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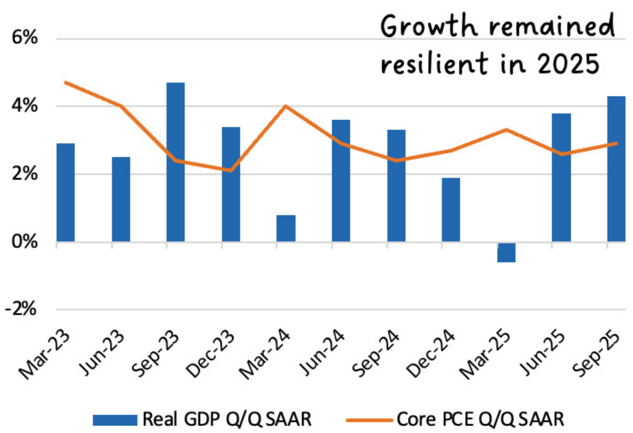
Fixed Income:
Economic Backdrop

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

January 2, 2026

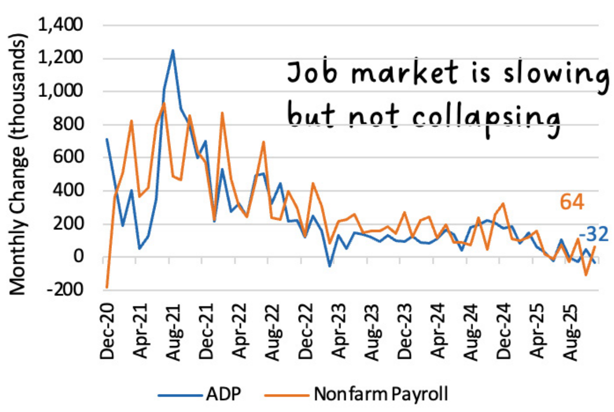
- **Expectations Defied:** 2025 confounded many forecasters. Entering the year, consensus pointed toward slowing growth, rising unemployment, and renewed disinflation as the lagged effects of higher rates took hold. Instead, the economy proved remarkably resilient, growth persisted, inflation remained sticky, and the labor market softened without collapsing.
- **Growth Defies Gravity:** Despite restrictive monetary policy and political dysfunction, the economy expanded modestly through 2025. Early calls for a hard landing proved premature as productivity gains, fueled by automation and AI adoption, offset slower job creation and weak real income growth. Business investment, particularly in technology and process efficiency, surprised to the upside, reflecting structural rather than cyclical momentum.
- **Structural Inflation:** Inflation stayed above target as traditional monetary policy proved less effective. Core inflation showed limited responsiveness to higher policy rates, while services inflation, notably in health care, insurance, and housing, remained persistently elevated. These trends reflected structural stickiness tied to demographics, supply constraints, and pricing power rather than excess demand. Goods and energy prices stayed contained, keeping headline inflation stable but masking uneven pressures beneath the surface.
- **Job Market Softens Without Breaking:** The labor market slowed but did not collapse. Payroll growth moderated and unemployment edged slightly higher, defying expectations that tighter credit and weaker demand would trigger job losses. Wage growth remained uneven, with strength in higher-skill sectors offset by softness in lower-wage industries. This "job-light" expansion reflects capital substitution and labor market resilience, challenging traditional cyclical models linking employment directly to output.
- **Consumers Stay in the Game:** The biggest surprise was the consumer. Despite depleted savings and elevated inflation, aggregate spending remained firm, supported by higher-income households. Credit usage rose but stayed manageable. The resulting "K-shaped" landscape highlights resilience at the top and strain at the bottom, a pattern likely to persist into 2026.
- **Looking Ahead:** The post-pandemic economy no longer follows pre-pandemic rules. Growth may persist without broad hiring; inflation can remain sticky amid easing; and consumers can sustain demand despite affordability pressures. Structural forces, demographics, technology, and inequality, now define the cycle. While growth may moderate, the economy enters 2026 with surprising momentum and fragile durability.

