

Q3 Bond Market Review: Inflation, Labor and the Fed

Sep 2025

The Bloomberg US Aggregate Bond Index returned 2.03% during Q3 of 2025, bringing year-to-date performance for the Index to 6.13%. 2025 year-to-date performance represents the best nine-month start to a calendar year since 2020's 6.79%. Q3 brought a mix of market-moving developments: the long-delayed tariffs were implemented on August 7; the labor market showed signs of weakness and a dovish shift from the Federal Reserve at Jackson Hole coincided with growing concerns over a potential government shutdown. As in Q2, risk assets have continued to shrug off economic and political headwinds, with investor demand keeping spreads near historically tight levels. Overall, Q3 reflected a market increasingly focused on central bank policy, with credit markets showing resilience despite mounting macroeconomic uncertainty.

Shifts at the Federal Reserve

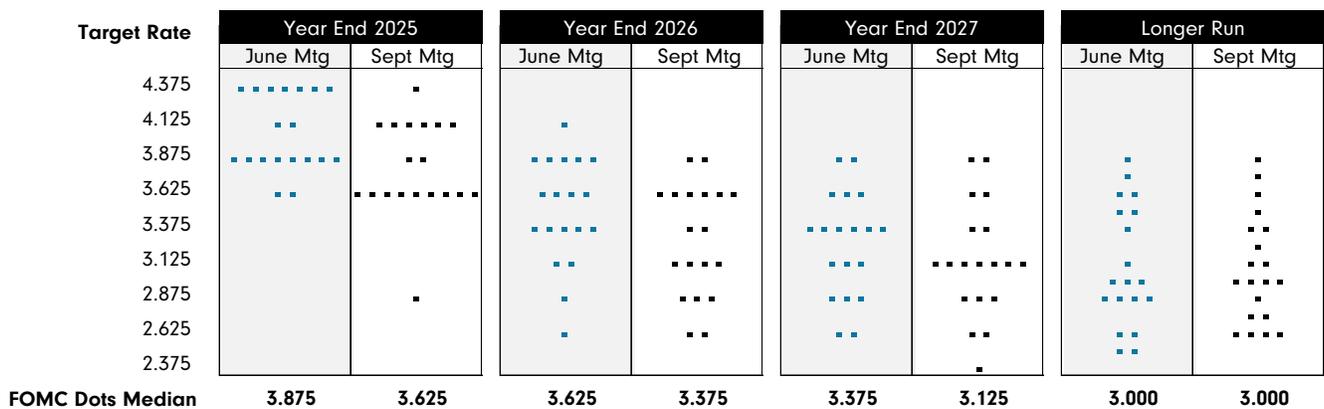
After an unexplained absence at the July 30 and 31 meeting of the FOMC, former Federal Reserve Governor Adriana Kugler submitted her resignation from the board on August 1. Kugler was nominated and confirmed to the Fed board in 2023, and she was set to serve the remainder of Lael Brainard's 14-year term, expiring in January 2026. While no explanation was offered from Kugler regarding the reasoning for her departure just months ahead of her term expiring, the vacancy paved the way for President Trump to fill another position on the influential board. Stephen Miran, who is currently the chair of Trump's Council of Economic Advisors (CEA), was nominated for the position and confirmed in the days leading up to the September FOMC meeting. Miran distinguished himself at his first meeting by being the only member to advocate for a rate cut of 50 basis points (bps).

