Fixed Income:

Economic Backdrop

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

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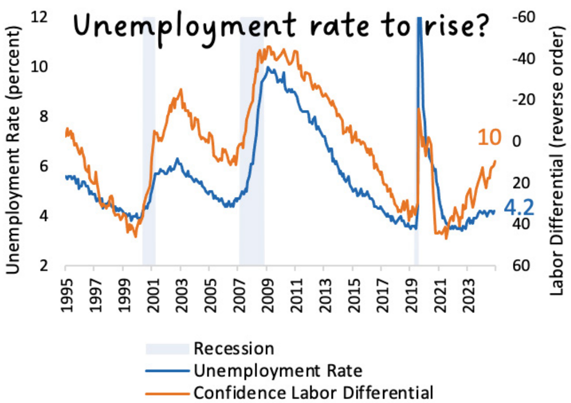
- **Consumer Resilient:** As we head into fall, the consumer remains resilient, supported by solid wage growth. We expect economic growth to stay slow through year-end though, pressured by softening job momentum and a modest drag from tariffs. Still, there are reasons for optimism.
- **Inflation Waves:** Inflation is likely to hover near 3% in the near term, with more tariff costs expected to pass through to consumers in the coming months. History shows inflation tends to arrive in waves, raising the risk of another price surge next year.
- **Living with Tariffs:** Although the U.S. Court of Appeals rejected the administration's use of the International Emergency Economic Powers Act to justify current trade policy, tariffs will remain in place during the appeal. If the ruling is upheld, an alternative tariff plan is likely ready. The administration is likely to argue that continuing tariffs secures foreign investment commitments and prevents a deficit shock from lost tariff revenue.
- **Policy Pivot:** In his final Jackson Hole speech, Chair Powell shifted the Fed's focus from inflation toward weakening labor conditions, signaling that monetary policy may need adjustment. Markets read the speech as a dovish cue for easing this month.
- **Fresh Framework:** Powell also unveiled the Fed's review of its monetary policy framework, dropping flexible average inflation targeting while reaffirming the 2% inflation goal and maximum employment mandate. Paradoxically, these changes imply that policy should remain more restrictive to rein in inflation. We continue to expect cautious, gradual rate cuts toward the neutral rate (assuming the Fed remains largely independent).
- **Data Dependent:** Upcoming employment and inflation data will be critical in clarifying today's uncertain backdrop. While Fed easing and the One Big Beautiful Bill Act may support the economy in 2026, it's unclear if these measures will be enough to catch growth—and a renewed inflation wave could complicate the picture.

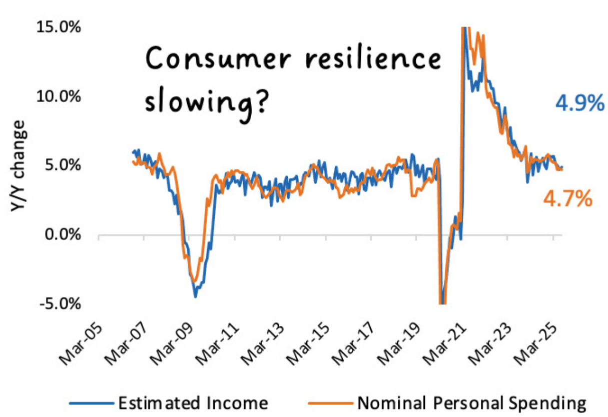
Employment Trends



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.

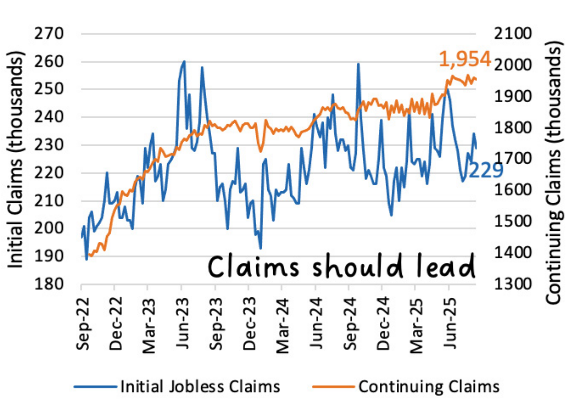
Source: Bloomberg. 30 years of monthly data through Aug 2025, Unemployment through Jul 2025

Income and Spending



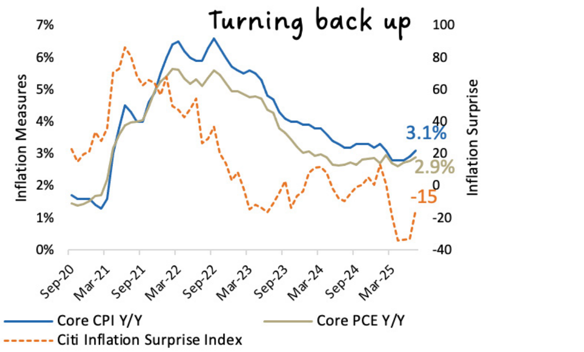
Source: Bloomberg. 20 years of monthly data through Jul 2025; Estimated Income is the product of number of employed, hours worked, and hourly wage.

