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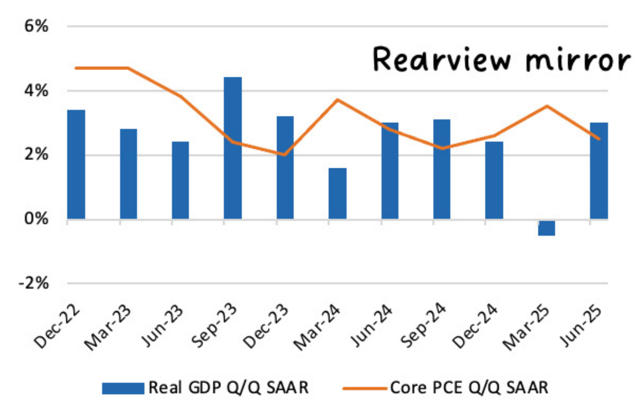
Fixed Income:
Economic Backdrop

Authors: Crit Thomas, CFA, CAIA / Erik M. Aarts, CIMA / Tim Paulin, CFA

August 1, 2025

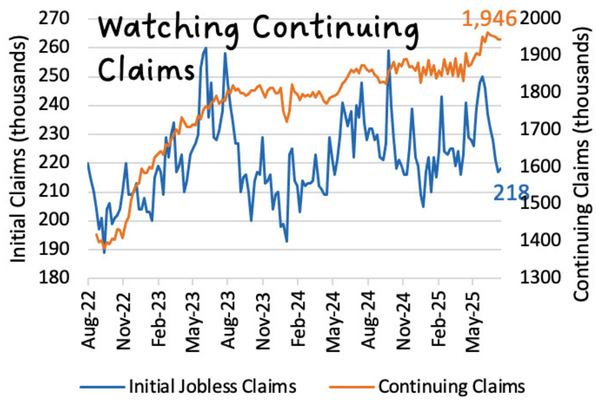
- **No Goldilocks in Sight:** Markets are pricing a "Goldilocks" environment of balanced growth and inflation, but that's unlikely. Q2 growth did rebound as net exports reversed course, but business investment cooled. The result, slower first half growth relative to last year. We expect U.S. economic growth to stay slow, but not stall, in the second half, driven by a weakening job market, slowing consumption, and a soft housing market. Inflation remains stuck above the 2% target.
- **Living with Tariffs:** Several key trading partners have agreed to broad trade frameworks rather than retaliate, reducing uncertainty for now. However, the result may be a de facto consumption tax of around 15%, a headwind to growth. Trade risks persist as court rulings could invalidate current deals, and talks with Canada, Brazil, and India remain challenging. Remember comprehensive trade deals are difficult and time-consuming.
- **Labor Market Headwind:** Anti-immigrant policies may strain the labor market. Over the next decade, U.S.-born labor force growth is projected at just 0.2% annually, compared to 0.7% for the total labor force (including immigration) over the past 10 years. AI driven productivity may offset some labor force slowdown, but long-term potential growth, the product of labor force and productivity, will likely trend lower.
- **Reshoring Demands Commitment:** Reshaping the economy through reshoring requires long-term investment, labor expansion, and policy coordination. In today's polarized, populist environment, these conditions are hard to sustain. The key: how much hardship households and policymakers are willing to endure. For now, tolerance appears low.
- **Employment is the Bellwether:** The economy has proved more resilient than many forecasters expected, including ourselves. While signs of a slowdown are emerging, we must remain open-minded. The labor market remains central, if conditions continue to weaken through year-end, we may need to revise our outlook.

Real GDP and Inflation



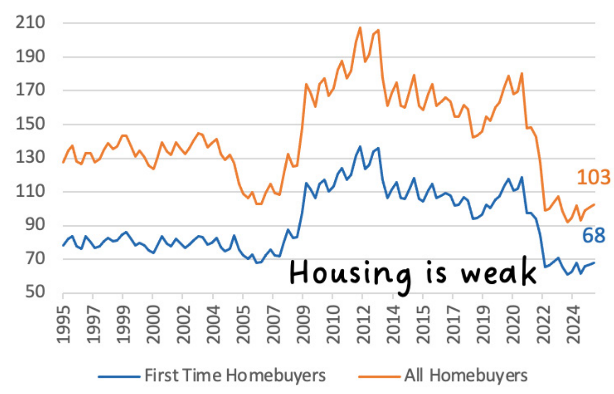
Source: Bloomberg. 3 years of quarterly data through Jun 2025. SAAR = Seasonally Adjusted Annual Rate