Real GDP and Inflation



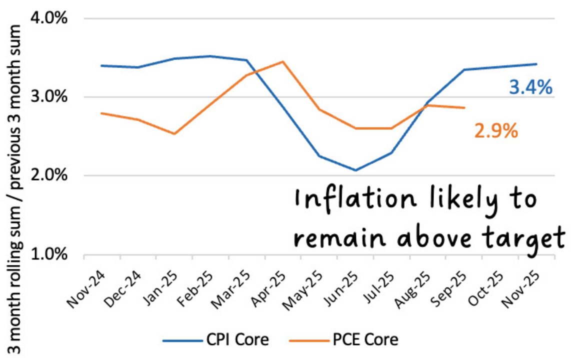
Source: Bloomberg. 3 years of quarterly data through Sept 2025. SAAR = Seasonally Adjusted Annual Rate.

Change in Employment



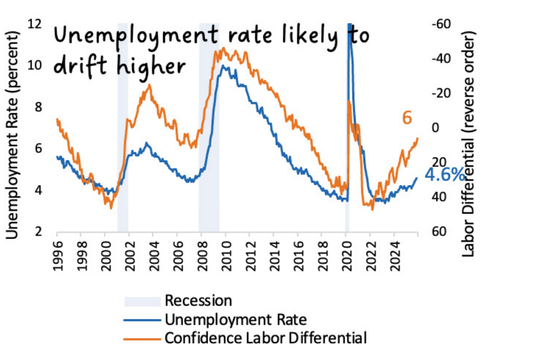
Source: Bloomberg. 5 years of monthly data. ADP through November; Payroll through November.

Core Inflation Q/Q Annualized



Source: Bloomberg. 1 year of monthly data through Nov 2025, and PCE Core through Sep 2025.

Employment Trends



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

Source: Bloomberg. 30 years of monthly data through Dec 2025, Unemployment through Nov 2025.

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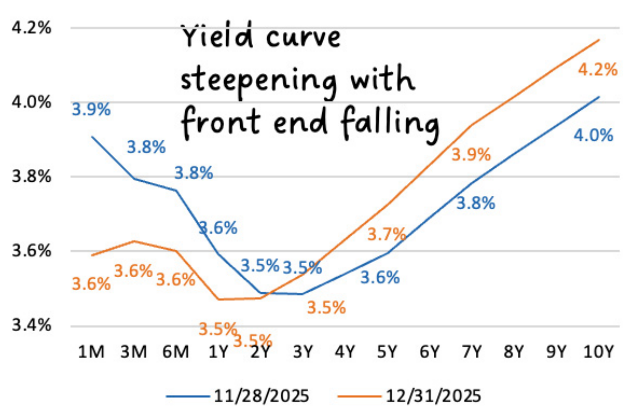
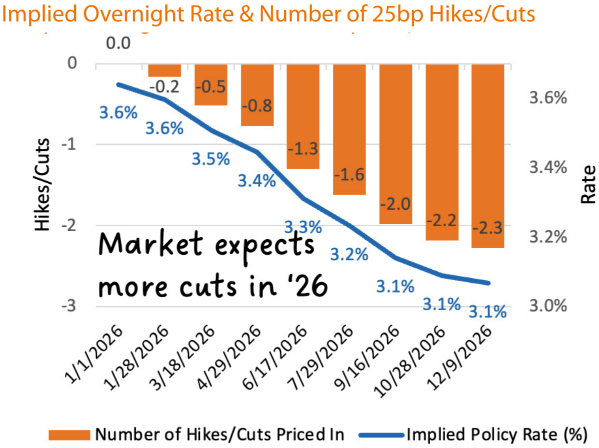
- **Sticky Yields Defy Expectations:** The year began with near-consensus expectations for slowing growth and lower yields, yet economic resilience and sticky inflation kept the long end of the Treasury curve elevated much of the year. The 10-year yield did meander lower, falling from 4.7% at the start of the year to 3.9% by October, only to end the year near 4.2%. Yet the 30-year yield did not follow, ending the year about where it started at 4.8%.
- **Fed Cuts Resume, Policy Still Restrictive:** After maintaining a "pause and assess" stance through summer, the Fed cut rates three times (75 bps total) beginning in September in response to the balance of risks shifting to slowing job gains. Despite this pivot, the real policy rate is still positive and above the presumed neutral rate, underscoring the Fed's cautious bias.
- **Curve Steepening Despite Resilient Growth:** The yield curve steepened for much of the year, not because the economy weakened, but because short rates fell on Fed easing while long-term yields stayed elevated. Ongoing economic resilience, sticky inflation, and fiscal pressures kept the long end anchored, producing a rare re-steepening driven by policy relief at the front end and stagflation-like concerns further out the curve, rather than a growth slowdown that typically pulls long rates lower.
- **Term Premium Reawakens:** The curve was also influenced by a rising term premium. Even as the Treasury leaned on bill issuance, the long end remained under pressure from persistent fiscal deficits and rising debt levels. These forces, alongside sticky inflation and an elevated term premium globally, kept long yields firm despite Fed easing, limiting the rally many expected and underscoring that supply concerns were less about quantity and more about quality and duration risk appetite.
- **Duration Paid, Credit Outperformed:** Intermediate Treasuries posted mid-single digit total returns, reversing 2022–23 losses, while credit-sensitive sectors outperformed as spreads tightened alongside stable growth and improving liquidity, underscoring that rate volatility, not credit stress, defined 2025.
- **Municipals Quietly Compelling:** Amid turbulent markets, municipal bonds delivered steady, but lagging, returns as state and local credit fundamentals held firm and issuance remained manageable. As individual investor demand picks up, we expect high-quality municipals to provide ballast in diversified portfolios.
- **High-Quality Focus:** We remain at our strategic weight for fixed income overall and are tactically overweight investment grade bonds, supported by continued attractive yields and lower economic sensitivity. Risk-adjusted return prospects for 2026 are favorable.

