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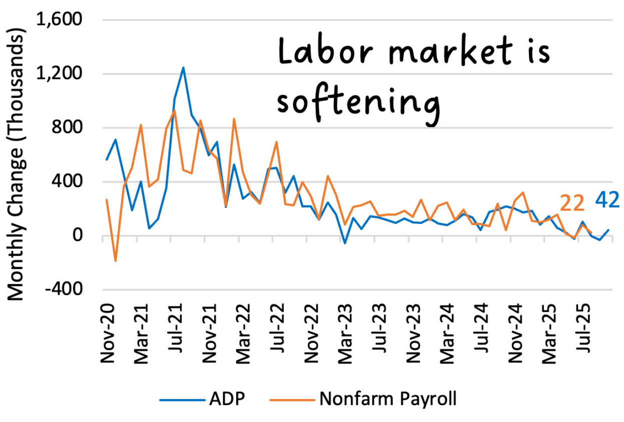
# Fixed Income:
## Economic Backdrop

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

**November 3, 2025**

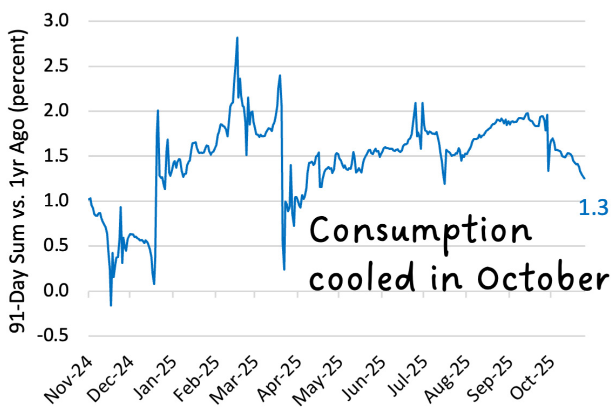
- **Flying Blind:** With the government shutdown delaying key economic reports, investors are relying on private data sources to fill in the gaps. Growth appears to be cooling in the fourth quarter, but we don't expect the economy to "fall out of bed". A softer labor market may temper momentum, yet 2026 could see a reacceleration driven by tax incentives and massive AI-related capital spending.
- **Fewer Jobs Needed:** Labor demand is losing steam while tighter immigration policies constrain supply. As a result, fewer new jobs are needed to maintain a low unemployment rate. Limited labor mobility may continue to pressure wages, even as productivity gains reduce hiring needs or create layoffs. We are watching for signs that the recent spate of corporate layoffs becomes a trend.
- **Bifurcated Consumption:** Consumer behavior is increasingly K-shaped, with higher-income households sustaining spending through wealth, while lower and middle income consumers struggle as credit tightens and prices remain high. While potential stimulus next year could support consumption, any economic disruption or market downturn could quickly erode this fragile resilience.
- **Inflation Stuck:** CPI data, released despite the shutdown to enable 2026 COLA calculations, shows inflation hovering around 3%. With on-going tariff-related costs likely to increasingly pass through to consumers, inflation may stay elevated longer than desired.
- **In a Fog:** Solid growth alongside slowing job creation and sticky inflation leaves data-dependent policymakers in a difficult spot. The Fed did cut rates again in October, but both dovish and hawkish dissent underscore policy uncertainty. We expect modest, gradual easing as the Fed navigates toward an uncertain neutral rate. Market expectations for several more cuts in 2026 are likely in jeopardy.
- **Not Working:** The shutdown has entered its second month. The House remains out of session, the Senate refuses to pass a stopgap measure, and no fiscal year budget has been proposed. Elected officials continue to be paid while federal employees go without. Historically, shutdowns have had limited economic impact, but risks that this episode creates disruption are rising with each passing day.

### Change in Employment



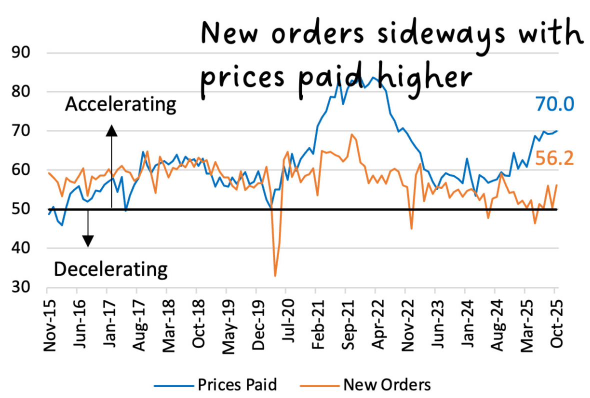

*Source: Bloomberg. 5 years of monthly data. ADP through September; Payroll through August.*