Kugler's departure four months before the expiration of her term was a bit of a surprise, as she offered no forewarning. An even bigger surprise was the President's attempt to terminate Lisa Cook, who was nominated by President Joe Biden in 2022 and confirmed in 2023 to serve a 14-year term as a member of the Federal Reserve Board of Governors. President Trump announced his intention to fire Governor Cook on August 25, citing allegations that she committed mortgage fraud. Bill Pulte, the director of the Federal Housing Finance Agency, alleges that Cook claimed two primary residences in 2021 to obtain better terms on both mortgages, as mortgage rates on second homes and investment properties are often higher than those for primary residences. The Federal Reserve Act states that governors can only be removed "for cause," meaning malfeasance, neglect of duty or inefficiency. Establishing a for-cause removal typically requires a proceeding that would allow Cook, according to legal experts, to answer the charges and present evidence, which hasn't happened in this case. On September 9, a federal judge blocked Cook's removal from the Federal Reserve Board, allowing her lawsuit to proceed and for her to remain as Fed governor until her lawsuit is heard, and she was able to attend the September FOMC meeting. The case now moves before the Supreme Court, which will decide whether the President was within his power to terminate a member of the Federal Reserve. The outcome of this case will have far-reaching implications — not just for the Federal Reserve's leadership, but for the foundational belief in its independence from political influence.

The next easing cycle begins

Despite the shifts in the composition of the Federal Reserve and the ongoing uncertainty around Lisa Cook’s term, the FOMC moved forward with the first adjustment to Fed Funds since December 2024. The decision to ease reflected a “shift in the balance of risks,” with the Committee believing that the “downside risks to employment have risen.” Inflation has ticked up since the spring – a trend acknowledged in the post-meeting statement. At the same time, job growth has slowed sharply, and the unemployment rate has reached the upper end of the Committee’s central range consistent with full employment. Powell’s post-meeting press conference was mildly hawkish and signaled that there was no rush to get rates back to neutral. Powell characterized the adjustment as a “risk management cut” and expectations are for a “meeting-by-meeting” approach. The Committee’s ongoing bias to ease was more apparent in the September Summary of Economic Projections (SEP), with the median projection for the Fed funds rate at year end slipping to 3.625% from 3.875% in the June SEP, implying most officials see an additional 50 bps of easing over the Committee’s two remaining meetings of 2025. The median estimation for 2026 signaled just one cut, but this masks a decent amount of dispersion across the participants. Just two of the 19 participants were at the median (3.375%), and the median was just one dot away from slipping another 25 bps to 3.125%. Notably, the median estimate for the longer-run, “neutral” Fed funds rate was unchanged at 3%. This underscores how most Committee members still view the policy setting as at least somewhat restrictive, giving some scope to lower the fed funds rate to cushion the labor market without outright accommodative monetary policy stoking higher inflation.

Exhibit 1



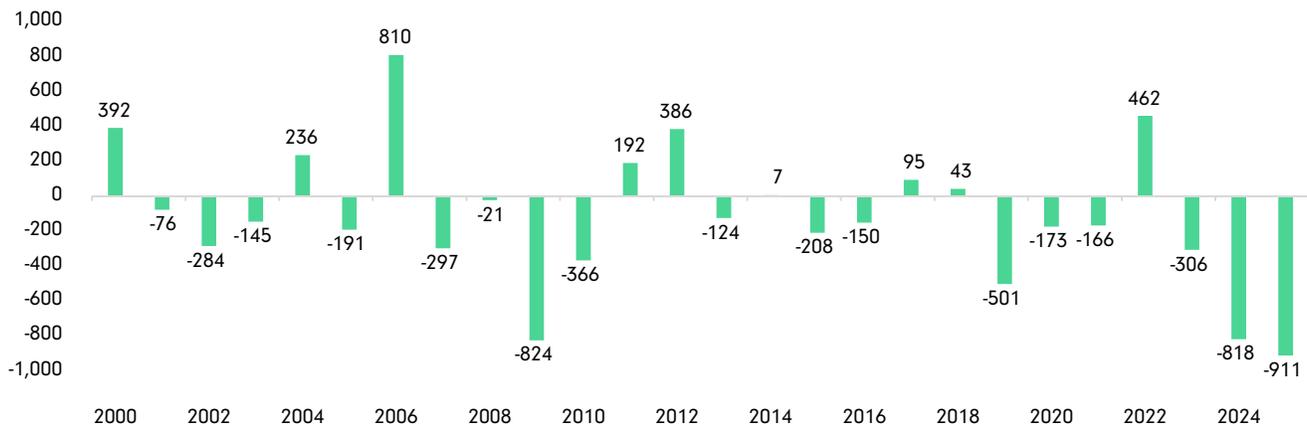
Source: Federal Reserve.