Treasury Yield Curve vs Prior Month



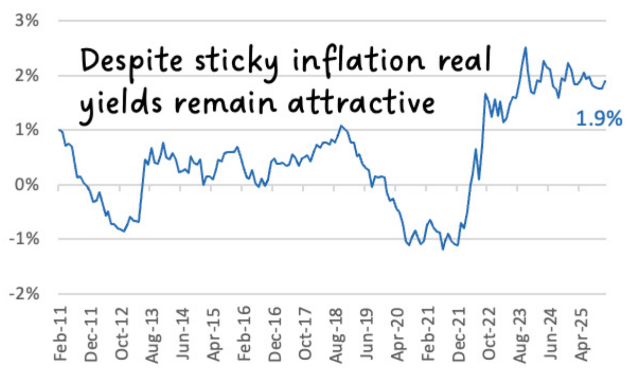
Source: Bloomberg.

Federal Funds Rate
Implied Overnight Rate & Number of 25bp Hikes/Cuts



Source: Bloomberg. Data as of Jan 1 2026.

U.S. 10-year Treasury Inflation-Protected (TIPS) Yield



Source: Bloomberg. 15 years of monthly data through Dec 2025.

U.S. Government Securities Liquidity Index

Source: Bloomberg. 10 years of weekly data through Dec 28 2025. The Liqudity 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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Fixed Income:

