FIXED INCOME INSIGHTS / 3Q26

A Higher Bar

Weitz | INVESTMENT MANAGEMENT



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Financial markets have a way of humbling forecasters. The third quarter offered another reminder. Rising interest rates were the culprit this time, as the U.S. economy proved much more durable than feared following the start of the war in Iran. Survey data continued to describe an anxious consumer, and the September payroll report appeared soft at first glance. Yet household spending, business investment and employment in cyclical industries told a sturdier story. Through August, nominal consumer spending had increased 6.1% from a year earlier, while inflation-adjusted spending rose 2.6%. Combined construction and manufacturing employment also recovered to a new cycle high.

Following the money, households and businesses remain notably stronger than headlines and surveys suggest. Higher asset values, accumulated savings and continued access to credit have helped sustain demand, but spending cannot indefinitely outrun income. For now, however, the economy has proved strong enough to absorb higher financing costs, forcing the bond market to reconsider an essential question: How restrictive are interest rates if growth remains this durable?

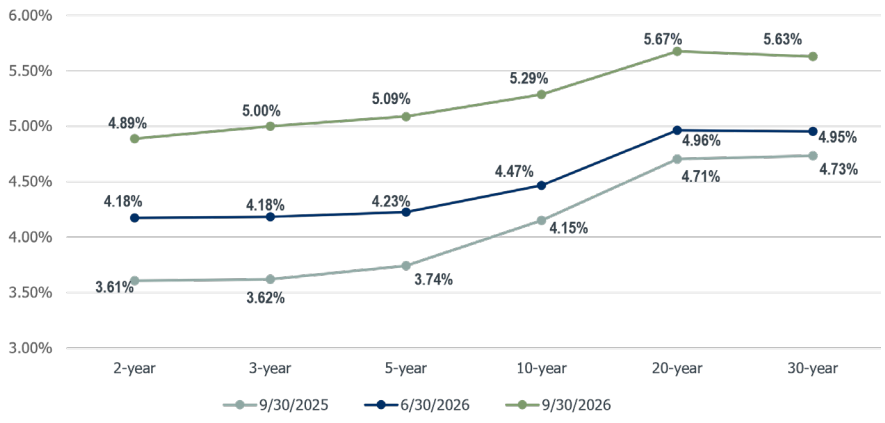
The Federal Reserve

After holding the federal funds target range at 3.50% to 3.75% in July, the Federal Open Market Committee raised it by 25 basis points in September—the first increase since 2023—to a range of 3.75% to 4.00%. The decision was unanimous. With inflation still above the Fed's 2% objective and economic activity expanding at a solid pace, policymakers signaled that the bar for renewed easing had risen.

How far does the Fed have to hike in this new tightening cycle? The Treasury market delivered a forceful message—more may be needed. The 10-year Treasury yield climbed 82 basis points during the quarter, from 4.47% to 5.29%, its largest quarterly increase since 1994. The 2-year yield rose from 4.18% to 4.89%, while the 30-year yield increased from 4.95% to 5.63%. Unlike the bear flattening of the second quarter, yields rose sharply across the curve, with the long end also pressured by resilient growth, heavy government borrowing and substantial demand for capital to fund artificial-intelligence infrastructure.

As of early October, the upward movement in yields has pushed the bond market to price in three additional hikes through July 2027 (to a target range of 4.50% to 4.75%). A well-regarded macro economist dubbed the spike in yields the “Great Rate Hike Freakout of 2026.”

U.S. Treasury Yields



While the move in yields was impressive, the composition of the move matters. Inflation expectations rose far less than nominal yields, leaving higher real yields to do much of the work. In other words, the market was not simply pricing an inflation accident. It was also pricing an economy capable of sustaining stronger real growth, heavier investment demand and a higher real cost of capital. That is an encouraging signal about the durability of U.S. economic growth, but a challenging one for holders of long-duration fixed income assets.

Credit Markets

The rise in Treasury yields has not translated into broad credit weakness. Investment-grade corporate spreads ended September at approximately 84 basis points, still near historically tight levels. High-yield spreads finished near 312 basis points. Those levels were wider than at midyear, particularly in the riskier portions of the market, but the adjustment was modest relative to the sharp rise in Treasury yields.

