Fixed Income:

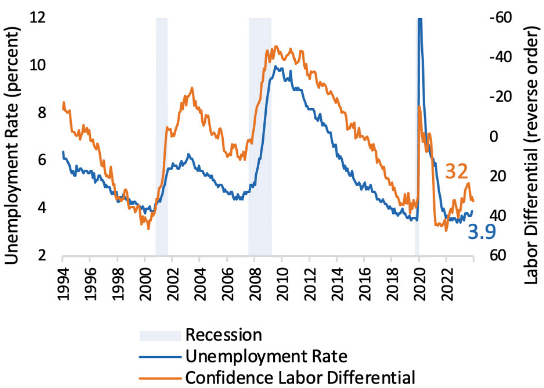
Economic Backdrop

Authors: Crit Thomas, CFA, CAIA / Erik M. Aarts, CIMA / Brian Cheyne, CFA, CIMA

APRIL | 2024

- Despite the Fed's aggressive tightening campaign, a continued inverted yield curve, contracting money supply, and curtailed bank lending, the expected economic slowdown has remained elusive as fiscal stimulus, consumer willingness to spend down savings, and private credit liquidity help to bolster growth and support the markets.
- The Fed maintained its cautious stance in March as Chair Powell opined the risk to its goals of full employment and price stability are now in better balance and it can be patient before beginning to cut interest rates later this year.
- Yet persistent downward revisions to job gains and an uptick in the unemployment rate may be a signal that a crack is forming in the labor market, which could leak into consumption at some point. Meanwhile, last month's inflation reports have continued to point to a bumpy path for prices and for the potential for inflation to stay sticky.
- Despite these cross-currents our base case remains that the economy is coming in for a soft landing, which implies somewhat slower growth ahead and we continue to expect that the Fed will pivot this summer. This outcome would be supportive for the markets, including fixed income.
- Inflation reports in April will be important in evaluating the persistence of inflationary pressures. Should the pace of improvement continue to reverse course it could impact Fed timing on policy and our fixed income positioning.

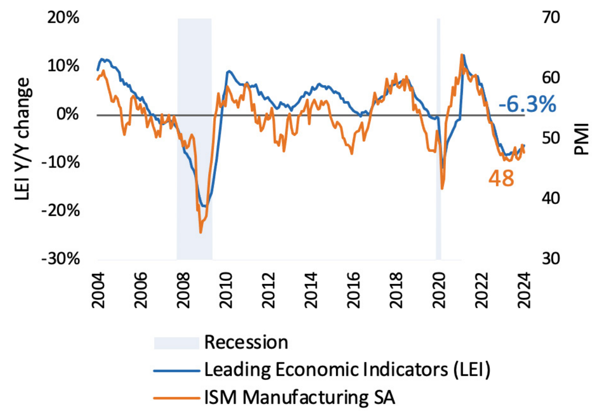
Employment Trends



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 monthly data through Mar 2024

