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Fixed Income:

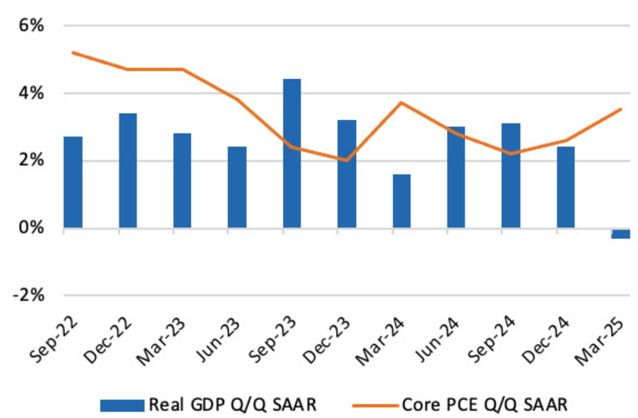
Economic Backdrop

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

May 2, 2025

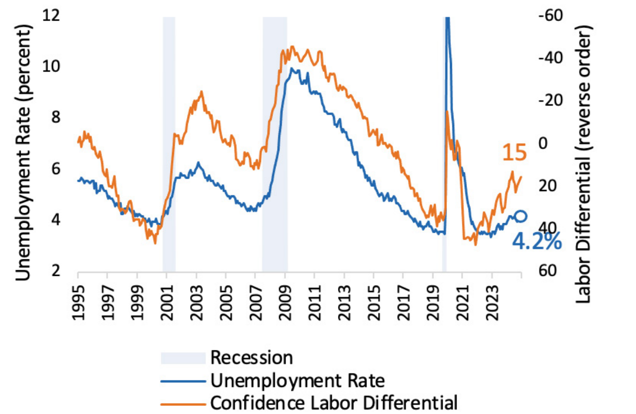
- **Caution Ahead:** The US economy contracted by -0.3% in the first quarter, following 2.4% growth last quarter, driven by a pre-tariff import surge and slower consumer spending. Notably final sales, which exclude trade and inventories, were solid at 3.0%. While the risk of recession has increased due to the unexpected scale of the announced tariffs, it is too soon to conclude that a hard landing is imminent.
- **Command and Control:** The erratic rollout of the Trump administration's trade policies is generating significant uncertainty for businesses and consumers. The fluid and unpredictable nature of the White House decision making is likely to freeze activity. Bilateral trade deals typically take a long time to negotiate, and declining global trust in the U.S. may make agreements even harder to secure.
- **Labor Market Cooling:** The strength of the labor market remains a key indicator for assessing the economic impact of the administration's tariff, spending and deportation policies. We expect job growth to slow, but should we see sharper-than-expected deterioration, we would likely revise our outlook toward a harder landing.
- **More "stag", less "flation":** Companies are likely to pursue aggressive strategies, such as exemptions and carve outs, to avoid tariffs, while consumers may shift spending and/or cut back. As a result, we believe one-time price increases may have a smaller impact on inflation than currently anticipated potentially opening the door to more Fed rate cuts.
- **Secular Transformation:** Restructuring an economy takes time. Repatriating manufacturing will require substantial capacity expansion, which will be costly and take years to achieve. Deglobalization is inherently inflationary. The key question is how much economic and inflationary pain citizens, or the administration, are willing to endure to allow for this transition.

Real GDP and Inflation



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

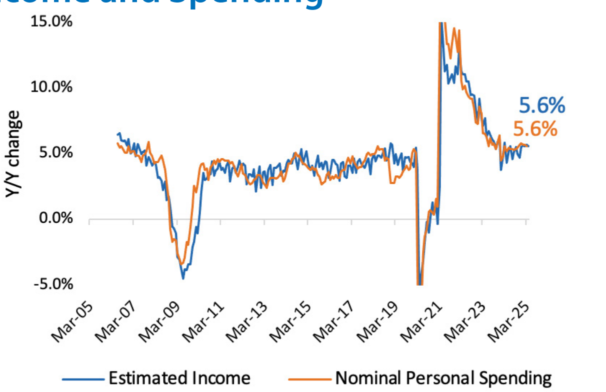
Employment Trends



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.

