperform Treasuries. While mortgages remain attractive versus other high-quality bonds, we prefer collateral with rates between 4.5% and 5.5% trading at a price near or below par value.

Auto loans and credit card debt both declined during the period, an indication consumers may be a bit hesitant to assume more debt given economic uncertainties.Delinquency rates recently stabilized for auto loans and credit card debt while delinquencies increased for student loans due to the resumption of credit reporting for this debt category.

Quarterly Change in Consumer Debt



YTD Spread Change for High Yield Bonds



Select High Yield Sectors Reflect Economic Uncertainties

Risk premiums rose during the quarter for the most economically sensitive sectors of the high yield bond market. Since the beginning of the year, spread volatility has been provoked by uncertainties surrounding tariffs and government spending as well as geopolitical turmoil.

Though we do not expect a recession, we anticipate continued volatility and slower economic growth. As such, we believe it is prudent to position portfolios in sectors which are likely to be able to weather economic storms. Historically, the Basic Industry, Consumer Cyclical, Energy, and Transportation sectors have struggled during times of slower economic growth. Conversely, the Capital Goods, Consumer Non-cyclical, and Utility sectors have tended to be more resilient.

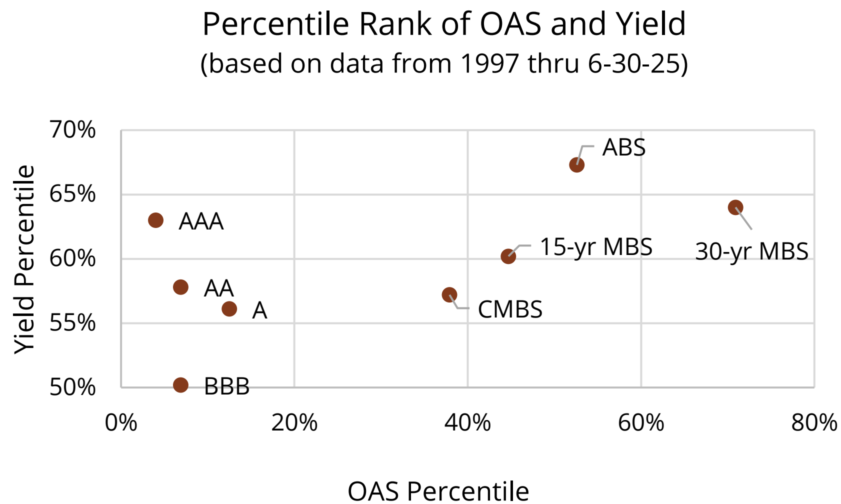
Source: Madison, Bloomberg, ICE Global Indices

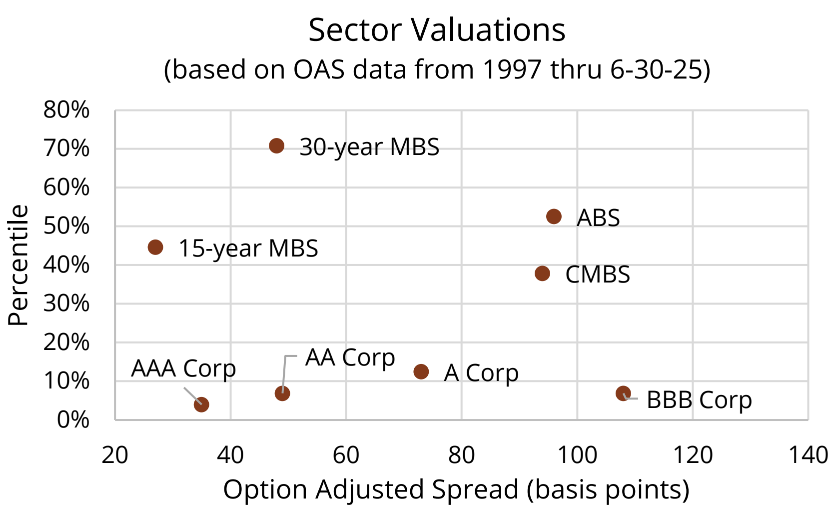
Asset Class (Sector Valuations)

