Touchstone Investments®
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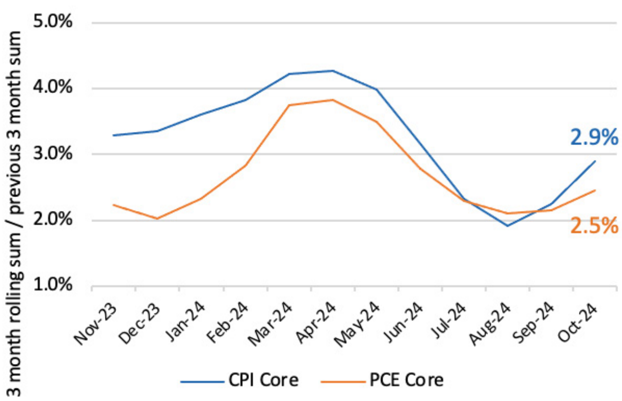
Fixed Income:
Economic Backdrop

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

December 2, 2024

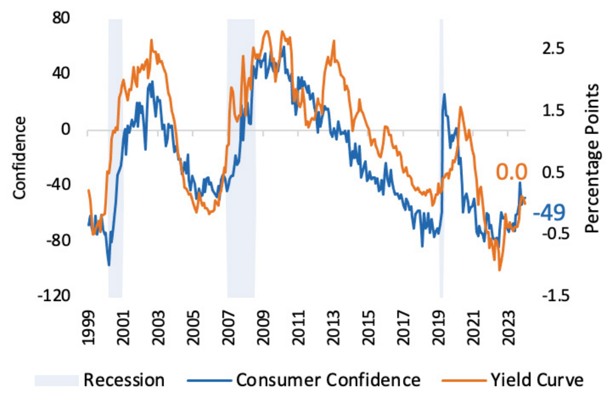
- **Economic Resilience May Continue:** We anticipate U.S. economic growth to slow next year, but still beat current consensus expectations, driven by continued consumption and potentially better capital spending.
- **Potentially Sticky Inflation:** We anticipate moderating price increases but expect inflation to remain above the Fed's target. Recent reports show inflation stuck in the 2–3% range. Uncertainty around tariffs and deportations could influence this outlook.
- **Fed Normalizing Rates:** The Fed is not "easing" to stimulate the economy but rather "normalizing" interest rates to balance full employment and price stability. Given the economy's current resilience, strong household finances, and potential policy shifts from the incoming administration, we expect the neutral rate to be much higher than in the previous cycle.
- **Housing Market Stuck:** Mortgage rates have risen since the Fed began normalizing rates, while home prices remain elevated due to a lack of supply. Homeowners are staying put and housing affordability remains depressed. The housing market, an important engine of the economy, may remain stuck absent a sharp slowdown and significantly lower interest rates.
- **Proceeding with Caution:** With the election behind us, we are assessing how tax, trade and immigration policies might impact growth, inflation, and markets.

Core Inflation Q/Q Annualized



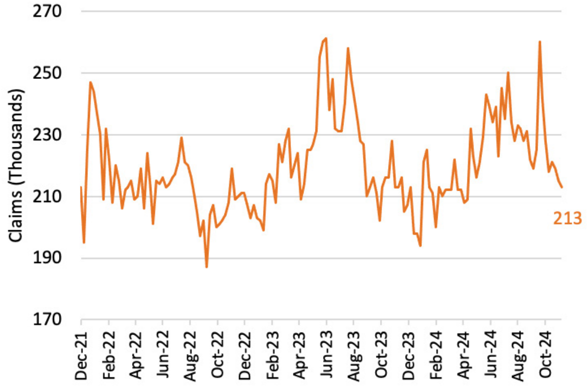
Source: Bloomberg. 1 year of monthly data through Oct 2024

Consumer Confidence Signal



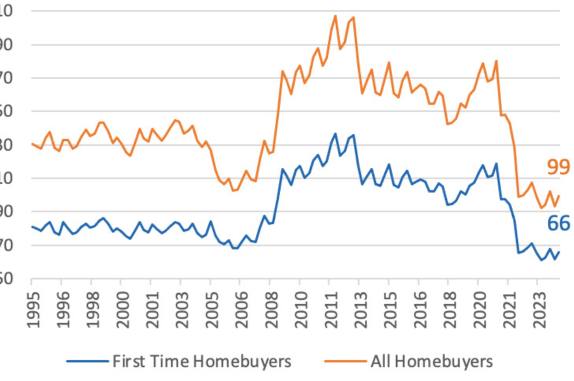
Source: Bloomberg. 25 years of monthly data through Nov 2024; Yield Curve is the difference between 10 and 2 year Treasury yields. The Confidence measure is the difference between future expectations and current conditions.