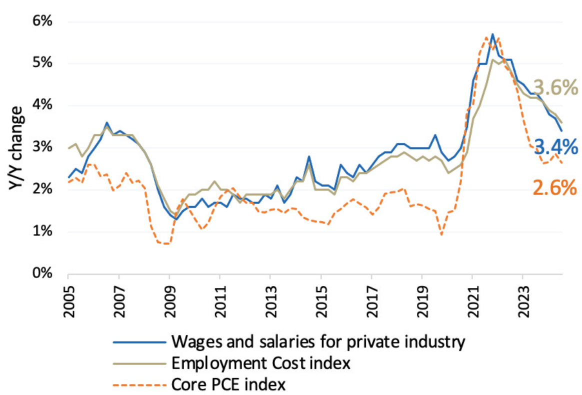
Source: Bloomberg. 30 years of monthly data through Apr 2025

Income and Spending



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

Wages and Salaries



Source: Bloomberg. 20 years of quarterly data through Mar 2025

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Fixed Income:

Interest Rate Risk

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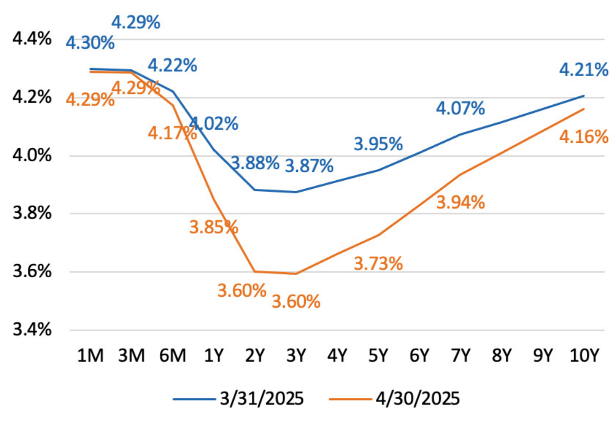
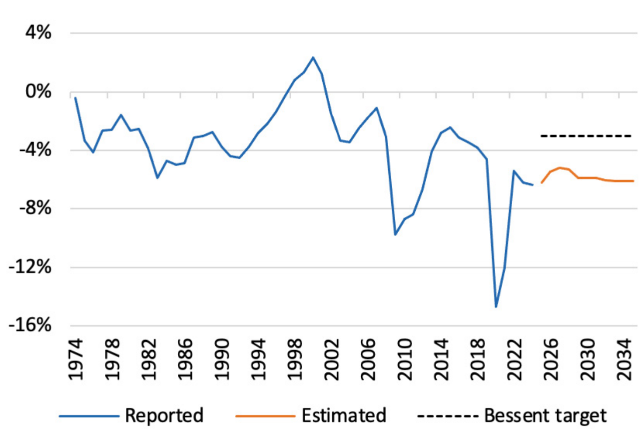
- **Overweight Fixed Income:** We have shifted to a slight overweight in fixed income within our models to help mitigate risk, as recession odds have risen following the unexpectedly large tariff announcement.
- **Leaning High Quality:** We have also tactically raised our allocation to investment-grade bonds to a moderate overweight. High quality fixed income presents an attractive risk-adjusted return profile, with appealing yields and lower sensitivity to economic downturns.
- **Duration Neutral:** We remain neutral on interest rate risk. While we do see value in intermediate maturities, especially as slower growth could put downward pressure on yields, we remain cautious about extending too far out the yield curve, given the potential for investors to demand a higher term premium at the long end.
- **Budget Negotiations:** Congress still needs to pass spending plans and raise the debt ceiling. Ironically, the tariffs are generating additional tax revenue, giving lawmakers slightly more time to act. As the administration pushes for progress, Congress faces mounting pressure to pass legislation through reconciliation and will likely rely on budget gimmicks, such as baseline policy assumptions and sunsetting provisions, to get a tax cut through, potentially undermining confidence in the Treasury market.
- **Monetary Policy Pause:** We believe the Fed remains in easing mode but is likely to hold off on further rate adjustments until it has greater clarity on the economic effects of the administration's policies.
- **Concerning Correlations:** The post–Liberation Day spike in market volatility was expected, but the simultaneous weakness in the dollar, equities, and long-term Treasuries is worrisome. The fact that the yield curve steepened despite weaker growth expectations is troubling, and we will wait for a better entry point before increasing duration exposure further.

Treasury Yield Curve vs Prior Month



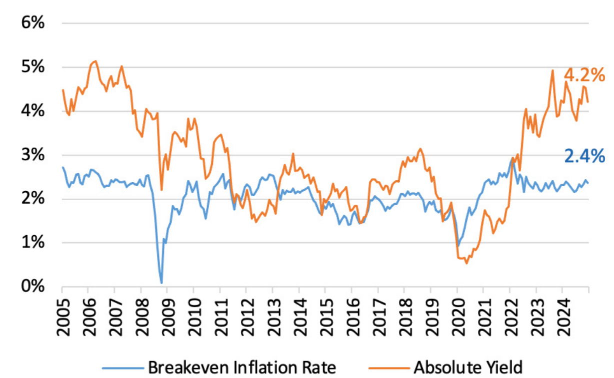
Source: Bloomberg

U.S. Budget Deficit or Surplus % of GDP



Source: Bloomberg. Annual data from fiscal 1974 through 2024; CBO annual estimates through 2035

U.S. 10 Year Treasury Bond



Source: Bloomberg. 20 years of monthly data through Apr 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.