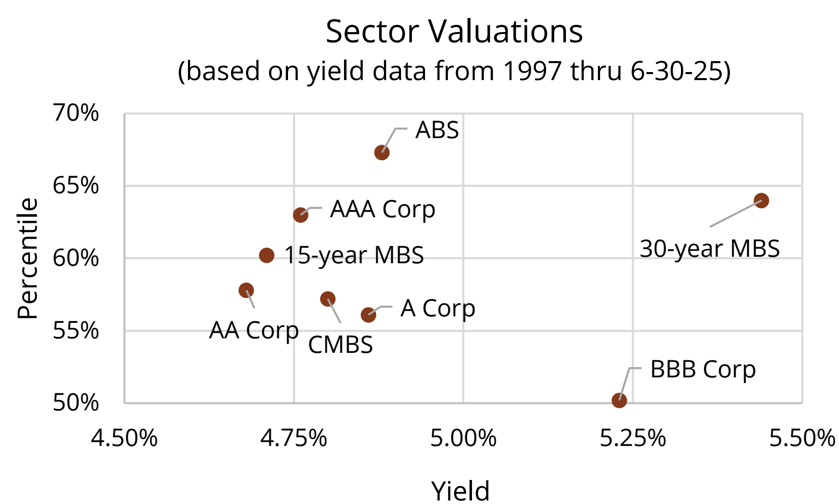
Valuation Comments

Residential mortgage-backed securities continue to offer the best combination of yield and spread as measured by percentile rank. Corporate bonds currently offer compelling yields from a historical perspective, although risk premiums remain low when compared to the past.

With option-adjusted spreads (OAS) below the 20th percentile, incremental return from corporate spread compression seems unlikely. Within the corporate sector, single-A bonds are slightly more attractive than both AA-rated and BBB-rated paper. Finance paper accounts for a large portion of A-rated bonds and offers higher yields. We believe this sector offers value versus industrial paper.







Source: Madison, Bloomberg, ICE Global Indices

Fixed Income Scorecard

Madison INVESTMENTS

Potential Impact on Bond Returns

	Negative			-0-		Positive	
U.S. Macroeconomics							
Economic Growth					Current	Prior	
Employment				Current	Prior		
Inflation			Prior	Current			
U.S. Policy							
Monetary (Fed)					n/c		
Fiscal (Congress)				n/c			
Regulatory				n/c			
Global							
Foreign Economics					n/c		
Geopolitical Tensions				n/c			
Central Bank Policies					n/c		
U.S. Corporates							
Credit Fundamentals				n/c			
Risk Premiums		n/c					
Liquidity			Prior	Current			
U.S. Treasury Market							
Interest Rates					n/c		
Sentiment					n/c		

Current
Prior
n/c No Change

The U.S. economy has held up well in the face of policy uncertainty. Consumption has yet to feel the full impact of tariff induced price increases. So far, employment remains stable given the uncertain landscape. Incoming data will be watched closely for signals of impending changes as fiscal and trade policy becomes more certain.

The Fed projects it will make two 0.25% rates cuts prior to year end. A new Fed Chair could be named later this year, although it's unlikely such a move would disrupt the rates market. The final federal budget bill may lead to deficits requiring incremental Treasury issuance. There is no guarantee the proposed tax cuts result in meaningful economic stimulus.

Many global central banks have cut rates to curtail slowing economic activity. Despite higher U.S. rates and unrest in the Middle East, foreign investors have been reluctant to increase their U.S. Treasuries positions. Many fear a depreciating U.S. dollar coupled with the recently imposed tariffs will lead to elevated U.S. inflation.

Corporations are analyzing the potential affects of U.S. tariff policy and many companies are reexamining their supply chains. Some corporations are committing capital to relocate manufacturing facilities back to the U.S., endeavors that generally reduce free cash flow. The stability of credit spreads reflects optimism about the U.S. economy and corporate health.

The shape of the yield curve will continue to transition during the next few quarters as the Fed adjusts rates and investors reassess valuations for longer maturities. Short rates are likely to fall more so than longer term rates, especially if inflation remains sticky. For the next few quarters, rates will likely remain within 50 bps to 75 bps of current levels.

Source: Madison

Disclosures

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All investments contain risk and may lose value. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in foreign-denominated and/or -domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets.

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.

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

Definitions

Madison INVESTMENTS

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.

The S&P Midcap 400 is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

The Russell 2000®Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 11% of the total market capitalization of the Russell 3000® Index.

The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 35% of the total market capitalization of the Russell 1000® Index. As of the latest reconstitution, the average market capitalization was approximately $3.7 billion; the median market capitalization was approximately $2.9 billion. The largest company in the index had an approximate market capitalization of $10.3 billion.

The Russell 1000® Growth Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit growth characteristics.

The Russell 1000® Value Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit value characteristics.

The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE (Europe, Australasia & Far East) Index is a free-float adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada.

The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPXSM) call and put options.

A basis point is one hundredth of a percent.

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.

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.

Income from tax-exempt bonds may be subject to the federal Alternative Minimum Tax and state and municipal taxes.

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.

Option-adjusted spread (OAS) measures the difference in yield between a bond with an embedded option (e.g. callable bonds, mortgage-backed securities) with the yield on Treasuries.

Percentile Rank is a statistical measure that indicates the relative standing of a value within a dataset. As an example, a sector with an OAS of 35 and a percentile rank of 25 indicates that historically the OAS has been below 35 twenty-five percent of the time and above 35 seventy-five percent of the time.