Weekly Jobless Claims Data



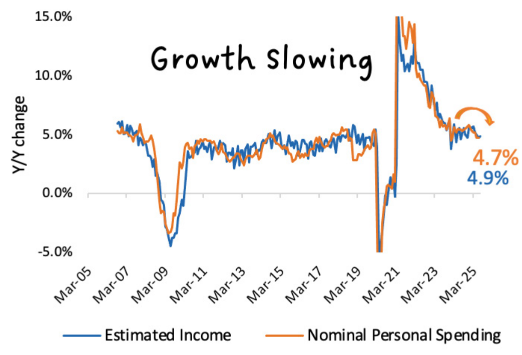
Source: Bloomberg. 3 years of weekly data through Jul 25 2025

Housing Affordability



Source: Bloomberg. 30 years of qiarterly data through Mar 2025

Income and Spending



Source: Bloomberg. 20 years of monthly data through Jul 2025, Spending through Jun 2025; Estimated Income is the product of number of employed, hours worked, and hourly wage.

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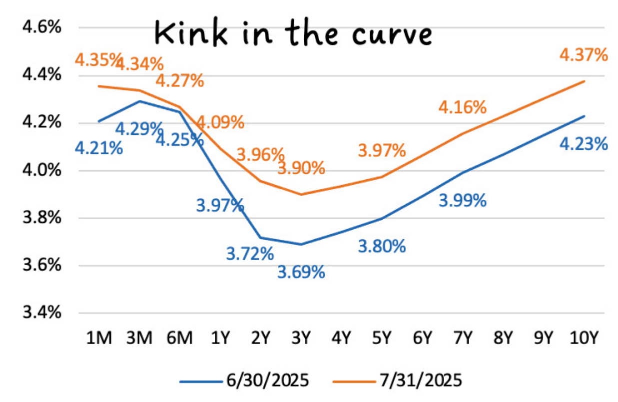
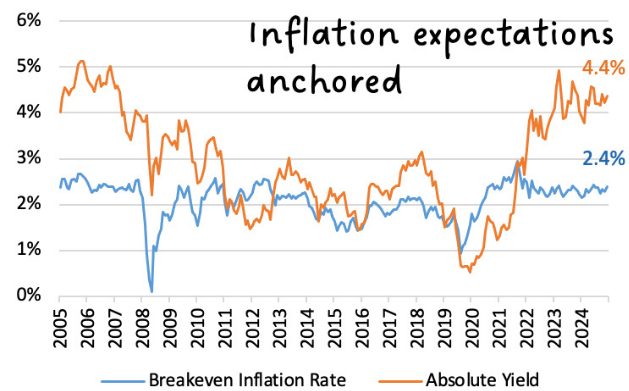
- **Overweight Fixed Income:** We remain slightly overweight, anticipating continued slow economic growth in the second half and potential market volatility from unexpected policy shifts. With bond yields near decade highs, fixed income offers attractive income and competitive return potential versus equities.
- **High Quality Bias:** We are tactically overweight investment-grade bonds, favoring their higher yields and lower sensitivity to economic cycles. We see strong risk-adjusted return potential in this space.
- **Refunding Status Quo:** Despite criticizing past policy, the Treasury is keeping its bond issuance plans largely the same for now. To fund the deficit and rebuild reserves, it will rely more heavily on T-Bill borrowing for now. It also slightly expanded a program to buy back older government bonds, though this move isn't expected to have much effect on interest rates or the overall debt structure. We remain duration neutral, awaiting a better entry point amid persistent long-end yield pressure.
- **Fed Division Emerges:** Previously unified on holding rates steady, Fed officials are now split, highlighted by two dissenting votes at the July meeting. While continuing the pause, the Chair acknowledged slowing activity, leaving the door open for future cuts. We expect policy to gradually shift back to a neutral stance of between 2.5-3.5%.
- **Tariff Backed Stimulus:** Even before the ink dries on the One Big Beautiful Bill Act the administration and Congress are working on new legislation to issue rebate checks funded by future tariff revenue. Though in the early-stages and lacking details, this approach could worsen the fiscal outlook, pressuring term premiums higher amid rising debt and deficits.
- **Looking Beyond the Noise:** Over the longer term, we expect a steeper yield curve, driven by short-term rates declining more than long-end yields. This view reflects our assumption that economic growth potential will slow to around 4% nominal and 2% real GDP growth.