US Initial Jobless Claims



Source: Bloomberg. 3 years of weekly data through Nov 22 2024

Housing Affordability



Source: Bloomberg. 30 years of quarterly data through Sep 2024

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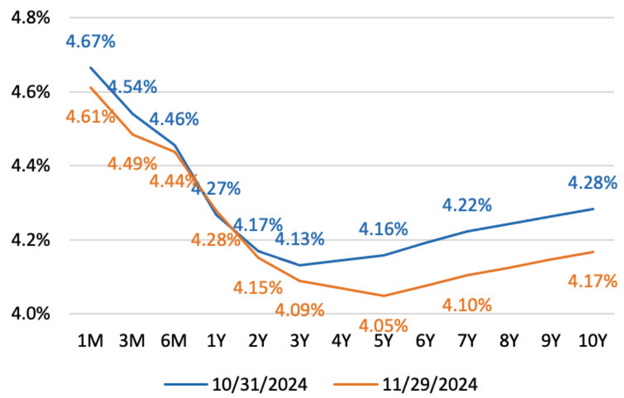
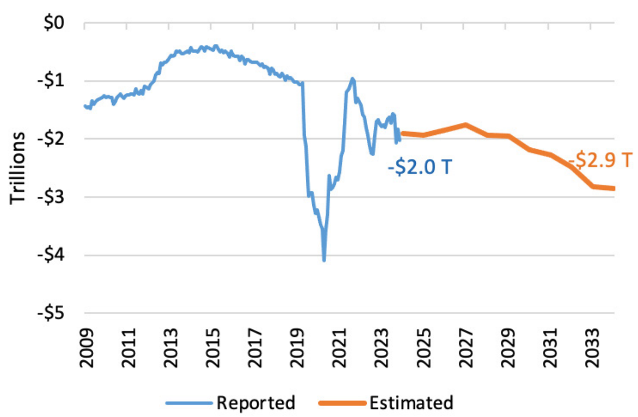
- **Reducing Rate Risk:** Following the election, we shifted to a slight duration underweight, anticipating a higher yield environment under a potential GOP sweep. We see the risk of higher yields driven by inflation concerns and unsustainable government spending.
- **Significant Challenges Ahead:** The next Treasury team will face significant challenges. The debt ceiling will be reached in January, and the team inherits a $2 trillion annual deficit while needing to fund $6 trillion in promised tax cuts over ten years. Current interest on the debt is more than 18% of tax revenue. With mandatory spending, interest costs, and defense comprising $5 of every $7 spent, identifying sufficient offsetting savings to fund tax cuts will be difficult.
- **Term Premium Watch:** Longer-maturity Treasury yields could stabilize in the near term. While Congress addresses the debt ceiling no new debt will be issued, reducing supply. Additional rate cuts and the end of quantitative tightening could temporarily ease pressure on the term premium.
- **Fed Not in a Hurry:** Meeting minutes indicate officials favor a gradual approach to further cuts and remain uncertain about the neutral rate's level. The market expects just three cuts next year, which could keep bond yields elevated.
- **Appealing Yields:** High-quality bond yields remain near the high end of their 10-year range. Higher-coupon, intermediate-maturity bonds are less sensitive to interest rate changes, potentially supporting returns even if long-term yields rise modestly in the new year.

