

Q2 2025 Newsletter

Market and Credit Insights from Belle Haven's Investment Team



Volatility & Recovery

Market Insights

The second quarter of 2025 brought a volatile start but a resilient finish. The Fed held rates at 4.25%–4.50%, with softer inflation giving policymakers flexibility to consider cuts later this year. Core inflation remained slightly above target, and economic signals were mixed; job growth slowed to its weakest non-recessionary pace in over a decade, while consumer and corporate spending stayed firm.

Markets were briefly shaken by new White House tariffs and rising geopolitical tensions. A tariff announcement in April sparked a sharp selloff, sending the S&P 500 into bear territory and the 10-year Treasury yield up 50 bps within days. A swift policy pause helped markets recover. Oil spiked above \$80 on Middle East headlines but fell back to ~\$68 by quarter-end. Despite these shocks, both stocks and bonds rallied to finish the quarter strong.

What's inside our latest issue:

Market Insights

- Volatility gave way to stability
- Taxable municipal bonds outperformed
- Tax-exempt munis offer compelling value

Credit Insights

- The One Big Beautiful Medicaid Bill
- Mid-Year State Credit Round-Up

Interest Rates

Q2 saw a rare curve “twist”: short-term Treasury yields fell on expectations of Fed cuts, while long-term yields rose on growth and supply concerns. The result was a steeper curve, breaking from the inversion trend. The 30-year Treasury yield climbed 27 bps to 4.84%, while 2- and 3-year yields edged lower. Concerns over future Treasury issuance, including the One Big Beautiful Bill Act, added upward pressure on long-end rates.

Taxable Municipals

Taxable municipal bonds had a strong second quarter. Even though they represented only about 5–10% of the record high \$153 billion of overall muni issuance, volume jumped roughly 20–30% from a year earlier as universities, airports and infrastructure projects tapped the market. Most new deals were readily absorbed and yields on 10-year A/AA taxable munis finished around 4.75%-5.00%, still a healthy premium to similarly rated corporates.

Demand was fueled by institutional and crossover buyers drawn to the sector’s solid credit quality, and favorable spreads. For tax-deferred accounts and global portfolios, taxable munis remained a high-quality, income-generating diversifier, outperforming on total return and positioned well as supply moderates into summer.

While corporate spreads tightened over the quarter amid stronger risk appetite, investment-grade spreads remain near 25-year lows. In our view, this skews the risk/reward tradeoff, especially when compared to sectors like taxable municipals, which continue to offer both attractive yields and high credit quality.

We continue to encourage reducing corporate exposure in favor of high-quality taxable munis.

Tax-Exempt Municipals

Municipal yields reached their most attractive levels in over a decade during Q2, with the Bloomberg Muni Index peaking at 4.29%, a taxable-equivalent yield of ~7.25% for top tax bracket investors. While yields pulled back slightly by quarter-end, they remained

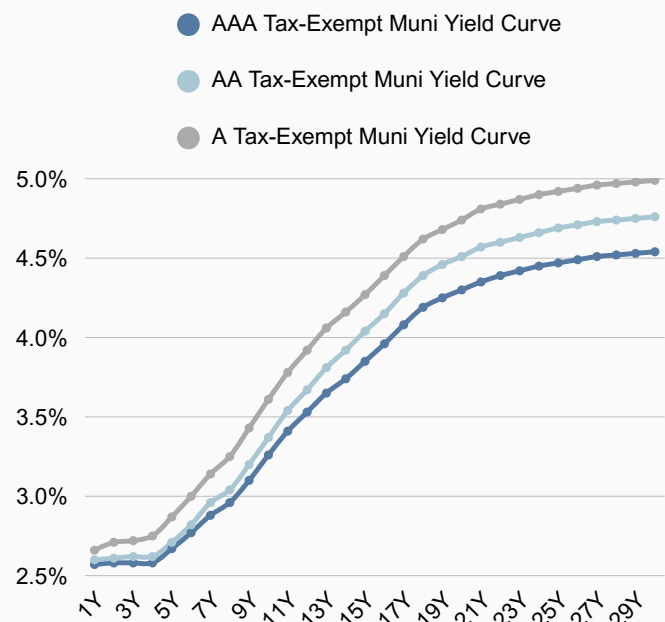
elevated, with a broad index yield-to-worst around 4% (~6%+ taxable-equivalent). The muni curve steepened meaningfully, offering compelling compensation for investors extending out the curve.