Treasury Yield Curve vs Prior Month



Source: Bloomberg

U.S. 10 year Treasury Bond

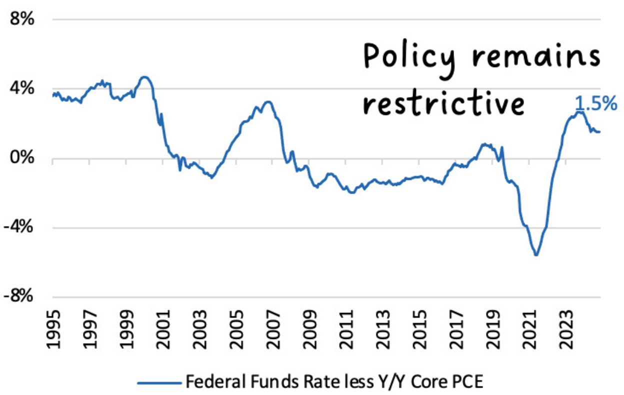


Source: Bloomberg. 20 years of monthly data through Jul 2025. Breakeven inflation rate is a measure of expected inflation derived from the difference between the 10-year Treasury yield and the 10-year TIPS yield.

U.S. Budget Interest Expense/Total Revenues

Source: Bloomberg. Annual data from fiscal 1974 through 2024 June 2025

Real Federal Funds Rate



Source: Bloomberg. 30 years of monthly data through Jun 2025

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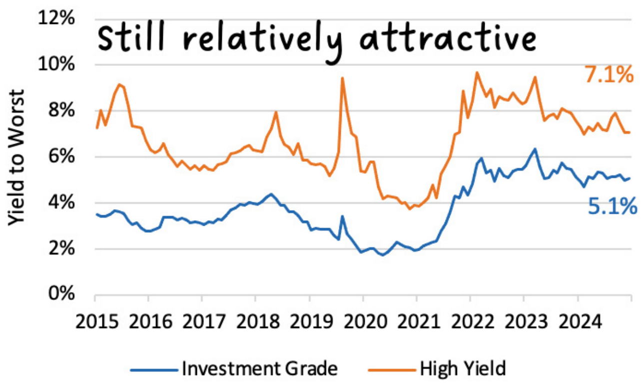
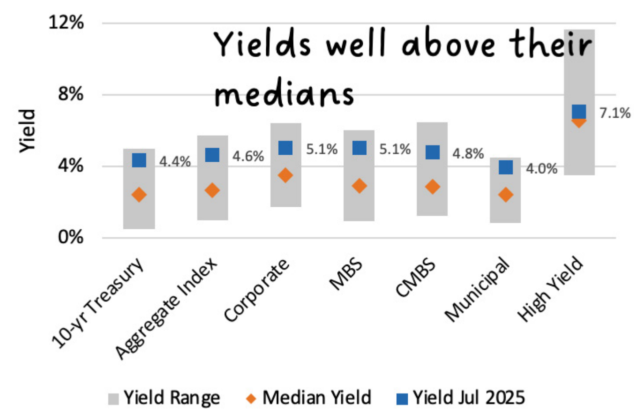
- **Cautious on Credit:** We remain tactically underweight below-investment-grade bonds, as tighter spreads appear inconsistent with the potential for continued slower economic growth. Still, loose financial conditions, better index quality, and a manageable maturity wall reduce the urgency for a more defensive stance.
- **Relative Yields Still Compelling:** Corporate and securitized credit yields remain attractive versus other sectors. Yields held steady in July and are well above 10-year medians. While we favor higher-quality credit today, we continue to maintain meaningful allocation to below-investment-grade exposure given our relatively high strategic weight as a starting point.
- **Quality Control in High Yield:** The high yield market has evolved post-GFC, shifting toward BB-rated issuers and away from CCCs. High yield issuers now average around $1B in EBITDA, 5 times larger than 20 years ago. This improved quality and scale may support more stable earnings and cash flow. Adjusted for quality, current spreads may have room to fall to new lows, supporting our allocation.
- **Corporate Credit Convergence:** As BB exposure grows in high yield, BBB exposure has expanded within investment grade. This convergence is blurring traditional credit distinctions and creating more overlap in issuer quality across the spectrum.
- **Credit Watch:** Rating agency credit watch warnings and downgrades are rising relative to upgrades in high yield, a sign of strain likely related to weaker economic conditions. The upgrade-to-downgrade ratio also worsened slightly in Q2. We're closely tracking profit margins, earnings revisions, and hiring trends to gauge credit market strength.
- **Active Management Key:** Deregulation and tariff dynamics may create winners and losers across corporate and securitized credit, presenting opportunities for both return generation and risk management. We remain focused on actively adjusting our tactical credit allocations as conditions evolve.