Weekly Jobless Claims Data



Source: Bloomberg. 3 years of weekly data through Aug 22 2025

Inflation Surprise



Source: Bloomberg. 5 years of monthly data through Aug 2025. The inflation Surprise Index measures the difference between official inflation releases versus consensus expectations. Positive numbers indicate inflation has been higher than expected and vice versa.

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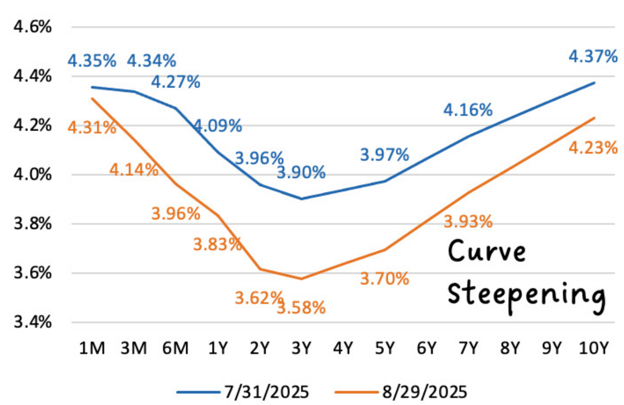
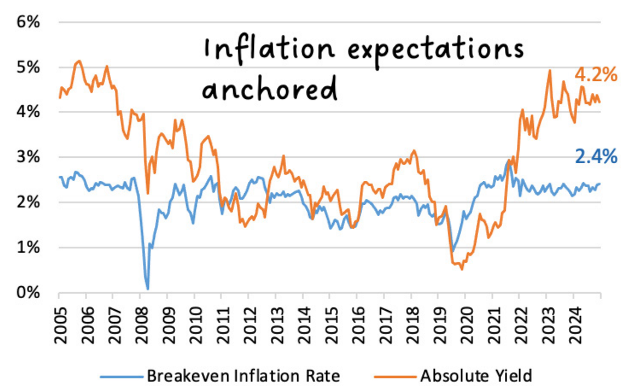
- **Overweight Fixed Income:** We maintain a slight overweight. With slow growth and policy uncertainty fueling volatility, fixed income may offer attractive income and potentially competitive risk-adjusted returns versus riskier assets.
- **High-Quality Bias:** We favor investment grade for its appealing yields and lower sensitivity to the economy. Beyond Treasuries, we see value in investment grade corporates, securitized credit, and municipal bonds.
- **Beware the Long End:** We remain cautious on duration. Sticky long-term Treasury yields, and a likely curve steepening, make intermediate maturities more compelling. While conditions could support lower long-end yields, persistent inflation and lack of fiscal discipline may offset, keeping upward pressure on long-term yields.
- **Fed Independence Risk:** Direct political pressure on the Fed, demanding lower rates and replacing Governors with loyalists, erodes the central bank's independence. Such moves damage credibility, risk policy mistakes, and could push inflation higher, potentially raising borrowing costs and hurting mortgage borrowers. History shows that once lost, credibility takes decades to rebuild.
- **Leaning on the Front End:** A sign of fiscal dominance is the Treasury's reliance on expanding bill issuance to fund deficits and refinance debt, while buying back long-term Treasury bonds. This strategy risks weakening monetary policy's effectiveness and further distorting Treasury markets.
- **Looking Beyond the Noise:** Confidence could erode suddenly, though the catalyst and timing are unclear. For now, we expect a steeper yield curve, with short-term yields falling more than the long end. This view reflects our assumption that modest productivity gains against weak labor force growth cap potential economic growth near 4% nominal and under 2% real.