Leading Economic Indicators

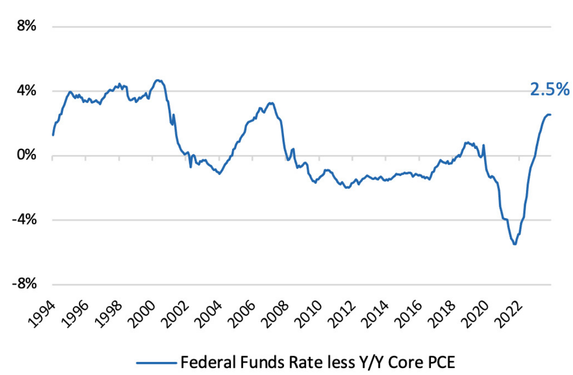


Source: Bloomberg. 20 years of monthly data through Feb 2024

United States Budget Deficit

Source: Bloomberg. 15 years of monthly data through Feb 2024

Real Federal Funds Rate



Source: Bloomberg. 30 years of monthly data through Feb 2024

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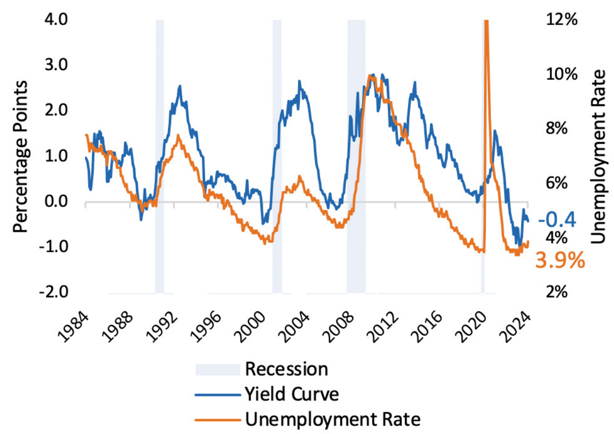
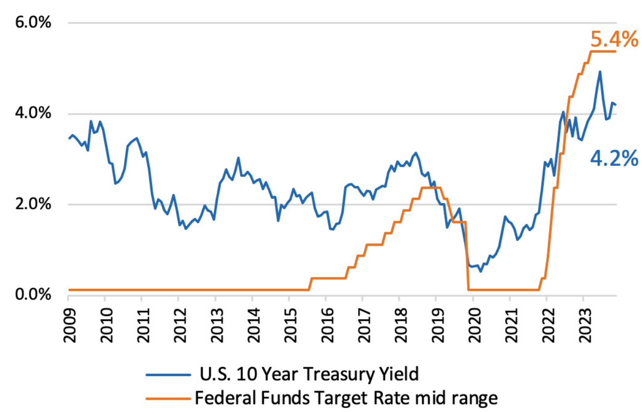
- Bonds bounced back in March after backtracking earlier this year in the face of disquieting inflation news and a potential delay in rate cuts. Most sectors posted positive returns while longer-term bonds bested shorter-term bonds for the month. Given the back up in rates during the quarter, cash returns remain competitive for now.
- While the Fed messaged rate cuts are likely later this year, the new dot plot signaled the Committee also sees stronger economic growth with higher inflation by year end and they indicated a higher median policy rate at the end of 2025. Uncertainty in the interest rate market will likely persist until the Fed resolves this possible contradiction.
- Congress did manage to resolve budget negotiations for the current fiscal year, but we expect large ongoing deficits to prompt increased Treasury issuance and higher debt service costs, potentially increasing interest rate volatility as well.
- Municipal bonds are down modestly YTD while yields remain attractive on an after-tax basis. We note that large cities may experience stress in the coming year as markdowns of commercial real estate valuations negatively impact tax revenues. Property taxes represent anywhere from 5% to 15% of annual budgets for some municipalities.
- Yields across high-quality fixed income remain near the high end of their 10-year range. We expect demand for fixed income will continue and that the lagged effect of monetary policy may eventually slow the economy allowing yields to fall.

Yield Curve



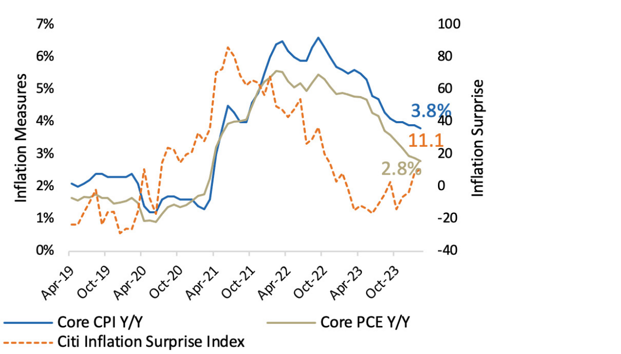
Source: Bloomberg. 40 years of monthly data through Mar 2024. Yield curve based on the difference between the 10 and 2 year Treasury yields.

Interest Rates



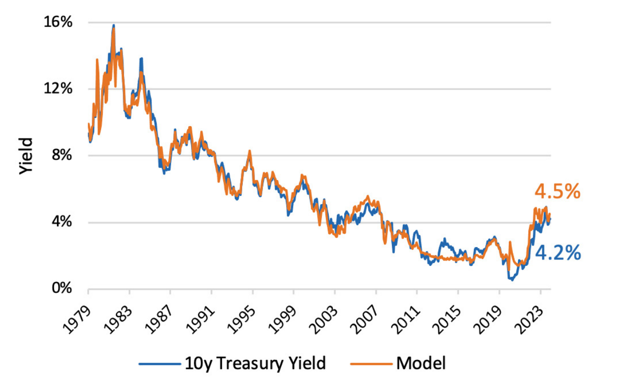
Source: Bloomberg. 15 years of monthly data through Mar 2024

Inflation Surprise



Source: Bloomberg. 5 years of monthly data through Mar 2024. 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.