Bloomberg U.S. Corporate Bond Indexes



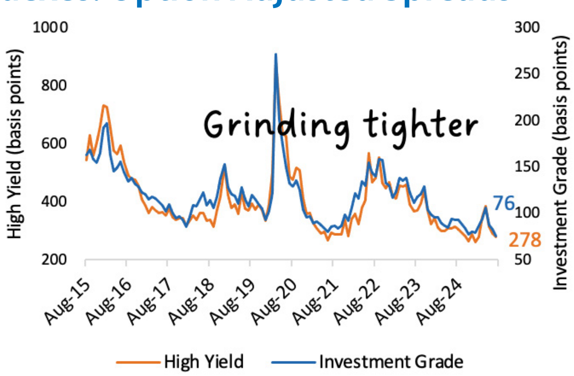
Source: Bloomberg. 10 years of monthly data through Jul 2025

10-year Yield Range for Fixed Income Sectors



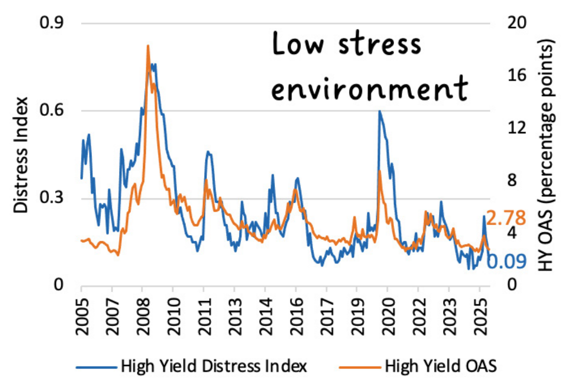
Source: Bloomberg. 10 years of monthly data through Jul 2025

Bloomberg U.S. Corporate Bond Indexes: Option Adjusted Spreads



Source: Bloomberg. 10 years of monthly data through Jul 2025

NY Fed Corporate Bond Distress Index



Source: Bloomberg. 20 years of monthly data through Jul 2025

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Market Characteristics

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The Indexes mentioned are unmanaged statistical composites of stock market or bond market performance. Investing in an index is not possible.

Total Returns

	Jul 2025	YTD	2024	2023	2022	Duration years
Bloomberg Long Term Treasury	-0.9%	2.1%	-6.4%	3.1%	-29.3%	14.6
Bloomberg U.S. TIPS	0.1%	4.8%	1.8%	3.9%	-11.8%	4.3
Bloomberg U.S. Aggregate	-0.3%	3.7%	1.3%	5.5%	-13.0%	6.0
Bloomberg U.S. Agg Corporates	0.1%	4.2%	2.1%	8.5%	-15.8%	6.8
Bloomberg U.S. Agg ABS	0.1%	3.1%	5.0%	5.5%	-4.3%	2.7
Bloomberg U.S. Agg MBS	-0.4%	3.8%	1.2%	5.0%	-11.8%	6.0
Bloomberg U.S. Agg CMBS	-0.1%	4.4%	4.7%	5.4%	-10.9%	3.9
Bloomberg Municipal Bond	-0.2%	-0.5%	1.1%	6.4%	-8.5%	7.0
Bloomberg 1-3 year Corporate	0.1%	3.2%	5.3%	5.5%	-3.3%	1.8
ICE BofA Listed Preferreds	2.9%	2.8%	8.5%	9.8%	-18.1%	NA
Bloomberg High Yield	0.5%	5.0%	8.2%	13.4%	-11.2%	2.9
S&P UBS Leveraged Loan	0.8%	3.8%	9.1%	13.0%	-1.1%	NA
Bloomberg Global Agg	-1.5%	5.7%	-1.7%	5.7%	-16.2%	6.5
Bloomberg Emerging Markets USD	0.9%	5.9%	6.6%	9.1%	-15.3%	6.0