### Credit and Debit Card Transactions

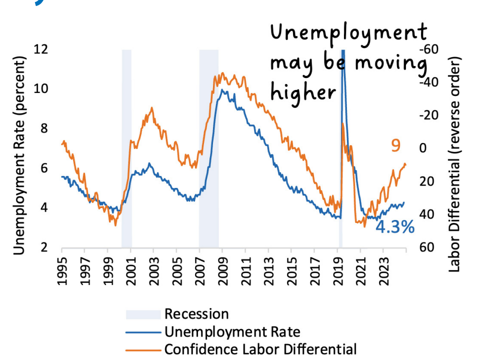



*Source: Bloomberg. 1 year of daily data through Oct 28, 2025.*

### ISM Services Activity




### Employment Trends




The conference Board Consumer Labor Differential measures the difference between the percent of consumers responding jobs were plentiful versus those responding they were hard to get.

*Source: Bloomberg. 30 years of monthly data through Oct 2025, Unemployment through Aug 2025*

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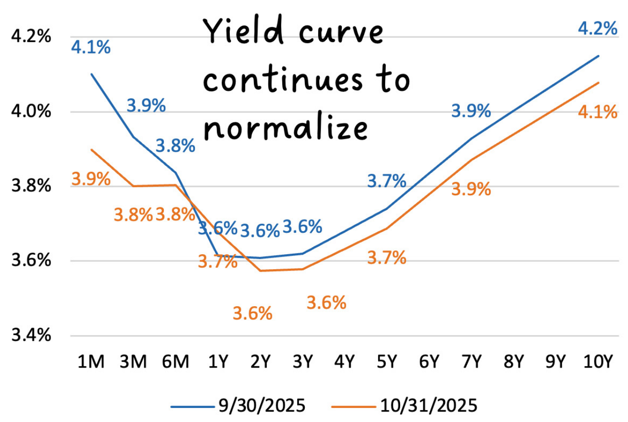
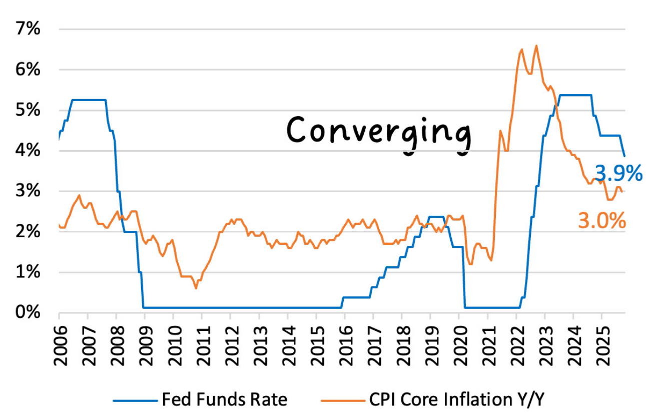
- **Neutral:** We remain neutral on our overall fixed income stance. Although yields have fallen and spreads have tightened, fixed income continues to provide essential ballast and stable income within diversified portfolios**.**
- **High-Quality Bias:** We remain tactically overweight investment-grade bonds, attracted by compelling yields and lower economic sensitivity. Despite returning more than 7% over the past year, investment-grade credit still yields at or above the 70th percentile looking at the past decade, leaving room for further solid returns. Longer-term, high-quality municipal bonds also look appealing. Having lagged taxable sectors this year, they offer relative safety, supported by state fiscal discipline and record rainy day reserves that help buffer against near-term downturns.
- **Watch the Long End:** We remain cautious on interest rate risk. While long Treasuries have rallied, yields remain stubbornly elevated, and we expect the curve to stay steep. The Fed may cut rates modestly into 2026, but with nominal GDP near 5%, meaningful declines in long yields appear unlikely absent a major economic disruption. We continue to favor the belly of the curve and remain patient for opportunities to extend duration.
- **Fiscally Deficient:** The government faces both spending and revenue challenges, and the OBBBA legislation does little to address them. Treasury debt now comprises roughly 46% of the overall U.S. bond market and, given structural deficits, will continue to steal share, potentially crowding out corporate and securitized credit formation. This dynamic could make credit sectors relatively more attractive from a supply-demand and risk-adjusted return perspective.
- **Fed to the Rescue?:** The Fed's decision to freeze its balance sheet and reinvest maturing agency MBS into short-duration Treasuries helps front-end liquidity but also supports the funding of structural deficits with short-term debt, an ill-advised approach if pursued long term in our view. We prefer avoiding Treasury bills in favor of other short-term fixed income opportunities.
- **Quality as a Safeguard:** Even as risk assets rally, investor risk appetite is fading, and confidence could erode quickly. While the timing and catalyst of a risk-off event remain uncertain, the rising probability underscores the importance of maintaining a high-quality fixed income allocation as a safeguard within diversified portfolios.

