Fixed Income:

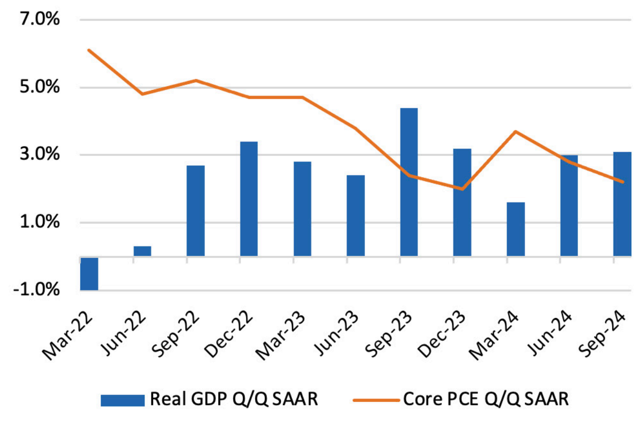
Economic Backdrop

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

January 2, 2025

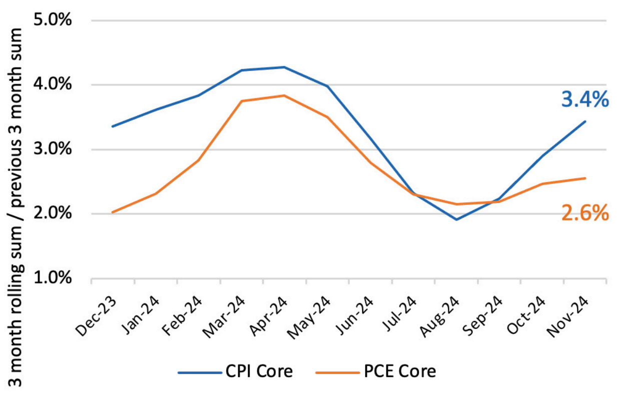
- **Economic Resilience:** The Atlanta Fed GDP Now fourth quarter forecast projects the U.S. economy may post a third consecutive quarter of solid growth propelled by strong consumer spending. While we expect growth to slow modestly from here, there is little to signal an impending recession.
- **Labor Market Watch:** Initial unemployment claims remain low, while continuing claims have risen. The unemployment rate is trending back up toward its recent peak of 4.3%. Given the consumer's importance to growth we will be watching the job market closely.
- **Persistent inflation pressure:** We think inflation may continue to moderate, but there is a risk that the inflation rate may be stuck closer to 3%, not 2%, influenced by potential price and wage pressures from possible tariffs and deportations.
- **Kicking the Can:** Congress averted a government shutdown by passing a continuing resolution to fund spending through mid-March. It included new spending on storm relief and farm aid but did not address the debt ceiling. We expect tumultuous budget negotiations in the coming months.
- **Policy Impact:** While the Fed has now cut rates by 1 percentage point, it is important to remember that recent policy tightening was less effective in slowing growth, requiring us to consider whether current policy easing will be less effective in stimulating growth. On the fiscal front we are waiting to see how tax, trade and immigration plans might impact growth, inflation, and markets.

Real GDP and Inflation



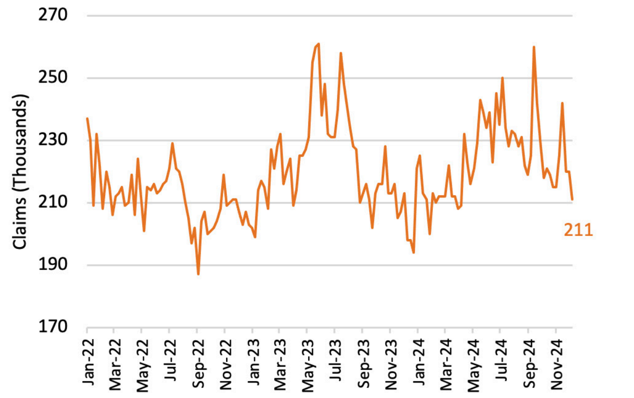
Source: Bloomberg. 3 years of quarterly data through Sept 2024.
SAAR = Seasonally Adjusted Annual Rate

Core Inflation Q/Q annualized



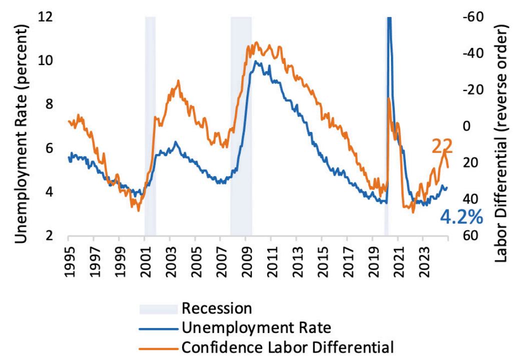
Source: Bloomberg. 1 year of monthly data through Nov 2024