Credit Risk

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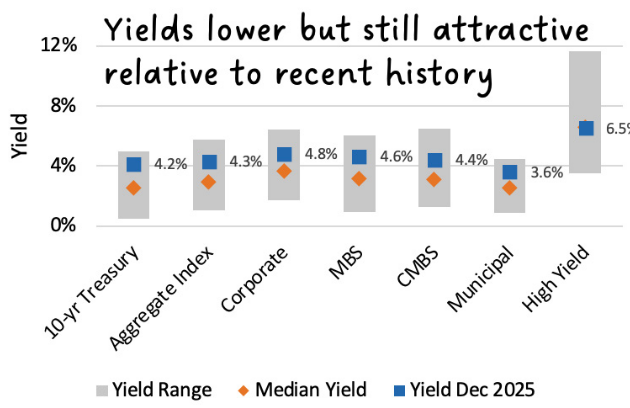
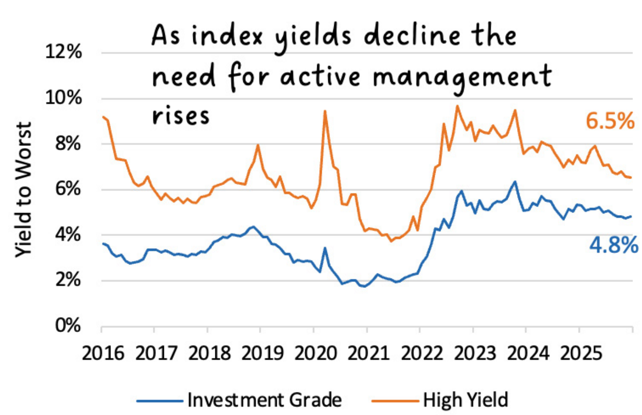
- **Credit Strength Defied Slowing-Growth Fears:** Entering 2025, consensus expected credit spreads to widen as growth cooled and defaults rose. Instead, resilient corporate fundamentals and steady liquidity drove spreads tighter and produced stronger than anticipated returns, particularly in high yield and EM debt.
- **Heavy Supply, Light Impact:** Investment grade issuance surged to near record levels in 2025, driven by technology and AI related capital spending. Despite concerns that refinancing waves would weigh on valuations, spreads held firm as robust demand absorbed new deals. The influx of large tech borrowers has begun to reshape benchmarks with tech index weightings growing. While balance sheets remain sound, this AI-funding cycle introduces subtle concentration risk, with exposures increasingly tied to a smaller set of capital-intensive issuers. Active management is essential as structural issuance shifts the balance within credit markets.
- **High Yield's Soft-Landing Surprise:** High yield outperformed expectations as spreads tightened and defaults stayed subdued, fueled by stable growth and healthy refinancing. Investors who positioned for late-cycle stress instead saw solid gains led by BB-rated bonds. However, riskier segments, CCC high yield and leveraged loans, underperformed as rate cuts eroded floating-rate income and demand favored higher-quality issuers. The result was a soft landing credit rally marked by quality leadership and widening dispersion.
- **Securitized Credit Staged a Comeback:** Despite skepticism around consumer credit, sectors such as RMBS, CMBS, and ABS generated competitive returns. Stable collateral quality, solid structural credit support, and technical demand from yield hungry buyers helped these markets outperform expectations set by early-year caution.
- **Tighter Spreads, Discipline Required:** By year end, spreads across IG, HY, and structured credit hovered near multi-year tights. The compression rewarded early risk taking but left little margin for error, reinforcing the need for selective, high-quality exposure heading into 2026.
- **Cautious on Credit:** We remain underweight high yield bonds given tight spreads. That said, the economy's ongoing resilience, supportive financial conditions, and higher overall index quality reduce the need for an overly defensive stance.

10-year Yield Range for Fixed Income Sectors



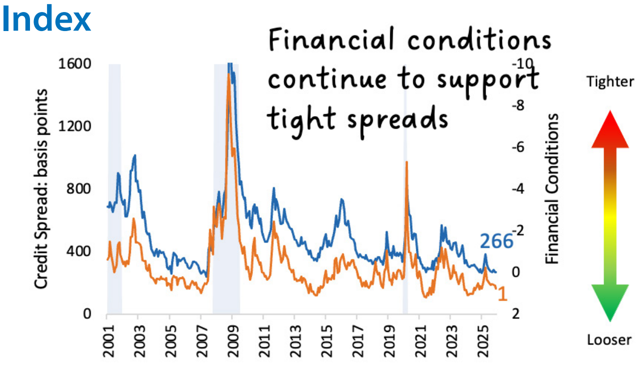
Source: Bloomberg. 25 years of monthly data through Dec 2025.