Treasury Yield Curve vs Prior Month



Source: Bloomberg

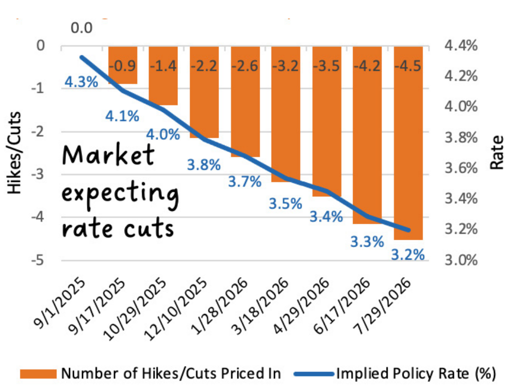
U.S. 10 year Treasury Bond



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

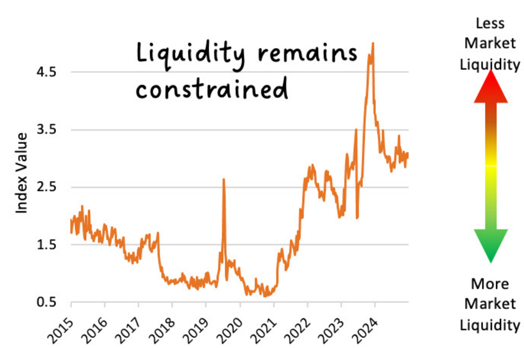
Federal Funds Rate

Implied Overnight Rate & Number of 25bp Hikes/Cuts



Source: Bloomberg. Data as of Sep 1 2025

U.S. Government Securities Liquidity Index



Source: Bloomberg. 10 years of weekly data through Aug 31 2025. The Liquidity Index as calculated by Bloomberg measures prevailing liquidity conditions in the U.S. Treasury market based on intra-day yield dislocations from fair value.

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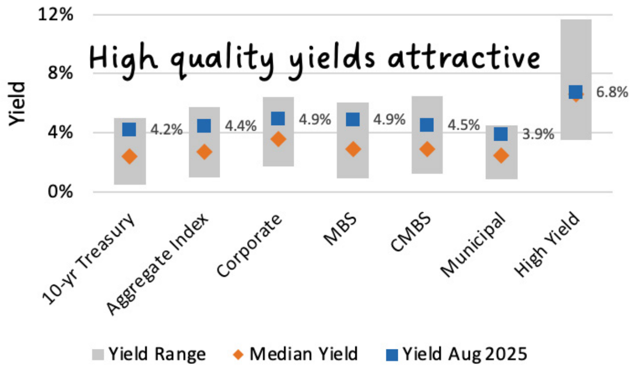
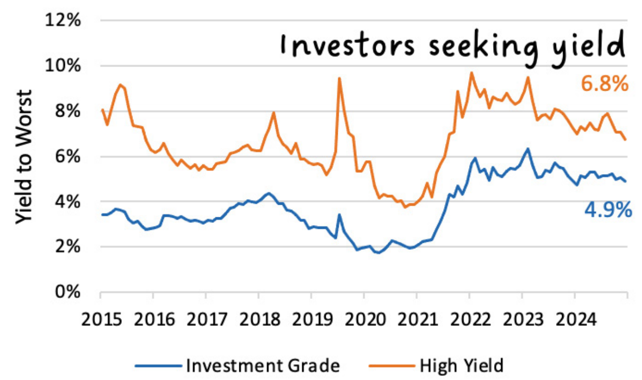
- **Cautious on Credit Risk:** We remain underweight below investment grade bonds as spreads continue to narrow despite slow expected growth. That said, loose financial conditions, stronger index quality, and a manageable maturity wall lessen the urgency for a more defensive stance.
- **Craving Attractive Yields:** Demand for long-term corporate debt is strong, while issuance remains relatively light as higher quality issuers manage borrowing costs carefully. Pensions and insurers are eager to lock in higher long-term yields, a favorable backdrop for credit investors seeking quality income.
- **Quality Control in High Yield:** Post GFC, the high yield market has evolved toward BB-rated issuers and away from CCCs. Issuers now average $1B in EBITDA, five times larger than 20 years ago, supporting more stable earnings and cash flow. Adjusted for this higher quality, current spreads may still have room to grind tighter.
- **Watch Corporate Leverage:** Deregulation and low borrowing costs could spark a wave of acquisitions and LBOs. Since June, companies have announced about $1 trillion in deals, with YTD activity up 25% from 2024. While new debt can fuel growth and tax efficiency, risks include reduced flexibility and higher rate sensitivity in a downturn. Net leverage remains below the 2020 peak, but we are monitoring closely.
- **Private Credit Risk:** True default risk in private credit may be understated as payment-in-kind and maturity extensions proliferate. These "selective defaults" are often excluded from reported figures, meaning we may be further along in the credit cycle than official data suggests.
- **Active Management Required:** Attractive yields, late credit cycle dynamics, and a wave of deal making create both risks and opportunities. We remain focused on actively managing credit allocations as conditions evolve.