US Initial Jobless Claims



Source: Bloomberg. 3 years of weekly data through Dec 27 2024

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 quarterly data through Dec 2024, Unemployment through Nov 2024

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Fixed Income:
Interest Rate Risk

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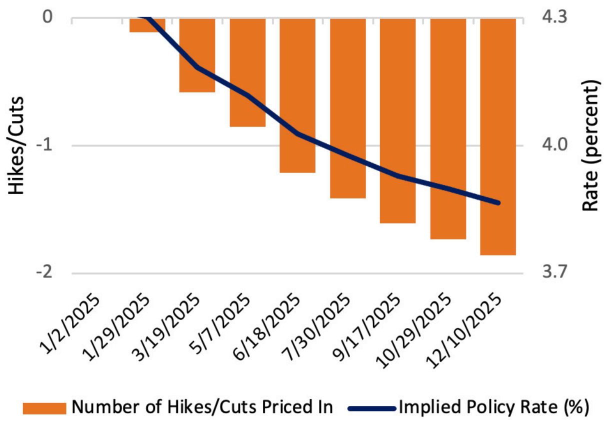
- **Caution on Rate Risk:** Last fall we shifted to a slight duration underweight as the 10-year Treasury yields rose by almost 1 percentage point after the Fed started to cut rates, creating a steeper yield curve. Our view reflects several risks: the potential for better-than-expected growth, less progress on inflation, or contentious Congressional budget negotiations that raise fiscal discipline doubts.
- **Bumpy Returns:** The bond market ended last year on a weak note with the Bloomberg Aggregate Index down 3.1% in the fourth quarter. The index managed just a modest 1.3% gain for 2024.
- **Hawkish Rate Cut:** The Fed cut rates for a third consecutive time in December, but signaled fewer, less frequent, rate cuts going forward. The committee revised its economic growth and inflation forecasts for 2025 upward and raised its estimate for the neutral interest rate.
- **Treasury Market Volatility:** With a temporary funding bill passed and no plan to increase the debt ceiling in place, a rising term premium for 10-year Treasuries may reflect market concerns that rates will be volatile again this year. While longer-maturity Treasuries could stabilize in the short-run as supply is suspended amid budget negotiations, less-than-expected progress on debt sustainability could pressure yields later in the year.
- **Attractive Starting Yields:** We begin the year with high-quality yields near the high end of their 10-year range. Higher-coupon, intermediate-maturity bonds are less sensitive to further interest rate changes, potentially supporting returns while short-term rates fall, and long-term yields rise.
- **Looking for an Entry Point:** While many factors may influence our decision to increase our duration within our fixed income allocation, rising longer-term Treasury yields have us looking for an entry point.

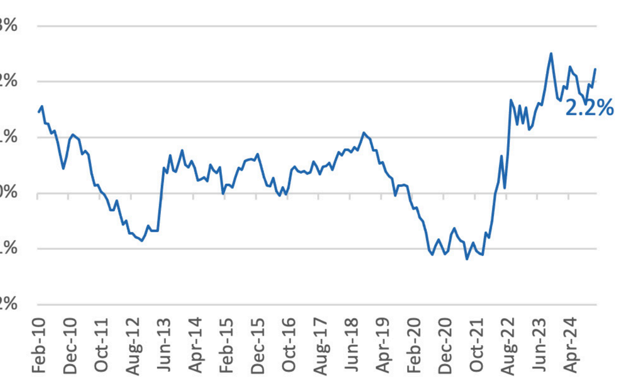
Federal Funds Rate

Implied Overnight Rate & Number of 25bp Hikes/Cuts



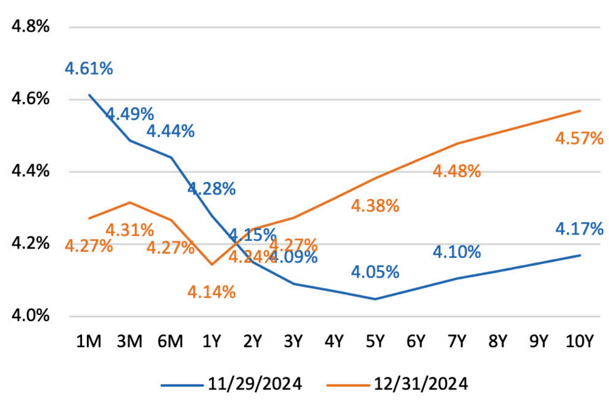
Source: Bloomberg. Data as of Jan 1 2025