Treasury Yield Curve vs Prior Month



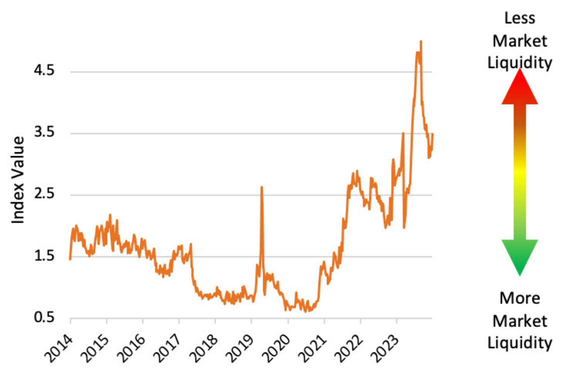
Source: Bloomberg

United States Budget Deficit



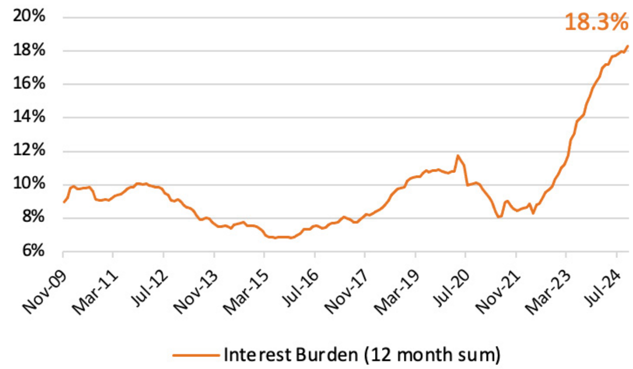
Source: Bloomberg. 15 years of monthly data through Oct 2024; CBO annual estimates through 2034

U.S. Government Securities Liquidity Index



Source: Bloomberg. 10 years of weekly data through Dec 1 2024. The Liquidity Index as calculated by Bloomberg measurers prevailing liquidity conditions in the U.S. Treasury market based on intra-day yield dislocations from fair value.

U.S. Budget Interest Expense/ Total Revenues



Source: Bloomberg. 15 years of monthly data as of Oct 2024

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Fixed Income:
Credit Risk

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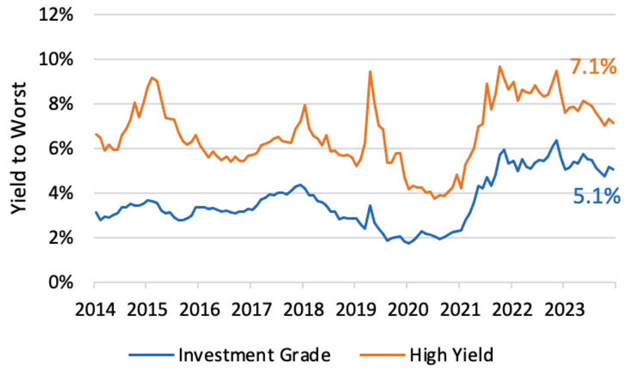
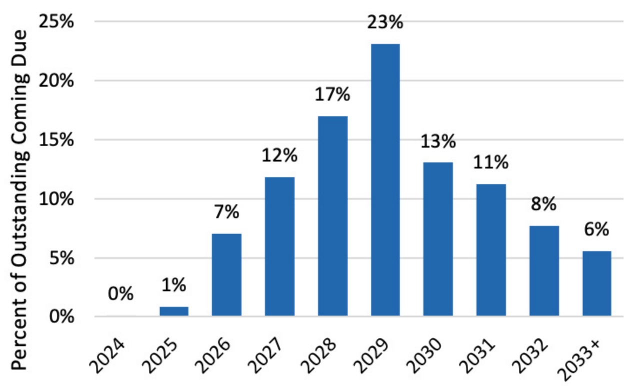
- **Overweight High Yield:** High-yield bonds have performed well despite rising interest rates, supported by economic resilience, a lower maturity wall, and higher index quality. We believe additional Fed rate cuts could prompt investors to shift into higher-yielding securities.
- **Pending Policy Support:** It is too early to tell whether trade and immigration policies will benefit or hinder corporate America. However, credit markets remain optimistic that deregulation and tax cuts could bolster profit margins and earnings. Tight credit spreads narrowed further after the election.
- **Consumer Health:** The strength of consumer finances is critical to supporting further gains across securitized credit sectors. Spreads have tightened toward corporate credit, while yields remain attractive. Sustained job and wage growth will be key to realizing those yields.
- **Active Management Key:** Policy changes may create both winners and losers in securitized and corporate credit markets, presenting opportunities to generate returns and manage risk effectively.
- **Earnings Watch:** With expensive starting valuations, earnings growth is crucial. While 2025 earnings expectations for the S&P 500 have declined modestly, solid growth is still anticipated. Should those expectations change, we would reassess our credit positioning.