## Treasury Yield Curve vs Prior Month



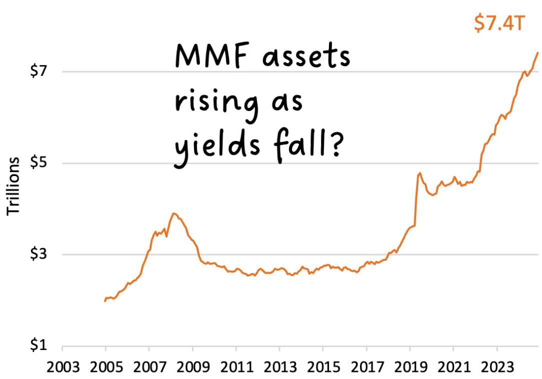

*Source: Bloomberg.*

## Policy Rate and Inflation



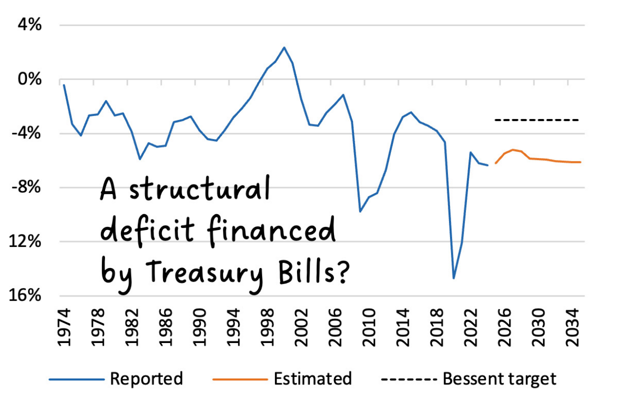

*Source: Bloomberg. 20 years of monthly data. Fed Funds through October; CPI through September.*

## ICI Money Market Fund Assets




*Source: Bloomberg. 20 years of monthly data through Oct 2025*

## US Budget Deficit or Surplus % of GDP




*Source: Bloomberg. Annual data from fiscal 1974 through 2024; CBO annual estimates through 2035, based on Jan '25 update.*