U.S. Treasury Inflation-Protected (TIPS) Yields



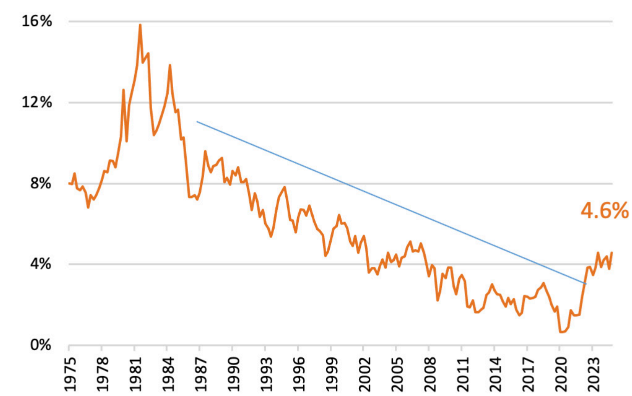
Source: Bloomberg. 15 years of monthly data through Dec 2024

Treasury Yield Curve vs Prior Month



Source: Bloomberg

10 Year U.S. Treasury Yield



Source: Bloomberg. 50 years of quarterly data as of Dec 2024

Fixed Income:

Credit Risk

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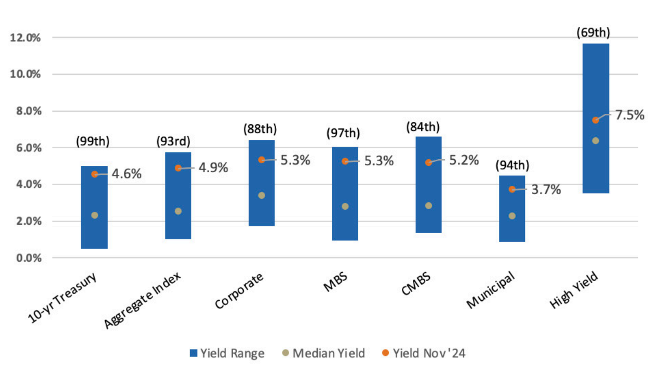
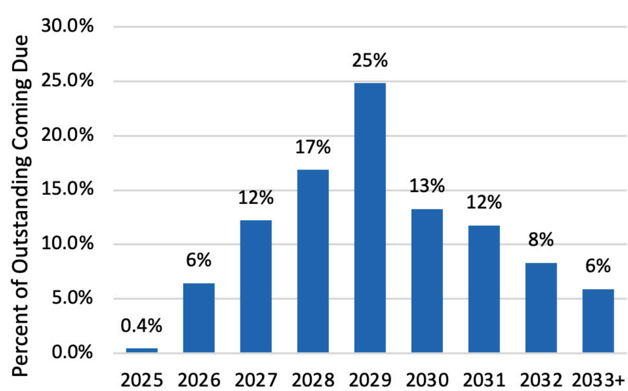
- **High Yield Overweight:** Despite rising rates, high-yield bonds performed well in 2024, buoyed by economic resilience, a lower maturity wall, and improved index quality. We continue to believe additional Fed rate cuts may prompt investors to shift into higher-yielding securities and we remain slightly overweight non-investment grade debt.
- **Credit over Duration:** Credit exposure bested duration risk in 2024 with high yield returning over 8% while the Treasury portion of the Bloomberg Aggregate Index returned less than 1%. Should the economy continue to outperform expectations, and government debt sustainability concerns persist, we expect this trend may continue.
- **Corporate Spreads Tight:** Our support for credit does not ignore that spreads across corporate sectors have generally declined to the very low end of their respective ten-year ranges. Our view is predicated on capturing yield. We generally see better value in securitized credit supported by strong consumer finances and positive real wage gains.
- **Yield Capture:** The key to our view on credit is that many areas continue to offer attractive yields near the high end of their ten-year respective ranges and offer real (above inflation) income potential. Should our economic and inflation thesis play out we expect to capture this yield.
- **Policy Uncertainty:** The impact of trade and immigration policies on corporate America remains unclear, yet credit markets remain optimistic that deregulation and tax cuts could bolster profits. Although spreads widened in December, they tightened overall this year. We remain vigilant for any adverse effects from policy errors.
- **Active Management Key:** Policy changes may create both winners and losers in credit markets, presenting opportunities to generate returns and manage risk. And the same goes for active allocation decisions. Should conditions change, we will reassess our credit positioning.