Yields

			Last 10 years			
	Jul 2025	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.4%	-20	88	2.4%	0.5%	5.0%
2 year Treasury	4.0%	-28	73	1.8%	0.1%	5.2%
10 year TIPS	2.0%	-25	87	0.5%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.6%	-27	81	2.7%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.1%	-26	76	3.5%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.5%	-20	74	2.2%	0.4%	6.0%
Bloomberg U.S. Agg MBS	5.1%	-20	88	2.9%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	4.8%	-37	74	3.0%	1.4%	6.6%
Bloomberg Municipal Bond	4.0%	24	95	2.4%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.5%	-31	73	2.4%	0.5%	6.2%
Bloomberg High Yield	7.1%	-41	56	6.6%	3.5%	11.7%
S&P UBS Leveraged Loan	8.2%	-61	71	5.8%	3.6%	13.1%
Bloomberg Global Agg	3.6%	-11	80	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	6.2%	-48	66	5.5%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	Jul 2025	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	76	-4	1	115	74	373
Bloomberg 1-3 year Corporate	47	-5	16	61	31	390
Bloomberg U.S. Agg ABS	51	7	48	52	22	325
Bloomberg U.S. Agg MBS	40	-3	59	35	7	132
Bloomberg U.S. Agg CMBS	80	0	46	92	62	275
Bloomberg High Yield	278	-9	4	375	253	1100
S&P UBS Leveraged Loan (discount margin)	450	-25	31	487	379	1275
Bloomberg Emerging Markets USD	195	-25	0	302	195	720

For Index Definitions see: TouchstoneInvestments.com/insights/investment-terms-and-index-definitions

2022 – The Fed embarked on one of its most aggressive tightening paths seen in decades as the inflation rate surged well above their goal. Interest rates rose across all maturities leading to one of the worst years for fixed income returns.

2023 – Inflation fell broadly while the economy grew with the labor market and consumer spending resilient. The Fed paused midyear helping rates and credit spreads fall late in the year and turning returns positive for the year.

2024 – Economic growth continued unabated, driven by consumer spending. Inflation moderated further. The Federal Reserve pause continued until September, after which it cut interest rates three times by a total of 1 percentage point. Bond yields rose in response, resulting in only modest gains for high quality fixed income but better returns for riskier areas of fixed income.

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The Touchstone Asset Allocation Committee (TAAC) consisting of Crit Thomas, CFA, CAIA – Global Market Strategist, Erik M. Aarts, CIMA – Vice President and Senior Fixed Income Strategist, and Tim Paulin, CFA – Senior Vice President, Investment Research and Product Management, develops in-depth asset allocation guidance using established and evolving methodologies, inputs and analysis and communicates its methods, findings and guidance to stakeholders. TAAC uses different approaches in its development of Strategic Allocation and Tactical Allocation that are designed to add value for financial professionals and their clients. TAAC meets regularly to assess market conditions and conducts deep dive analyses on specific asset classes which are delivered via the Asset Allocation Summary document. Please contact your Touchstone representative or call 800.638.8194 for more information.

A Word About Risk

Investing in fixed-income securities which can experience reduced liquidity during certain market events, lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal. When interest rates rise, the price of debt securities generally falls. Longer term securities are generally more volatile. Investment grade debt securities which may be downgraded by a Nationally Recognized Statistical Rating Organization (NRSRO) to below investment grade status. U.S. government agency securities which are neither issued nor guaranteed by the U.S. Treasury and are not guaranteed against price movements due to changing interest rates. Mortgage-backed securities and asset-backed securities are subject to the risks of prepayment, defaults, changing interest rates and at times, the financial condition of the issuer. Foreign securities carry the associated risks of economic and political instability, market liquidity, currency volatility and accounting standards that differ from those of U.S. markets and may offer less protection to investors. Emerging markets securities which are more likely to experience turmoil or rapid changes in market or economic conditions than developed countries.

Performance data quoted represents past performance, which is no guarantee of future results. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than performance data given. ***For performance information current to the most recent month-end, visit TouchstoneInvestments.com/mutual-funds.***

Please consider the investment objectives, risks, charges and expenses of a fund carefully before investing. The prospectus and the summary prospectus contain this and other information about a fund. To obtain a prospectus or a summary prospectus, contact your financial professional or download and/or request one at TouchstoneInvestments.com/resources or call Touchstone at 800.638.8194. Please read the prospectus and/or summary prospectus carefully before investing.

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