ICI Money Market Fund Assets

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

Fixed Income:

Credit Risk

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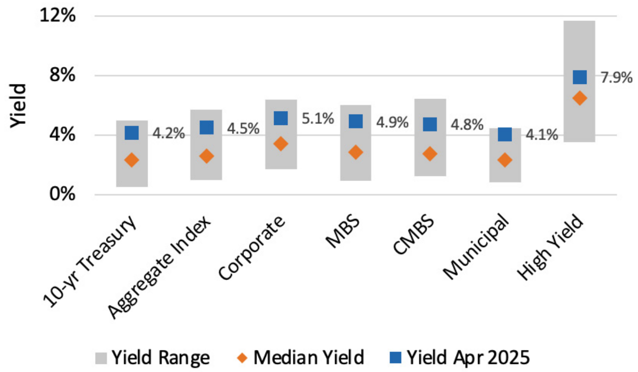
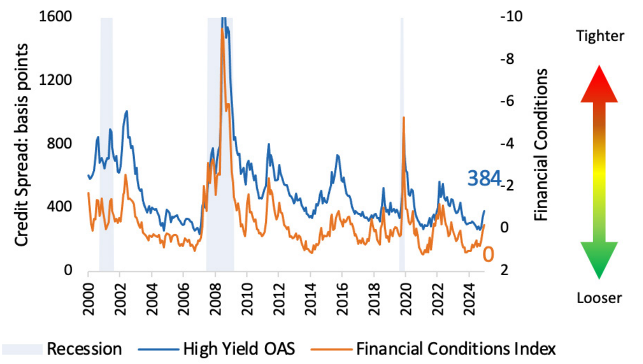
- **Cautious on Credit:** We remain slightly underweight non-investment grade bonds due to ongoing economic risks. However, supportive credit conditions, higher index quality, and a manageable maturity wall prevent us from adopting a more defensive stance at this time.
- **Wider Spreads:** The slower growth implications of the Liberation Day tariffs triggered spread widening across many areas of the corporate and securitized credit markets. However, this move reversed after the administration backtracked, and by month-end, spreads had retraced a significant portion of the earlier widening. Given ongoing uncertainty, we expect spread volatility to persist.
- **Fair Value:** In high yield, spreads widened enough by mid-April to approach fair value, measured as above the 50th percentile since the global financial crisis. This attracted investors back into the market, pushing spreads lower later in the month. On a total return basis, high yield ended the month flat and year-to-date period in positive territory, reflecting the resilience of the sector and the appeal of attractive yields.
- **Credit Watch:** While the rebound in returns is encouraging, some lasting damage to corporate credit is likely in a slower-growth environment. This may be difficult to quantify in the near term, as earnings and sales may have been pulled forward, and more companies are refraining from issuing forward guidance. We will continue monitoring profit margins, hiring trends, and changes in earnings estimates closely.
- **Stay Nimble:** Given that many businesses entered this period in strong financial shape, any improvement in relative value may attract investors, many of whom are sitting on ample dry powder, back into credit markets at spread peaks lower than those seen in past cycles.
- **Active Management Required:** Current market conditions are likely to distinguish winners from losers, offering opportunities to both generate returns and manage risk. We remain focused on adjusting our tactical credit allocations as market dynamics evolve.

10-Year Yield Range for Fixed Income Sectors



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

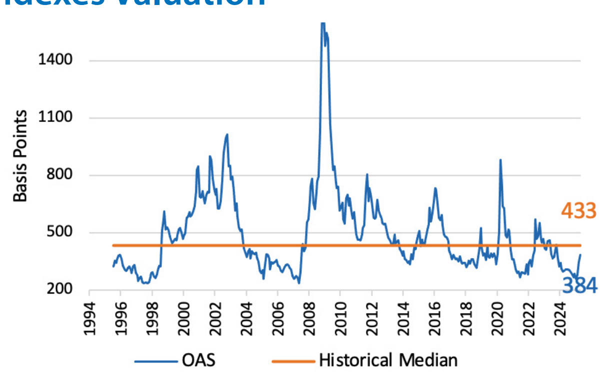
Bloomberg U.S. Financial Conditions Index



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.