While tax-exempts trailed their taxable peers in Q2 due to heavier supply, rate volatility, and muted demand, the story beneath the surface is more constructive:

- **Valuations look increasingly compelling**, with AAA muni ratios nearing 100% of Treasuries.
- **Tax policy uncertainty cleared**, as Congress passed the budget bill preserving muni tax-exemption.
- **Credit quality remains a standout**, with upgrades outpacing downgrades for 17 straight quarters and 72% of the muni index rated AA or higher. (Moody’s)

Munis enter the second half of 2025 offering historically attractive after-tax yields, strong credit fundamentals, and steep curves, making them a valuable source of income and diversification for tax-sensitive investors.

Tax-Exempt Muni Curves



Source: MMD Yield Curves, 6/30/2025

A Constructive Quarter for Fixed Income

The second quarter of 2025 brought crosscurrents but ultimately delivered solid results for fixed income investors. The Fed held rates steady as inflation eased, anchoring the short end of the curve, while growth optimism and fiscal stimulus nudged long-term yields higher.

Taxable bonds posted positive returns, supported by strong credit fundamentals and demand for income. Tax-exempt munis faced headwinds from heavy supply and weaker technicals, but now offer some of the most attractive tax-adjusted yields in years.

Looking ahead, market direction will hinge on the Fed and the data. Any shift in rate policy or growth trends could set the tone for bond performance in the second half.

Yields on the long end of the curve remain attractive for clients who can tolerate some volatility in pursuit of higher after-tax income.



The One Big Beautiful Medicaid Bill

CREDIT INSIGHTS

On July 4, 2025, President Trump signed the One Big Beautiful Bill Act (OBBBA) into law. Among a number of initiatives in the bill that will reduce federal spending are significant cuts to Medicaid. Medicaid funding is expected to be cut by \$1.0 to \$1.2 trillion over the next 10 years¹, making it one of the largest cuts in recent history.

Within the investment grade municipal market, the two key sectors that would be impacted are governments and hospitals.

State and Local Governments – Treatment Options Available

Since Medicaid spending typically accounts for 30% of state budgets and is about 50% funded by the federal government², it is also perhaps the most consequential part of the budget bill for state and local governments. The size of the cuts will vary by state, see map on next page. Since the majority of cuts do not take place until after the mid-term elections in 2026, governments have plenty of runway to plan how they want to respond to these federal cuts in their fiscal 2027 budgets. They can augment their Medicaid plans or fund the shortfall with their own resources. We are already seeing many states announce cuts to their Medicaid plans in anticipation of these cuts; either limiting who is eligible or the number of benefits participants can receive. For states that decide to fund the shortfall themselves, there are options. Overall state credit is still in a good position from a balance sheet perspective, and they have generally been more conservative in their budgeting since the Great Financial Crisis of 2008. While there have not been any major initiatives to increase taxes to fund the cuts, we do

¹ [The Truth About the One Big Beautiful Bill Act's Cuts to Medicaid and Medicare - Center for American Progress & Allocating CBO's Estimates of Federal Medicaid Spending Reductions Across the States: Senate Reconciliation Bill | KFF](#)

² [Top Five Medicaid Budget Pressures - National Association of Medicaid Directors](#)

expect calls to “tax the rich” to become more popular as the federal cuts take effect. One of the key indicators of future credit quality will be the political dynamics in the given state. Will elected leadership be pressured into picking up the funding slack and create potential budget imbalance? Or will they ignore the pressure and maintain fiscal balance.