Bloomberg U.S. Corporate Bond Indexes



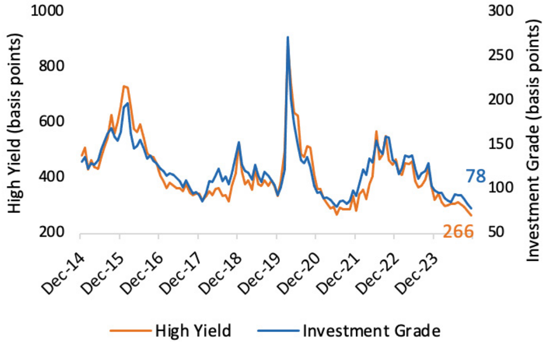
Source: Bloomberg. 10 years of monthly data through Nov 2024

Bloomberg High Yield Maturity Schedule



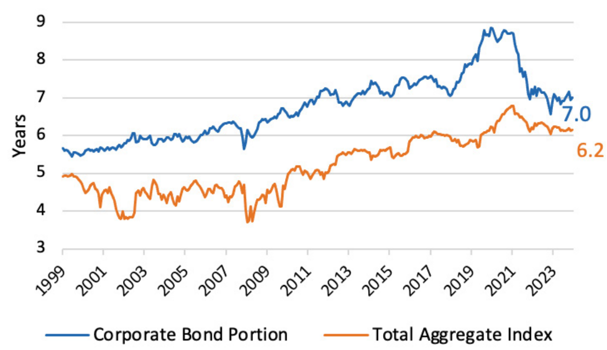
Source: Bloomberg. Data as of Sep 2024

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



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

Bloomberg U.S. Aggregate Bond Index Duration



Source: Bloomberg. 25 years of monthly data through Nov 2024

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

	November 2024	YTD	2023	2022	2021	Duration years
Bloomberg Long Term Treasury	1.8%	-1.2%	3.1%	-29.3%	-4.6%	15.1
Bloomberg U.S. TIPS	0.5%	3.5%	3.9%	-11.8%	6.0%	4.5
Bloomberg U.S. Aggregate	1.1%	2.9%	5.5%	-13.0%	-1.5%	6.2
Bloomberg U.S. Agg Corporate	1.3%	4.1%	8.5%	-15.8%	-1.0%	7.0
Bloomberg U.S. Agg ABS	0.7%	5.1%	5.5%	-4.3%	-0.3%	2.7
Bloomberg U.S. Agg MBS	1.3%	2.9%	5.0%	-11.8%	-1.0%	5.9
Bloomberg U.S. Agg CMBS	0.9%	5.3%	5.4%	-10.9%	-1.2%	4.2
Bloomberg Municipal Bond	1.7%	2.5%	6.4%	-8.5%	1.5%	6.0
Bloomberg 1-3 year Corporate	0.5%	5.1%	5.5%	-3.3%	-0.1%	1.8
ICE BofA Listed Preferreds	0.8%	12.0%	9.8%	-18.1%	7.7%	NA
Bloomberg High Yield	1.2%	8.7%	13.4%	-11.2%	5.3%	3.0
Credit Suisse Leveraged Loan (discount margin)	0.8%	8.4%	13.0%	-1.1%	5.4%	NA
Bloomberg Global Agg	0.3%	0.5%	5.7%	-16.2%	-4.7%	6.6
Bloomberg Emerging Markets USD	1.1%	7.9%	9.1%	-15.3%	-1.7%	6.1

Yields

			Last 10 years			
	November 2024	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.2%	29	92	2.3%	0.5%	5.0%
2 year Treasury	4.2%	-10	84	1.5%	0.1%	5.2%
10 year TIPS	1.9%	20	93	0.5%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.6%	11	86	2.5%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.1%	-1	81	3.4%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.7%	-29	80	2.0%	0.4%	6.0%
Bloomberg U.S. Agg MBS	5.0%	27	90	2.8%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	5.0%	-26	82	2.8%	1.4%	6.6%
Bloomberg Municipal Bond	3.4%	23	85	2.3%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.7%	-37	81	2.2%	0.5%	6.2%
Bloomberg High Yield	7.1%	-45	63	6.4%	3.5%	11.7%
Credit Suisse Leveraged Loan (discount margin)	8.6%	-50	78	5.6%	3.6%	13.1%
Bloomberg Global Agg	3.5%	1	83	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	6.5%	-56	75	5.3%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	November 2024	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	78	-21	1	119	74	373
Bloomberg 1-3 year Corporate	45	-22	13	65	31	390
Bloomberg U.S. Agg ABS	45	-23	37	54	22	325
Bloomberg U.S. Agg MBS	41	-6	64	33	7	132
Bloomberg U.S. Agg CMBS	84	-42	48	96	62	275
Bloomberg High Yield	266	-57	1	386	253	1100
Credit Suisse Leveraged Loan (discount margin)	461	-67	37	499	379	1275
Bloomberg Emerging Markets USD	222	-75	2	311	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.***

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