10-Year Yield Range for Fixed Income Sectors (Percentile Rank)



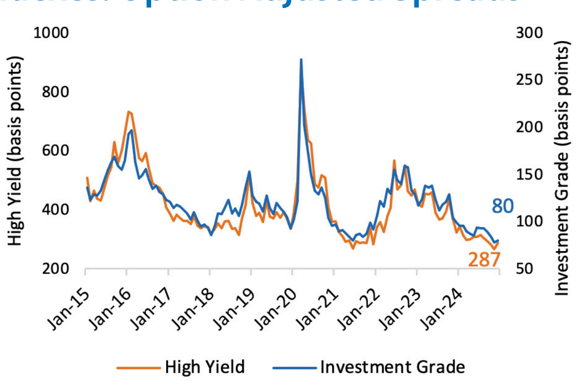
Source: Bloomberg. 10 years of monthly data through Dec 2024

Bloomberg High Yield Maturity Schedule



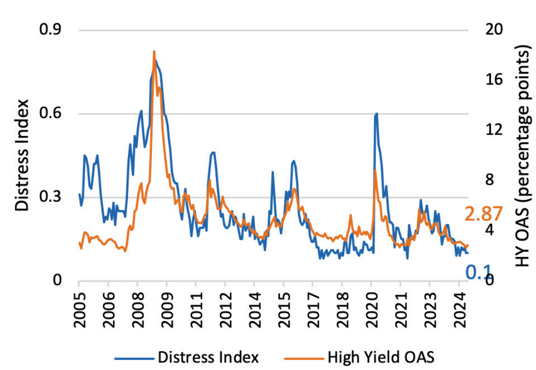
Source: Bloomberg. Data as of Dec 2024

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



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

NY Fed Corporate Bond Distress Index



Source: Bloomberg. 20 years of monthly data through Dec 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

	December 2024	YTD	2023	2022	2021	Duration years
Bloomberg Long Term Treasury	-5.3%	-6.4%	3.1%	-29.3%	-4.6%	14.7
Bloomberg U.S. TIPS	-1.6%	1.8%	3.9%	-11.8%	6.0%	4.1
Bloomberg U.S. Aggregate	-1.6%	1.3%	5.5%	-13.0%	-1.5%	6.1
Bloomberg U.S. Agg Corporate	-1.9%	2.1%	8.5%	-15.8%	-1.0%	6.8
Bloomberg U.S. Agg ABS	-0.1%	5.0%	5.5%	-4.3%	-0.3%	2.7
Bloomberg U.S. Agg MBS	-1.6%	1.2%	5.0%	-11.8%	-1.0%	6.2
Bloomberg U.S. Agg CMBS	-0.5%	4.7%	5.4%	-10.9%	-1.2%	4.1
Bloomberg Municipal Bond	-1.5%	1.1%	6.4%	-8.5%	1.5%	6.2
Bloomberg 1-3 year Corporate	0.2%	5.3%	5.5%	-3.3%	-0.1%	1.8
ICE BofA Listed Preferreds	-3.1%	8.5%	9.8%	-18.1%	7.7%	NA
Bloomberg High Yield	-0.4%	8.2%	13.4%	-11.2%	5.3%	3.1
Credit Suisse Leveraged Loan (discount margin)	0.6%	9.1%	13.0%	-1.1%	5.4%	NA
Bloomberg Global Agg	-2.1%	-1.7%	5.7%	-16.2%	-4.7%	6.6
Bloomberg Emerging Markets USD	-1.2%	6.6%	9.1%	-15.3%	-1.7%	5.9

Yields

			Last 10 years			
	December 2024	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.6%	69	99	2.3%	0.5%	5.0%
2 year Treasury	4.2%	-1	84	1.5%	0.1%	5.2%
10 year TIPS	2.2%	52	99	0.5%	-1.2%	2.5%
Bloomberg U.S. Aggregate	4.9%	38	93	2.6%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.3%	27	88	3.4%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.7%	-23	81	2.0%	0.4%	6.0%
Bloomberg U.S. Agg MBS	5.3%	59	97	2.8%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	5.2%	-8	84	2.8%	1.4%	6.6%
Bloomberg Municipal Bond	3.7%	52	94	2.3%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.8%	-28	81	2.2%	0.5%	6.2%
Bloomberg High Yield	7.5%	-10	69	6.4%	3.5%	11.7%
Credit Suisse Leveraged Loan (discount margin)	8.8%	-35	77	5.6%	3.6%	13.1%
Bloomberg Global Agg	3.7%	17	87	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	6.7%	-33	77	5.3%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	December 2024	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	80	-19	2	119	74	373
Bloomberg 1-3 year Corporate	52	-15	24	64	31	390
Bloomberg U.S. Agg ABS	44	-24	35	53	22	325
Bloomberg U.S. Agg MBS	43	-4	67	34	7	132
Bloomberg U.S. Agg CMBS	80	-46	44	95	62	275
Bloomberg High Yield	287	-36	5	384	253	1100
Credit Suisse Leveraged Loan (discount margin)	475	-53	42	498	379	1275
Bloomberg Emerging Markets USD	220	-77	2	310	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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