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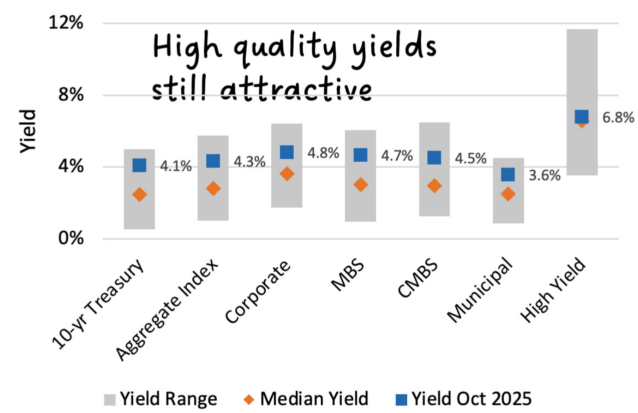
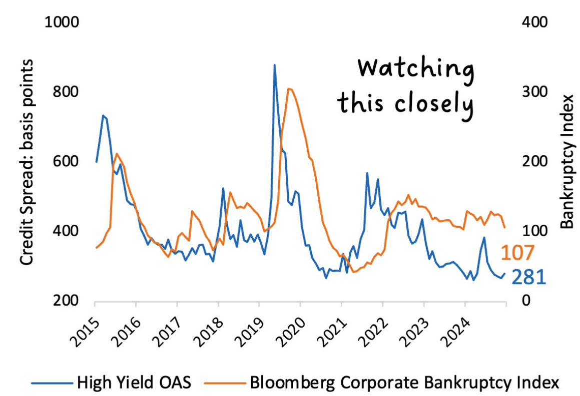
- **Cautious on Credit Risk:** We remain underweight high yield bonds as spreads stay tight. However, the economy's fragile resilience, loose financial conditions, and higher overall index quality reduce the need for an overly defensive stance. Given our structural allocation to below investment-grade credit, we continue to maintain meaningful exposure despite the tactical underweight.
- **Quality Control:** Since the Global Financial Crisis, the high yield market has migrated toward higher quality issuers. The Bloomberg High Yield Index now consists of roughly 52% BB-rated bonds and just 12% CCC-rated names. Adjusted for this improved quality mix, spreads may still have modest room to tighten further if corporate profits and economic growth remain stable.
- **Cockroaches?:** Recent bankruptcy filings in the auto sector briefly unsettled credit markets, raising fears of broader systemic stress. While vigilance is warranted, hence our continued focus on quality, we believe these events are idiosyncratic, likely the result of fraud, and not symptomatic of widespread weakness. Indeed, credit spreads widened only slightly across markets in October.
- **Credit Resilience:** Lower-income consumers are under pressure and may weigh on certain sectors such as consumer discretionary issuers and consumer-oriented asset backed securities. But strong profit growth and solid balance sheets should continue to support corporate issuers broadly. On the securitized side, structural enhancements may provide additional protection against potential consumer softness. Investment managers with robust due diligence and monitoring processes are best positioned to navigate these late cycle conditions, while those showing strain may need to reassess underwriting standards.
- **Active Management Essential:** With relative yields still appealing, late cycle dynamics unfolding, and deal activity high, credit markets offer both risks and opportunities. This environment reinforces the need for disciplined, active management to identify value and mitigate downside risk.

## 10-year Yield Range for Fixed Income Sectors




*Source: Bloomberg. 10 years of monthly data through Oct 2025*

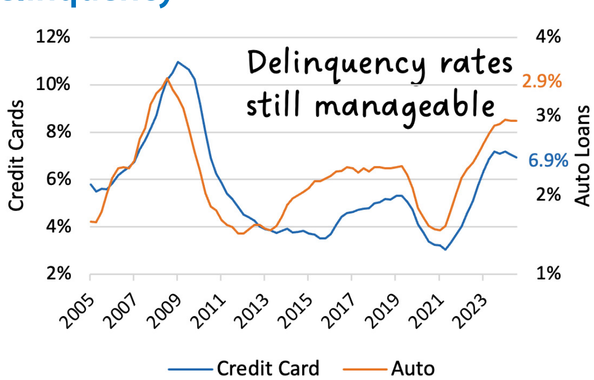
## U.S. Corporate Bankruptcies




Bloomberg U.S. Financial Conditions Index: tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit.

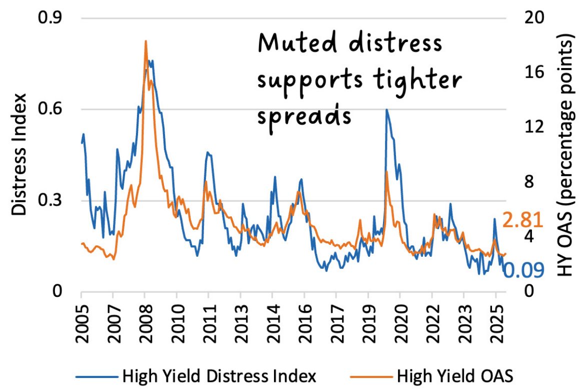
*Source: Bloomberg. 10 years of monthly data through Oct 2025*

## NY Fed/Equifax Transition Rates to Delinquency




*Source: Bloomberg. 20 years of quarterly data through Jun 2025*

## NY Fed Corporate Bond Distress Index




*Source: Bloomberg. 20 years of monthly data through Oct 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**