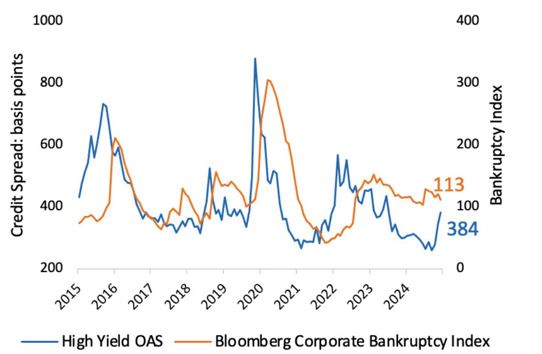
Source: Bloomberg. 25 years of monthly data through Apr 2025

Bloomberg U.S. Corporate High Yield Indexes Valuation



Source: Bloomberg. 30 years of monthly data through Apr 2025. Last observation percentile 40%

U.S. Corporate Bankruptcies



Bloomberg Corporate Bankruptcy Index (Bankruptcy Index): Measures both the occurrence and severity of current and recent US bankruptcy activity for corporations with at least $50 million in reported liabilities.

Source: Bloomberg. 10 years of monthly data through Apr 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

	April 2025	YTD	2024	2023	2022	Duration years
Bloomberg Long Term Treasury	-1.1%	3.5%	-6.4%	3.1%	-29.3%	14.8
Bloomberg U.S. TIPS	0.1%	4.3%	1.8%	3.9%	-11.8%	5.3
Bloomberg U.S. Aggregate	0.4%	3.2%	1.3%	5.5%	-13.0%	6.1
Bloomberg U.S. Agg Corporate	0.0%	2.3%	2.1%	8.5%	-15.8%	6.8
Bloomberg U.S. Agg ABS	0.5%	2.0%	5.0%	5.5%	-4.3%	2.6
Bloomberg U.S. Agg MBS	0.3%	3.4%	1.2%	5.0%	-11.8%	6.1
Bloomberg U.S. Agg CMBS	0.9%	3.5%	4.7%	5.4%	-10.9%	4.0
Bloomberg Municipal Bond	-0.8%	-1.0%	1.1%	6.4%	-8.5%	6.5
Bloomberg 1-3 year Corporate	0.6%	2.2%	5.3%	5.5%	-3.3%	1.8
ICE BofA Listed Preferreds	-0.9%	-2.6%	8.5%	9.8%	-18.1%	NA
Bloomberg High Yield	0.0%	1.0%	8.2%	13.4%	-11.2%	3.0
Credit Suisse Leveraged Loan (discount margin)	-0.1%	0.5%	9.1%	13.0%	-1.1%	NA
Bloomberg Global Agg	2.9%	5.7%	-1.7%	5.7%	-16.2%	6.6
Bloomberg Emerging Markets USD	0.0%	2.3%	6.6%	9.1%	-15.3%	5.9

Yields

			Last 10 years			
	April 2025	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.2%	-41	90	2.4%	0.5%	5.0%
2 year Treasury	3.6%	-64	75	1.6%	0.1%	5.2%
10 year TIPS	1.9%	-31	92	0.5%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.5%	-40	80	2.6%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.1%	-19	80	3.5%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.5%	-24	75	2.1%	0.4%	6.0%
Bloomberg U.S. Agg MBS	4.9%	-34	86	2.9%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	4.8%	-44	75	2.9%	1.4%	6.6%
Bloomberg Municipal Bond	4.1%	32	97	2.4%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.5%	-34	75	2.3%	0.5%	6.2%
Bloomberg High Yield	7.9%	41	77	6.5%	3.5%	11.7%
Credit Suisse Leveraged Loan (discount margin)	8.4%	-38	77	5.8%	3.6%	13.1%
Bloomberg Global Agg	3.5%	-22	77	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	6.6%	-12	74	5.3%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	April 2025	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	106	26	34	117	74	373
Bloomberg 1-3 year Corporate	73	21	63	62	31	390
Bloomberg U.S. Agg ABS	74	30	89	52	22	325
Bloomberg U.S. Agg MBS	43	0	66	35	7	132
Bloomberg U.S. Agg CMBS	97	17	62	93	62	275
Bloomberg High Yield	384	97	52	379	253	1100
Credit Suisse Leveraged Loan (discount margin)	514	39	61	495	379	1275
Bloomberg Emerging Markets USD	255	35	13	306	205	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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