For local governments, the level of impact will depend on their mandated responsibilities, social program philosophies, and level of financial conservatism. Generally smaller cities, villages and towns do not provide social services and will not be directly impacted. For counties, it depends on the state. For example, counties are responsible for social mandates in New York and California whereas in Texas, they are focused on road infrastructure and certain areas of law enforcement. To the extent the services are mandated by law, these issuers may not have a choice but to make-up for some portion of the reduced funding. This loss of revenue could be made up with tax increases, cuts in discretionary budget items or using rainy day reserves; of which the last two options are not sustainable.

Healthcare - The Frontline

The healthcare sector will be the first to feel the effects of these cuts and will be the least flexible to offset its effects. A number of factors will ultimately determine how acutely the cuts will affect any particular credit including the type of clientele they service. For example, rural hospitals that receive supplemental federal funding will have to tighten their belts in order to balance out the declines in these revenues. Many fear that these small rural hospitals may close as they won't be able to fund their operations. Inner city hospitals that serve indigent populations will also be challenged given their reliance on Medicaid. Hospitals will see reimbursement levels decline and, in some cases, have to provide charity care to patients that might have once been covered under Medicaid but become ineligible under the OBBA.

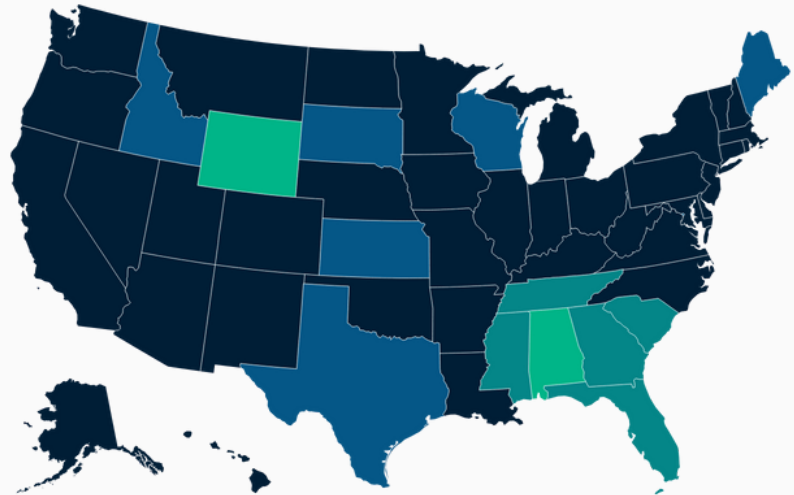
Seek Professional Help

The prognosis is not ideal, but far from fatal. Experienced analysts will be able to gauge how acutely these federal funding cuts will be felt and more importantly, the treatment options available to issuers to handle the situation.

Federal Medicaid Cuts in the Senate Reconciliation Bill, By State

As a % of 10-year baseline federal spending (2025-2034)

■ < 7% ■ 7%–10% ■ 10%–13% ■ ≥ 13%



Note: \$1 trillion in federal Medicaid spending cuts is allocated across states. See Methods in "Allocating CBO's Estimates of Federal Medicaid Spending Reductions Across the States: Senate Reconciliation Bill" for more details.

