FRANKLIN TEMPLETON

Franklin Intermediate Government Bond SMA

Commentary | as of December 31, 2025

Key Takeaways

- **Markets**: The fourth quarter of 2025 (Q4) saw monthly shifts in market sentiment as uncertainties increased in the first part of the quarter. The US federal government went into a shutdown on October 1 as the US Senate was unable to pass a spending bill. This, among other things, delayed or canceled the publication of key economic data leading to a lack of clarity on the economic condition of the United States. The shutdown was lifted mid-November, and subsequent data showed that economic growth in the United States remained resilient. US trade policy continued to be a source of uncertainty. The US Federal Reserve (Fed) delivered three consecutive 25-basis-point (bp) cuts in Q4, helping market sentiment to improve in December. Fixed income volatility measures fell toward the end of the quarter, reaching their lowest level since 2021. Over the period, the US Treasury (UST) yield curve steepened as shorter-maturity yields fell while longer-dated bond yields rose. The one-month UST bill fell 51 bps, and three-month UST bill yields declined 31 bps. Yields moved lower by 14 bps to 3.47% on the two-year UST note and by two bps to 3.73% on the five-year UST note. By the end of the quarter, the yield on the benchmark 10-year UST note moved two bps higher to 4.17%, and the yield on the 30-year UST bond increased by 11 bps to 4.84%.
- **Contributors**: Overweight to the five-year portion of the UST yield curve.
- **Detractors**: Security selection among USTs. Underweight to short-duration USTs.
- **Outlook**: We project balanced inflation risks with potential upside surprises in 2026, with core personal consumption expenditures remaining above the Fed's 2% target. Although the Fed signaled one cut for 2026, we anticipate a pause through Fed Chair Jerome Powell's term ending in May 2026, with labor market weakness being a key trigger for any "risk-management" cuts. If the Fed cuts fewer times than priced, we believe UST yields will drift higher. However, demand-supply technicals may limit how high yields climb in 2026.

Performance Review

- Yield curve positioning detracted from returns primarily from an underweight to the two-year portion of the UST yield curve as short-term yields fell in Q4. In contrast, overweight exposure to the five- and 10-year area of the curve contributed to results. Security selection in UST curbed returns for the period.

Outlook

- Progress on disinflation has stalled since April. Tariffs have pushed core goods prices higher, while core services excluding housing ("supercore") have reaccelerated above 3%. In 2026, we think inflation risks should be balanced, with the potential for upside surprises. Strong growth in the first half of the year and a more stable labor market can keep supercore sticky. On goods, much of the tariff effect is still ahead. Although the trade weighted applied tariff rate is roughly 16%, effective, tariffs paid were under 11% as of July, explaining the muted goods price pass through. We expect effective rates to rise in the coming months. While applied and effective tariff rates could fall if the Supreme Court rules against the administration on tariffs applied under the International Emergency Economic Powers Act (IEEPA), we think the White House will reimpose similar tariffs via Sections 122 and 301. That said, a partial recreation of IEEPA could limit upside risks to goods prices. Overall, gradual rent moderation combined with persistent services inflation should keep core personal consumption expenditures well above the Fed's 2% target through 2026.
- On interest rates, although the Fed has signaled one more cut for 2026, we continue to believe that the Fed will remain on pause at least through Fed Chair Jerome Powell's term ending in May 2026, and potentially through 2026 (as long as growth remains resilient and the expansion continues in line with our expectations). That said, the Fed's reaction function does lean dovish, and any signs of labor market weakness could force additional "risk-management" cuts under Powell or his successor. If our growth and inflation views are right and the Fed cuts fewer times than priced, we believe UST yields should drift higher from here. However, somewhat favorable demand-supply technicals (slower issuance of long-term USTs and the return of price-insensitive investors) could potentially limit how high yields might go in 2026.

Average annual total returns (%) - as of December 31, 2025

Composite	3-Mo*	6-Mo*	YTD*	1-Yr	3-Yr	5-Yr	10-Yr	15-Yr	20-Yr	25-Yr	Inception	Inception Date
Net of Fees	0.68	1.59	4.98	4.98	3.05	-0.36	0.71	0.77	1.65	—	1.58	12/31/2003
Pure Gross of Fees	1.05	2.35	6.55	6.55	4.59	1.14	1.96	1.98	2.88	—	2.81	12/31/2003
Benchmark	1.15	2.43	6.50	6.50	4.40	0.64	1.76	1.85	2.73	—	2.66	—

*Cumulative total returns

Benchmark(s)

Benchmark =Bloomberg US Government - Intermediate Index

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Glossary

Duration is a measure of the sensitivity of a bond's price to changes in interest rates.

Personal consumption expenditures, or PCE, is a measure of price changes in consumer goods and services.

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

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