Looking back, there are similarities between this year’s actions and those taken in 2024. In September 2024, the Fed initiated easing with a 50 bps cut, compared to the 25bps reduction in September 2025. However, the FOMC emerged from that meeting with what appears to be a replication of the actions taken in November and December 2024 – a reduction of 25 bps at both meetings. This year is slightly different as the next meeting is in October, but for now, the future path of rates based on the Fed SEP is another 50 bps lower over the next two meetings. Exhibit 1 illustrates the shift in expectations from the various members of the Federal Reserve for the remainder of 2025 as well as 2026, 2027 and longer-term. This shift, 25 bps lower across the near- and medium-term forecasts, reinforces the Committee’s cautious approach to easing while maintaining a steady long-run view of neutral policy at 3%.

NFP revisions, labor market weakening and an inflation update

Recent reports of a resilient labor market may have overstated the underlying strength. According to the Bureau of Labor Statistics' preliminary benchmark revision to March 2025 non-farm payrolls, total employment was 911,000 lower than previously reported. This revision implies an average monthly job loss of 76,000 – a sharp contrast to previous estimates of growth. Collectively, the data suggests the recent slowdown follows a longer period of modest expansion, potentially justifying a more aggressive Fed easing cycle. It's worth noting that this is a preliminary estimate; the final benchmark revision will be published in February 2026. In 2024, the benchmark revision to March reporting was a reduction of 818,000 jobs, the record until this most recent report. Notably, 2024's 818,000 job loss estimate was later revised to a loss of 598,000 jobs.

Exhibit 2 – Preliminary Payroll Benchmark Revisions (in thousands)

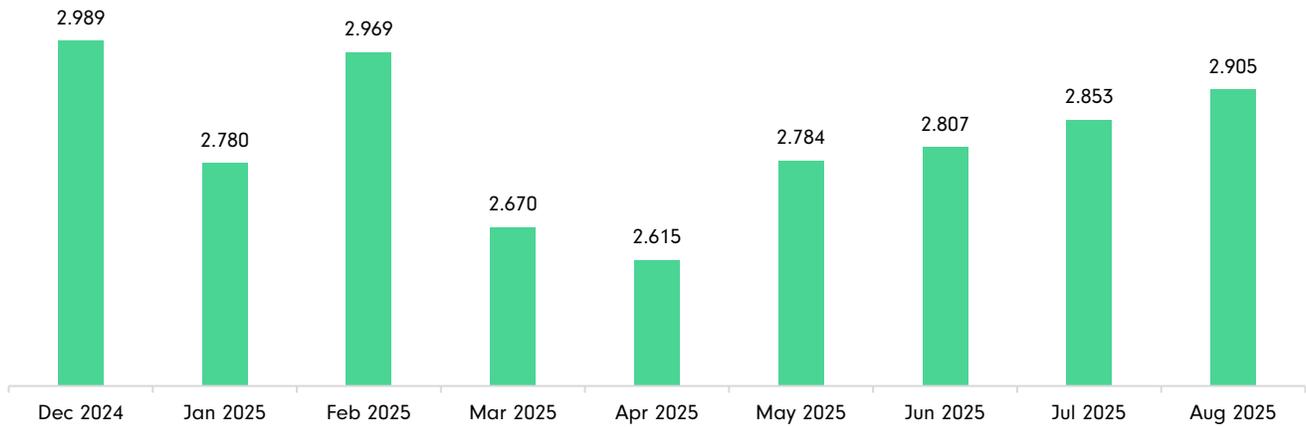


Source: Bureau of Labor Statistics.

In addition to the benchmark revision, broader labor market indicators paint a picture of sustained weakness. The average monthly job gains in 2025 have been 102,000. In comparison, job gains averaged 175,000 in 2024 and 209,000 in 2023. Historic revisions to the non-farm payroll reports in May and June (reduction of 258,000 jobs created) led to the termination of the head of the Bureau of Labor Statistics, creating more uncertainty for markets regarding data validity. Despite this slowdown, unemployment remains well below the "natural level of unemployment", averaging roughly 4.16% in 2024, though it should be noted that the past three months have seen an increase from 4.1% in June to 4.3% in August.