This apparent disconnect is less surprising than it first appears. According to Wells Fargo Research, the absolute level of the 10-year Treasury yield has historically been a poor standalone predictor of corporate spreads. Credit markets tend to care more about the pace and volatility of rate changes, expectations for Federal Reserve policy, the shape of the yield curve, corporate fundamentals and the availability of financing. During much of the quarter, continued economic growth and strong demand for income helped keep corporate credit spreads relatively stable despite rising Treasury yields.

The all-in yields (Treasury yield plus credit spread) available in corporate bonds remained compelling for many investors, but it is important to separate an attractive bond yield from an attractive credit spread. The first is now broadly available; the second is harder to find. A large portion of today's corporate yield comes from the underlying Treasury rate, while the incremental compensation for assuming credit and liquidity risk remains limited. That distinction becomes especially important when rate volatility is elevated and refinancing costs are rising.

Dispersion among individual issuers also continued to widen. Companies with durable free cash flow, manageable maturities and ready access to capital remained well supported. More leveraged borrowers—and businesses facing unusually high capital requirements or potential disruption from artificial intelligence—faced a less forgiving market. Stress was most visible among lower-quality high-yield issuers, a reminder that a benign index spread can obscure a much wider distribution of individual outcomes.

For active managers, dispersion can create opportunities. Broad valuations may offer little cushion, but individual credits can still become mispriced when investors apply a common narrative too indiscriminately. Our emphasis remains on underwriting the durability of cash flows, the issuer's ability to refinance under less favorable conditions and the price at which we are being asked to assume those risks.

Securitized credit continued to provide useful diversification and attractive income relative to similarly rated corporate bonds. Consumer spending and employment supported collateral performance across many asset-backed and residential mortgage sectors, while floating-rate structures continued to appeal to investors seeking protection from higher short-term rates. Demand remained healthy, although wider rate volatility periodically created better entry points in selected structures and lower-rated tranches.

Agency mortgage-backed securities (MBS) underperformed as rising interest rates and higher rate volatility put pressure on current coupon spreads. Non-agency MBS generally held up better than agency MBS as home prices held steady and mortgage credit quality remained relatively stable. Asset-backed securities (ABS), particularly higher-quality, shorter-duration assets such as automobile, consumer and equipment loans, held up relatively well compared with other fixed income sectors. Floating-rate assets such as collateralized loan obligations (CLOs) and certain commercial mortgage-backed securities (CMBS) remained relatively resilient, particularly in senior tranches, as overall spread levels and credit performance remained generally stable.

While large portions of the credit markets remain at or near historically low spread levels, we continue to seek attractive risk-adjusted opportunities both within and outside broad benchmark categories.

Outlook

Across our fixed-income strategies, we continue to emphasize liquidity, higher-quality securities and attractive income generation. Treasuries and agency mortgage-backed securities provide liquidity and increasingly attractive yields. Selected corporate and securitized credits can add incremental income where we believe the underlying cash flows and structural protections justify the risk. Our flexibility to invest beyond traditional benchmark sectors also allows us to avoid areas where valuations do not compensate us adequately and to act when dislocations create more favorable opportunities.

The economic outlook remains unusually dependent on competing forces. A resilient consumer, strong business investment and improving productivity could support growth longer than expected. At the same time, lower household savings, higher financing costs, geopolitical uncertainty and growing fiscal demands leave the expansion with identifiable vulnerabilities. We do not believe successful fixed-income investing requires choosing one precise macroeconomic forecast. It requires constructing portfolios that can earn attractive income while retaining the liquidity and resilience to respond as the range of outcomes changes.

The bar is higher in more ways than one. Economic resilience has raised the bar for the Fed to remain on hold. Higher real yields have raised the return investors can demand from high-quality fixed income. Tight credit spreads have raised the bar for accepting incremental risk. In our view, that combination favors patience and selectivity: remain invested, collect meaningful income and preserve flexibility to provide liquidity when markets offer better spread compensation.

We are thankful for the trust and partnership so many have placed in our firm and our investment process. Please see our Quarterly Commentaries for further details regarding investment activity during the third quarter.

IMPORTANT DISCLOSURES

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 10/8/2026, they are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.