| | Oct 2025 | YTD | 2024 | 2023 | 2022 | Duration years |
|---|---|---|---|---|---|---|
| Bloomberg Long Term Treasury | 1.3% | 7.0% | -6.4% | 3.1% | -29.3% | 14.7 |
| Bloomberg U.S. TIPS | 0.4% | 7.2% | 1.8% | 3.9% | -11.8% | 5.1 |
| Bloomberg U.S. Aggregate | 0.6% | 6.8% | 1.3% | 5.5% | -13.0% | 6.0 |
| Bloomberg U.S. Agg Corporates | 0.4% | 7.3% | 2.1% | 8.5% | -15.8% | 6.9 |
| Bloomberg U.S. Agg ABS | 0.4% | 5.0% | 5.0% | 5.5% | -4.3% | 2.8 |
| Bloomberg U.S. Agg MBS | 0.9% | 7.7% | 1.2% | 5.0% | -11.8% | 5.7 |
| Bloomberg U.S. Agg CMBS | 0.5% | 6.8% | 4.7% | 5.4% | -10.9% | 3.9 |
| Bloomberg Municipal Bond | 1.2% | 3.9% | 1.1% | 6.4% | -8.5% | 6.7 |
| Bloomberg 1-3 year Corporate | 0.3% | 4.9% | 5.3% | 5.5% | -3.3% | 1.8 |
| ICE BofA Listed Preferreds | -0.5% | 4.5% | 8.5% | 9.8% | -18.1% | NA |
| Bloomberg High Yield | 0.2% | 7.4% | 8.2% | 13.4% | -11.2% | 2.9 |
| S&P UBS Leveraged Loan | 0.3% | 5.0% | 9.1% | 13.0% | -1.1% | NA |
| Bloomberg Global Agg | -0.3% | 7.6% | -1.7% | 5.7% | -16.2% | 6.4 |
| Bloomberg Emerging Markets USD | 1.7% | 10.4% | 6.6% | 9.1% | -15.3% | 6.1 |

**Yields**

| | | | Last 10 years | | | |
|---|---|---|---|---|---|---|
| | Oct 2025 | YTD Change bps | Current Percentile | Median | Min | Max |
| 10 year Treasury | 4.1% | -49 | 82 | 2.5% | 0.5% | 5.0% |
| 2 year Treasury | 3.6% | -67 | 70 | 2.0% | 0.1% | 5.2% |
| 10 year TIPS | 1.8% | -47 | 82 | 0.5% | -1.2% | 2.5% |
| Bloomberg U.S. Aggregate | 4.3% | -58 | 72 | 2.8% | 1.0% | 5.7% |
| Bloomberg U.S. Agg Corporate | 4.8% | -51 | 71 | 3.6% | 1.7% | 6.4% |
| Bloomberg U.S. Agg ABS | 4.2% | -51 | 71 | 2.4% | 0.4% | 6.0% |
| Bloomberg U.S. Agg MBS | 4.7% | -61 | 76 | 3.0% | 0.9% | 6.1% |
| Bloomberg U.S. Agg CMBS | 4.5% | -69 | 70 | 3.1% | 1.4% | 6.6% |
| Bloomberg Municipal Bond | 3.6% | -17 | 82 | 2.5% | 0.9% | 4.5% |
| Bloomberg 1-3 year Corporate | 4.2% | -64 | 70 | 2.6% | 0.5% | 6.2% |
| Bloomberg High Yield | 6.8% | -71 | 54 | 6.6% | 3.5% | 11.7% |
| S&P UBS Leveraged Loan | 8.0% | -74 | 67 | 6.0% | 3.6% | 13.1% |
| Bloomberg Global Agg | 3.4% | -25 | 72 | 1.8% | 0.8% | 4.4% |
| Bloomberg Emerging Markets USD | 5.8% | -89 | 57 | 5.5% | 3.5% | 8.7% |

**Option Adjusted Spreads (bps)**

| | | | Last 10 years | | | |
|---|---|---|---|---|---|---|
| | Oct 2025 | YTD Change | Current Percentile | Median | Min | Max |
| Bloomberg U.S. Corporate Agg | 78 | -2 | 3 | 113 | 72 | 373 |
| Bloomberg 1-3 year Corporate | 49 | -3 | 21 | 60 | 31 | 390 |
| Bloomberg U.S. Agg ABS | 55 | 11 | 58 | 51 | 22 | 325 |
| Bloomberg U.S. Agg MBS | 28 | -15 | 30 | 36 | 7 | 132 |
| Bloomberg U.S. Agg CMBS | 77 | -3 | 43 | 90 | 62 | 275 |
| Bloomberg High Yield | 281 | -6 | 7 | 371 | 253 | 1100 |
| S&P UBS Leveraged Loan (discount margin) | 454 | -21 | 37 | 477 | 379 | 1275 |
| Bloomberg Emerging Markets USD | 182 | -38 | 0 | 299 | 181 | 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.***

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