The Federal Reserve's preferred measure of inflation, the core personal consumption expenditures (PCE), increased 2.9% compared to August 2024, in line with both market expectations and July's reading. This marked the highest reading since February 2025 and was the fifth consecutive increase since April (2.6%). Rounding in the reported number shows July and August in line with one another at 2.9%, but digging into the details, the report indicates a month-over-month increase from 2.853% to 2.905%. Thus, the economic conundrum continues to plague the Federal Reserve – higher inflation requires higher rates, but a weaker labor market requires lower rates, and if both exist concurrently, which is the best area to attack? Given these dual pressures, the Fed appears poised to prioritize stabilizing the labor market while tolerating modestly elevated inflation – at least in the short term.

Exhibit 3 – Year-over-Year Increase in Personal Consumption Expenditures (%)



Source: Bureau of Economic Analysis.

Treasury update

The Federal Reserve has begun its latest easing cycle, but its duration will hinge on upcoming economic data. Market expectations for the future path of rates started in the latter days of the volatility brought on by Liberation Day, as the uncertainty around the breadth and depth of the tariffs fueled expectations for a more accommodating Fed. While the Fed held the line on rates during the summer, the weakening of the labor market outweighed the potential impact of stubborn inflation, and the September FOMC meeting brought the first 25 bps move since late 2024. The Treasury yield curve had been in a bull steepening shift leading into Q3, with a more stabilized spread between shorter and longer yields over the past three months. A bull steepening of the curve occurs when short-term rates move lower (fueled by an accommodative Federal Reserve), but market concern over longer-term inflation and increased Treasury issuance pushes long-term rates higher. Since the beginning of 2025, the spread between the yield on the 2-year and 10-year Treasury has grown from 0.33% to 0.54% while the spread between the 2-year and 30-year has jumped from 0.54% to 1.12% as of September.

Exhibit 4 – Inflation Remains Above Fed’s Target, Pushing Long-Term Rates Higher (%)



Source: Bloomberg, Federal Reserve.

While the Treasury market delivered positive performance during Q3 (+1.51% for the Bloomberg US Treasury Index), it lagged both the corporate and securitized sectors and pulled the overall performance of the Bloomberg US Aggregate Bond Index lower. Returns were positive across the Treasury curve in Q3, fueled by rates grinding lower. The bull steepening curve shift we’ve seen throughout 2025 continued, albeit at a slower pace than prior quarters. The 2-year Treasury yield dropped from 3.72% to 3.61% while the 30-year Treasury yield slid from 4.77% to 4.73% as concerns around the fiscal situation and the impact of political impasse in Washington continued to grow.

Exhibit 5 – Treasury Bellwethers (%)

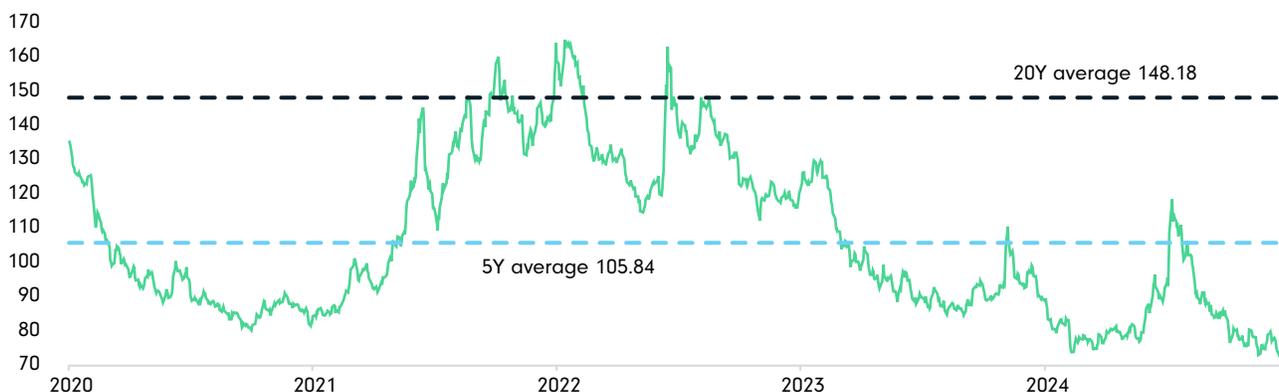
	2Y	5Y	10Y	30Y
31 Dec 2024 Yield	4.24	4.38	4.57	4.78
30 Jun 2025 Yield	3.72	3.80	4.23	4.77
30 Sep 2025 Yield	3.61	3.74	4.15	4.73
Return	1.03	1.18	1.84	2.10