Bloomberg U.S. Corporate Bond Index



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

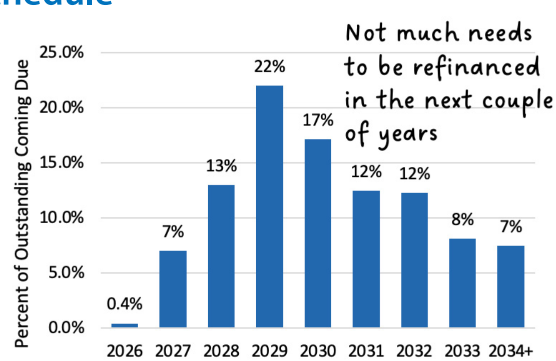
Bloomberg U.S. Financial Conditions Index



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. 10 years of monthly data through Nov 2025

Bloomberg High Yield Maturity Schedule



Source: Bloomberg. Data as of Dec 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

	Dec 2025	YTD	2024	2023	2022	Duration years
Bloomberg Long Term Treasury	-1.7%	5.6%	-6.4%	3.1%	-29.3%	14.6
Bloomberg U.S. TIPS	-0.4%	7.0%	1.8%	3.9%	-11.8%	4.6
Bloomberg U.S. Aggregate	-0.1%	7.3%	1.3%	5.5%	-13.0%	6.0
Bloomberg U.S. Agg Corporates	-0.2%	7.8%	2.1%	8.5%	-15.8%	6.8
Bloomberg U.S. Agg ABS	0.3%	5.9%	5.0%	5.5%	-4.3%	2.9
Bloomberg U.S. Agg MBS	0.2%	8.6%	1.2%	5.0%	-11.8%	5.6
Bloomberg U.S. Agg CMBS	0.1%	7.7%	4.7%	5.4%	-10.9%	3.9
Bloomberg Municipal Bond	0.1%	4.2%	1.1%	6.4%	-8.5%	6.7
Bloomberg 1-3 year Corporate	0.4%	5.9%	5.3%	5.5%	-3.3%	1.8
ICE BofA Listed Preferreds	1.1%	5.2%	8.5%	9.8%	-18.1%	NA
Bloomberg High Yield	0.6%	8.6%	8.2%	13.4%	-11.2%	2.8
S&P UBS Leveraged Loan	0.7%	5.9%	9.1%	13.0%	-1.1%	NA
Bloomberg Global Agg	0.3%	8.2%	-1.7%	5.7%	-16.2%	6.3
Bloomberg Emerging Markets USD	0.4%	11.1%	6.6%	9.1%	-15.3%	6.0

Yields

			Last 10 years			
	Dec 2025	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.2%	-40	85	2.5%	0.5%	5.0%
2 year Treasury	3.5%	-77	68	2.2%	0.1%	5.2%
10 year TIPS	1.9%	-33	86	0.5%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.3%	-59	71	3.0%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	4.8%	-52	69	3.7%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.1%	-64	67	2.7%	0.4%	6.0%
Bloomberg U.S. Agg MBS	4.6%	-64	74	3.1%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	4.4%	-76	68	3.2%	1.4%	6.6%
Bloomberg Municipal Bond	3.6%	-14	82	2.6%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.0%	-77	66	2.9%	0.5%	6.2%
Bloomberg High Yield	6.5%	-96	49	6.6%	3.5%	11.7%
S&P UBS Leveraged Loan	8.1%	-68	63	6.0%	3.6%	13.1%
Bloomberg Global Agg	3.5%	-16	76	1.8%	0.8%	4.4%
Bloomberg Emerging Markets USD	5.7%	-100	54	5.5%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	Dec 2025	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	78	-2	4	112	72	373
Bloomberg 1-3 year Corporate	51	-1	27	59	31	390
Bloomberg U.S. Agg ABS	52	8	51	51	22	325
Bloomberg U.S. Agg MBS	22	-21	12	36	7	132
Bloomberg U.S. Agg CMBS	75	-5	40	89	62	275
Bloomberg High Yield	266	-21	2	367	253	1100
S&P UBS Leveraged Loan (discount margin)	455	-20	38	474	379	1275
Bloomberg Emerging Markets USD	178	-42	0	297	175	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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