Source: KFF analysis of CBO estimates of the Senate Reconciliation Bill

KFF

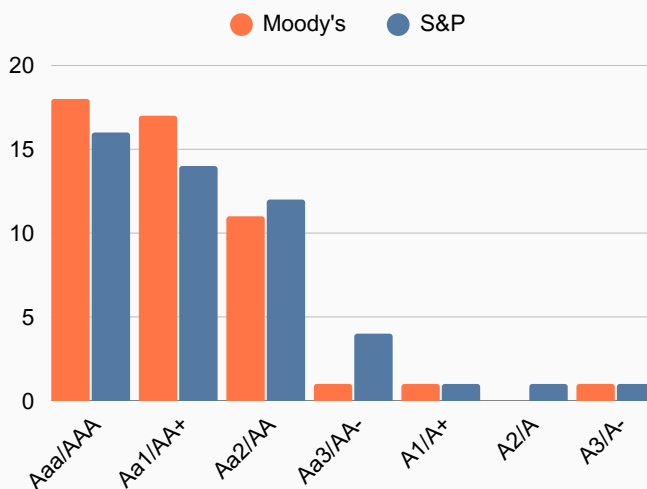


Mid-Year State Credit Round-Up

CREDIT INSIGHTS

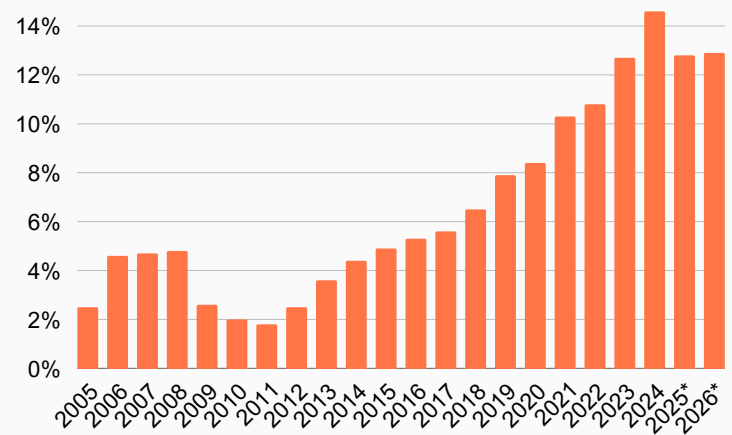
As in prior Q2 Credit Commentaries, we're highlighting a few of the most active states in the municipal market. According to the National Association of State Budget Officers, states, on average, projected a slow 1.9% revenue growth for fiscal 2025, and these projections have largely held true³. Fiscal 2026 budget proposals are showing a similarly pessimistic view on revenues with some states projecting small declines in tax collections on increased economic uncertainty. The OBBBA will not start to impact state budgets until 2027, so states will not experience additional stress this year.

Distribution of State Issuer Ratings



Source: S&P and Moody's, 7/1/2025

Median State Rainy Day Funds as a Percentage of Expenditures



*2025 are estimated figures and 2026 are recommended figures. Total dollar amounts for fiscal 2025 and fiscal 2026 are adjusted to allow for year-over-year comparisons by including most recent rainy day fund balance figure available for states that were unable to report rainy day fund balance projections for those years. Source: National Association of State Budget Officers

³ Summaries of Fiscal Year 2026 Proposed Budgets – National Association of State Budget Officers

New York (Aa1/AA+)

- General fund spending is set to rise 7.3% to \$116.3B (vs. 7.6% last year).
- Revenues projected to decline 1.8%, mainly due to loss of federal aid.
 - Tax revenues are expected to increase 2.3%.
- FY 2026 year-end cash balance projected at \$31.5B, down \$1.3B from FY 2025 but still healthy.
- One risk that remains in the budget relates to the state needing to fill the Metropolitan Transportation Authority's capital funding gap if the courts overturn Congestion Pricing, which is expected to generate around \$500 million this year according to the MTA.

New Jersey (A1/A)

- Operating budget projected to decline 0.8% to \$56.98B.
- Recurring revenues expected to align closely with expenses, resulting in a structurally balanced budget.
 - A notable improvement from last year's 23% reserve draw.
- Fifth consecutive full pension payment planned.
- Reserves expected to finish the year at \$6.3B, or a very strong 10.9% of appropriations.

Illinois (A3/A-)

- Continued fiscal progress since 2018, with reduced unpaid bills and timely budgets.
- Revenues projected to grow 2.9% to \$55.5B; expenditures up 4.9% to \$53.9B.
- Expected surplus will bolster rainy day reserves.
- Budget includes full pension contributions and expanded funding for education and social services.

California(Aa2/AA-)

- Revenue volatility and spending growth have challenged budget balance.
- FY 2025 budget proposes \$228.9B in expenditures (down 1.4% YoY).
- General fund revenue projected to rise just 0.2%, leading to a \$7.1B draw on rainy day funds.
- Reliance on one-time revenues is lower than last year, and strong reserves offer budget flexibility.

Portfolio Management



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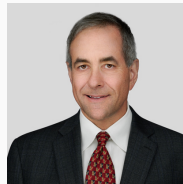


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