Touchstone Investments®
DISTINCTIVELY ACTIVE®

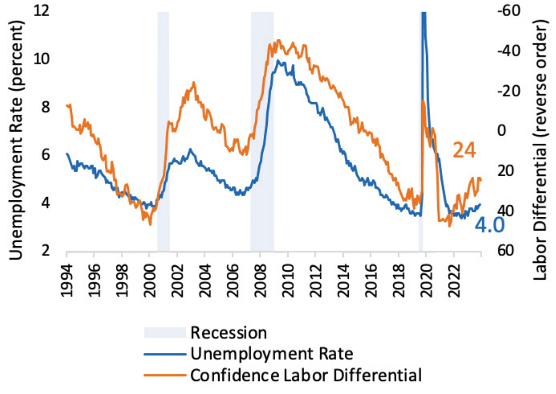
Fixed Income:
Economic Backdrop

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

JULY | 2024

- Recent economic data have been mixed, suggesting the economy sits on a knife's edge between continued positive momentum or something slower, giving both economic bulls and bears evidence to support their respective base cases.
- In our opinion, economic activity remains bifurcated. Middle-to-high income consumers are benefiting from strong wealth effects, high returns on cash savings, and locked-in low mortgage rates. Meanwhile lower income wage earners, dependent on expensive revolving credit and higher rents are increasingly stretched financially.
- Likewise, larger companies are generally flush with cash and are maintaining their profit margins, while small businesses struggle with higher interest rates, driving confidence to recessionary levels.
- Fed policy tends to be most effective when it is pre-emptive and that was not the case in this tightening cycle. That said, should the easing cycle be triggered by less inflation, as we expect, a soft landing is likely.
- We recognize that soft landings are very rare. We see labor market strength as the key to a soft landing as the consumer is such a large GDP driver. As such, we are watching labor conditions closely and are prepared to adjust our portfolio positioning should they begin to unravel.
- While economic data in the first half was mixed, we anticipate that the second half will provide more clarity and opportunity for tactical adjustments.

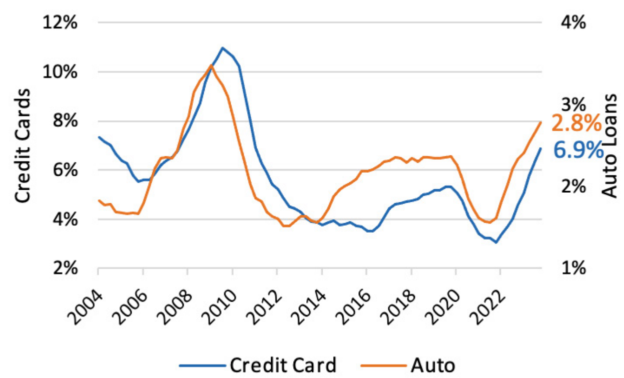
Employment Trends



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.

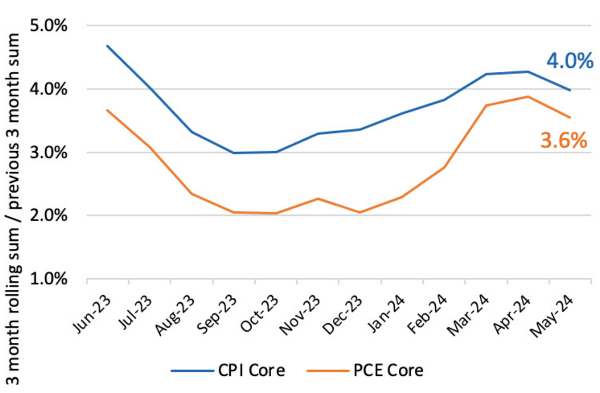
Source: Bloomberg. 30 years of monthly data through Jun 2024, Unemployment through May 2024