Touchstone Treasury Yield Model



Source: Bloomberg. 45 years of monthly data through Mar 2024

Fixed Income:

Credit Risk

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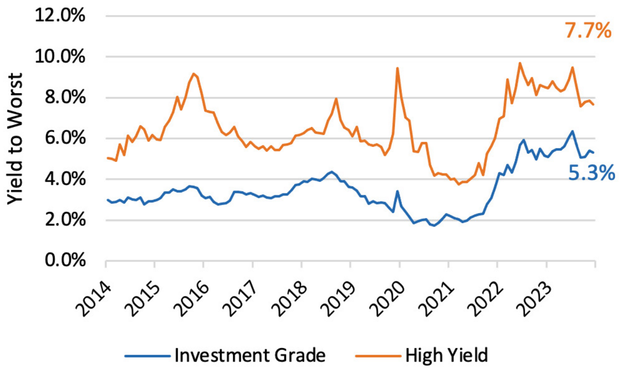
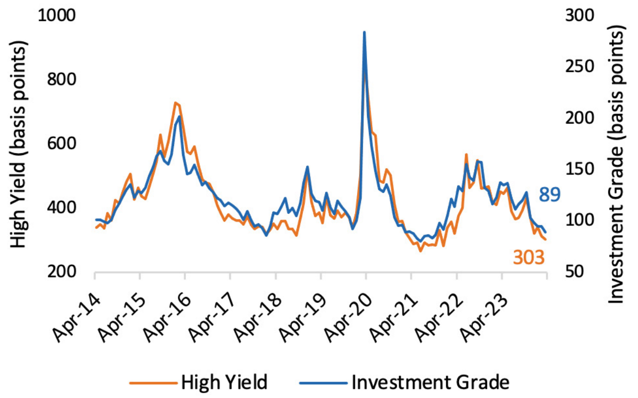
- Investment grade and high yield corporate bonds rallied in March as the credit markets celebrated continued economic growth and prospects for continued earnings growth. Preferred securities and leveraged loans posted strong returns for the quarter. Within the high yield bond market lower quality outperformed high quality during the quarter.
- Absolute yields across most credit markets were modestly lower by month end but remain near the high end of their 10-year range. In our view yields remain attractive at these levels.
- Credit spreads narrowed slightly in March and have generally tightened since the start of the year. Corporate credit spreads sit near the low end of their 10-year history which is generally not viewed as a good starting point for returns.
- So, while corporate credit spreads today are not cheap, they can perhaps be justified by the fact that the economy has remained resilient, corporate earnings growth expectations remain positive, and the Fed may cut interest rates this year.
- Within high yield it is also important to recognize that the index is higher in quality today versus history, supporting the idea that spreads can be lower than they otherwise would be, and that strong demand for new issuance is reducing what little near-term refinancing needs exist.
- In our view attractive starting yields in the face of rising prospects of a soft landing and a potential Fed pivot may support solid returns from credit sensitive bonds.

Bloomberg U.S. Corporate Bond Indexes



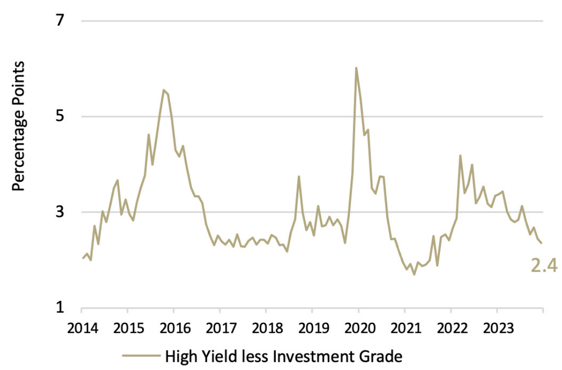
Source: Bloomberg. 10 years of monthly data through Mar 2024