10-year Yield Range for Fixed Income Sectors



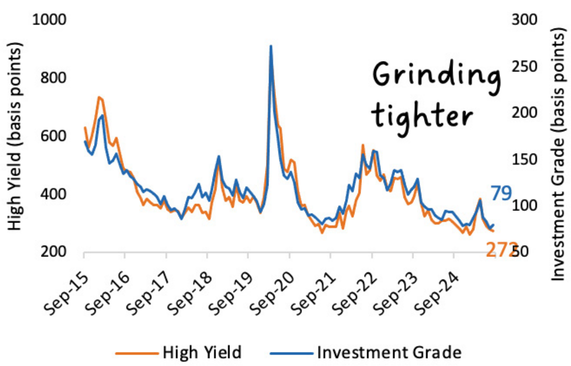
Source: Bloomberg. 10 years of monthly data through Aug 2025

Bloomberg U.S. Corporate Bond Indexes



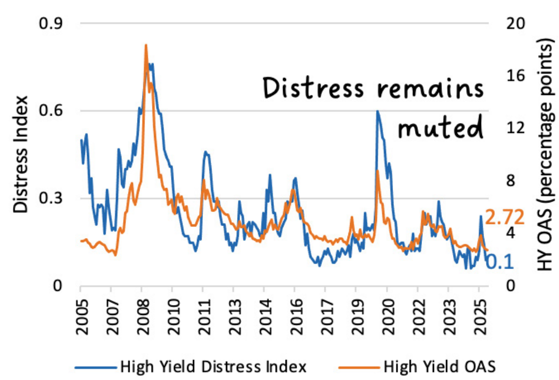
Source: Bloomberg. 10 years of monthly data through Aug 2025

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



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

NY Fed Corporate Bond Distress Index



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

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Fixed Income:
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

	Aug 2025	YTD	2024	2023	2022	Duration years
Bloomberg Long Term Treasury	0.3%	2.5%	-6.4%	3.1%	-29.3%	14.7
Bloomberg U.S. TIPS	1.5%	6.4%	1.8%	3.9%	-11.8%	4.6
Bloomberg U.S. Aggregate	1.2%	5.0%	1.3%	5.5%	-13.0%	6.0
Bloomberg U.S. Agg Corporates	1.0%	5.3%	2.1%	8.5%	-15.8%	6.8
Bloomberg U.S. Agg ABS	1.0%	4.0%	5.0%	5.5%	-4.3%	2.7
Bloomberg U.S. Agg MBS	1.6%	5.5%	1.2%	5.0%	-11.8%	5.9
Bloomberg U.S. Agg CMBS	1.5%	5.9%	4.7%	5.4%	-10.9%	3.9
Bloomberg Municipal Bond	0.9%	0.3%	1.1%	6.4%	-8.5%	7.1
Bloomberg 1-3 year Corporate	0.9%	4.1%	5.3%	5.5%	-3.3%	1.8
ICE BofA Listed Preferreds	1.2%	4.0%	8.5%	9.8%	-18.1%	NA
Bloomberg High Yield	1.2%	6.4%	8.2%	13.4%	-11.2%	2.8
S&P UBS Leveraged Loan	0.4%	4.2%	9.1%	13.0%	-1.1%	NA
Bloomberg Global Agg	1.5%	7.2%	-1.7%	5.7%	-16.2%	6.4
Bloomberg Emerging Markets USD	1.3%	7.3%	6.6%	9.1%	-15.3%	6.0

Yields

			Last 10 years			
	Aug 2025	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.2%	-34	90	2.4%	0.5%	5.0%
2 year Treasury	3.6%	-62	72	1.8%	0.1%	5.2%
10 year TIPS	1.8%	-41	85	0.5%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.4%	-47	75	2.7%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	4.9%	-42	72	3.6%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.2%	-50	71	2.3%	0.4%	6.0%
Bloomberg U.S. Agg MBS	4.9%	-41	82	2.9%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	4.5%	-67	71	3.0%	1.4%	6.6%
Bloomberg Municipal Bond	3.9%	15	93	2.4%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.2%	-60	70	2.5%	0.5%	6.2%
Bloomberg High Yield	6.8%	-74	52	6.6%	3.5%	11.7%
S&P UBS Leveraged Loan	8.0%	-80	69	5.9%	3.6%	13.1%
Bloomberg Global Agg	3.5%	-19	76	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	6.1%	-64	64	5.5%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	Aug 2025	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	79	-1	3	115	73	373
Bloomberg 1-3 year Corporate	50	-2	23	61	31	390
Bloomberg U.S. Agg ABS	51	7	48	52	22	325
Bloomberg U.S. Agg MBS	34	-9	45	36	7	132
Bloomberg U.S. Agg CMBS	78	-2	43	91	62	275
Bloomberg High Yield	272	-15	3	373	253	1100
S&P UBS Leveraged Loan (discount margin)	457	-18	38	483	379	1275
Bloomberg Emerging Markets USD	199	-21	1	301	187	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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