Corporate update

The investment grade corporate market, as tracked by the Bloomberg US Corporate Bond Index, posted its strongest quarterly return (+2.60%) since Q3 2024 (+5.84%), driven by spread tightening and strong investor demand. Except for the market disruption in Q2 around the announcement of tariffs, investment grade corporate spreads have continued to grind tighter throughout the year. Following that disruption, investor risk appetite returned, pushing spreads lower. Investment grade corporate spread levels moved almost 10 bps lower during Q3, rallying from 83.2 bps to 73.81 bps. Spreads in this sector reached their lowest level since May 1998 in the latter part of the quarter (71.7 bps).

The yield on the Corporate Index followed a similar path, dropping roughly 18 bps from the beginning of Q3 (4.99%) to the low point in mid-September (4.70%) before climbing slightly to finish at 4.81% on September 30. Investors continue to look for opportunities in the investment grade corporate space while issuers flock to meet demand. Nearly \$400 billion in new issuance during the quarter brings year-to-date issuance to \$1.3 trillion, 3% ahead of 2024’s year’s pace.

Exhibit 6 – Investment Grade Spreads (bps)



Source: Bloomberg.

Securitized update

The securitized market (as measured by the Bloomberg US Securitized: MBS, ABS, CMBS Index) delivered another strong quarter of performance, returning 2.38%. The sector has consistently delivered strong quarter-over-quarter performance since the start of the year, delivering the best nine-month performance to start a calendar year (+6.70%) since 2009's 6.93%. Plain vanilla passthrough mortgage-backed securities (MBS), as measured by the Bloomberg US MBS Index, led the way, generating 2.43%, followed closely by collateralized mortgage obligations (CMOs), which returned 2.30% as measured by the ICE BofA CMO Index. Elsewhere within the securitized market, non-agency commercial mortgage-backed securities (CMBS) continued to deliver decent performance (+1.87%) while shorter-duration asset-backed securities (ABS) (+1.64%) continued their slow and steady performance, benefiting from attractive spread levels and shorter duration. Like the investment grade corporate markets, spreads moved lower throughout Q3 across all segments of the securitized market.

While spreads have moved lower throughout risk assets, higher yielding and better structured securitized segments of the market continue to offer better relative value for managers willing to dig into the details on the structures and underlying collateral. Issuance in the securitized market remains strong, with both CMBS and non-agency residential mortgage-backed securities (RMBS) outpacing issuance over the comparable 2024 period and ABS only slightly behind. After falling off the pace during Q2, issuance across securitized sectors is within striking distance of the record levels reached in 2024.

While overall market performance was strong, the quarter was not without headline risk. Subprime auto ABS issuer Tricolor filed for Chapter 7 bankruptcy following news that several banks disclosed potential losses tied to warehouse credit lines utilized by Tricolor, and the US Justice Department is conducting an ongoing investigation in alleged irregularities. Some subprime auto ABS deals from smaller issuers experienced slight spread widening in the immediate aftermath, but the reaction in the overall market was muted. The overall tone in the securitized market remains constructive heading into Q4.

Investment Grade is a bond quality rating of AAA, AA, A or BBB.

Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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