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



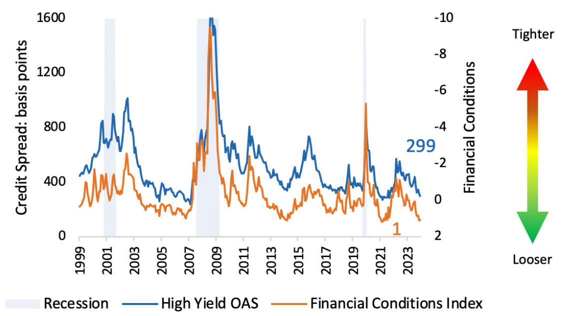
Source: Bloomberg. 10 years of monthly data through Mar 2024

Difference in Yield: High Yield less Investment Grade



Source: Bloomberg. 10 years of monthly data through Mar 2024

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. 45 years of monthly data through Mar 2024

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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

	March 2024	YTD	2023	2022	2021	Duration years
Bloomberg Long Term Treasury	1.2%	-3.3%	3.1%	-29.3%	-4.6%	15.5
Bloomberg U.S. TIPS	0.8%	-0.1%	3.9%	-11.8%	6.0%	6.8
Bloomberg U.S. Aggregate	0.9%	-0.8%	5.5%	-13.0%	-1.5%	6.2
Bloomberg U.S. Agg Corporate	1.3%	-0.4%	8.5%	-15.8%	-1.0%	7.2
Bloomberg U.S. Agg ABS	0.5%	0.7%	5.5%	-4.3%	-0.3%	2.6
Bloomberg U.S. Agg MBS	1.1%	-1.0%	5.0%	-11.8%	-1.0%	5.7
Bloomberg U.S. Agg CMBS	0.9%	0.8%	5.4%	-10.9%	-1.2%	4.3
Bloomberg Municipal Bond	0.0%	-0.4%	6.4%	-8.5%	1.5%	5.9
Bloomberg 1-3 year Corporate	0.5%	0.8%	5.5%	-3.3%	-0.1%	1.9
ICE BofA Listed Preferreds	0.5%	4.7%	9.8%	-18.1%	7.7%	NA
Bloomberg High Yield	1.2%	1.5%	13.4%	-11.2%	5.3%	3.7
Credit Suisse Leveraged Loan (discount margin)	0.8%	2.5%	13.0%	-1.1%	5.4%	NA
Bloomberg Global Agg	0.6%	-2.1%	5.7%	-16.2%	-4.7%	6.7
Bloomberg Emerging Markets USD	1.7%	1.5%	9.1%	-15.3%	-1.7%	6.3

Yields

			Last 10 years			
	March 2024	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.2%	32	98	2.3%	0.5%	5.0%
2 year Treasury	4.6%	37	94	1.3%	0.1%	5.2%
10 year TIPS	1.9%	17	97	0.4%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.8%	31	94	2.4%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.3%	24	90	3.2%	1.7%	6.4%
Bloomberg U.S. Agg ABS	5.2%	23	92	1.9%	0.4%	6.0%
Bloomberg U.S. Agg MBS	5.0%	36	95	2.8%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	5.3%	6	91	2.7%	1.4%	6.6%
Bloomberg Municipal Bond	3.5%	27	91	2.2%	0.9%	4.5%
Bloomberg 1-3 year Corporate	5.3%	21	92	2.0%	0.5%	6.2%
Bloomberg High Yield	7.7%	7	75	6.2%	3.5%	11.7%
Credit Suisse Leveraged Loan (discount margin)	9.3%	21	91	5.3%	3.6%	13.1%
Bloomberg Global Agg	3.7%	23	93	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	7.0%	0	83	5.1%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	March 2024	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	89	-9	7	120	80	373
Bloomberg 1-3 year Corporate	56	-11	33	66	31	390
Bloomberg U.S. Agg ABS	54	-14	54	52	22	325
Bloomberg U.S. Agg MBS	49	2	81	31	7	132
Bloomberg U.S. Agg CMBS	96	-30	58	95	62	275
Bloomberg High Yield	303	-20	7	391	262	1100
Credit Suisse Leveraged Loan (discount margin)	509	-19	55	498	379	1275
Bloomberg Emerging Markets USD	263	-34	10	312	211	720

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

2021 – Pandemic continued in waves. Fed held rates near zero and continued to grow its balance sheet at a moderate pace. Long duration bonds sold off while Treasury Inflation Protected Securities rallied on inflation concerns. Exclusive of duration credit exposed securities generally earned their yield.

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.

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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 Brian Cheyne, CFA, CIMA – Senior Investment Strategy Specialist, 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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