NY Fed/Equifax Transition Rates to Delinquency



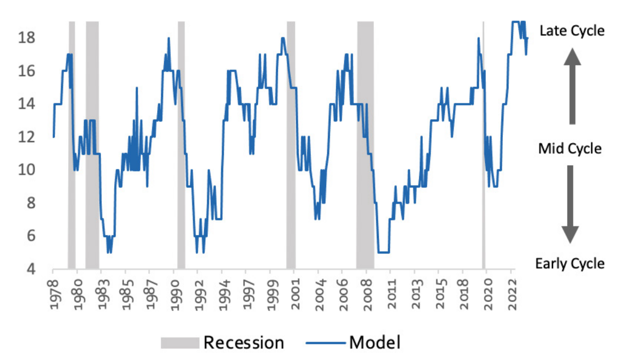
Source: Bloomberg. 20 years of quarterly data through Mar 2024

Core Inflation Q/Q Annualized



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

Stage of the Economic Cycle Model



Source: Bloomberg. 46 years of monthly data through May 2024; Model based on: Manufacturing Purchasing Manager Index, Treasury yield spreads, Consumer Confidence Indexes, and Conference Board business cycle indicators.

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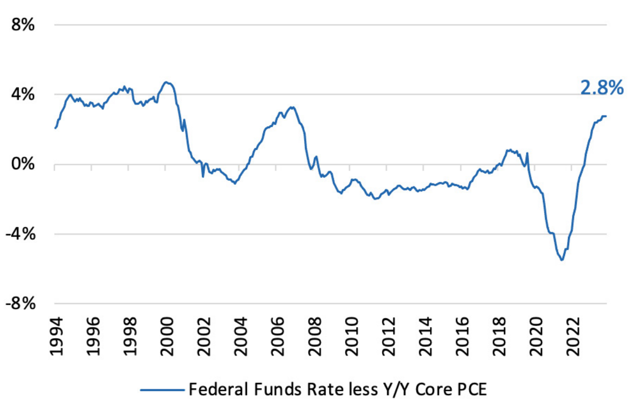
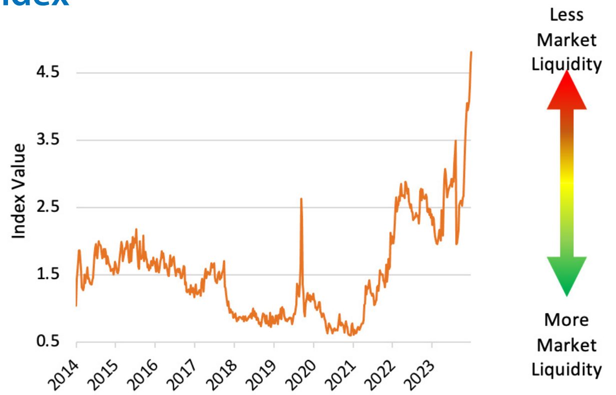
- The bond market spent the first half of this year unwinding unreasonable expectations around the number of Fed rate cuts in 2024. Lately there has been uncertainty whether the Fed cuts once or twice this year. The Fed says once. Expectations for two cuts this year are growing, and bond yields have moved down modestly as a result.
- We continue to believe that moderating inflation will allow the Fed to ease by year end. This is why we currently have a minimal cash weight, which pushes out our duration. Yet there are plenty of reasons to believe that this result won't translate into meaningful declines in bonds yields across the entire yield curve. For example, the labor market remains resilient supporting growth and has the potential to keep yields higher.
- Another factor to consider is that continued fiscal stimulus has driven Federal deficit estimates higher, while the Treasury note auctions grow. It isn't a stretch to think that the term premium could creep higher under these conditions.
- The issue won't go away anytime soon, as in 2025 the debt ceiling must be raised yet again, and expiring tax cuts must be addressed. Depending on how Congress addresses these issues investors could well demand a premium to justify taking on more Treasuries.
- For us it is enough that starting bond yields remain attractive and offer better "coupon" clipping return for now. As a result, we remain constructive on fixed income and fully invested. However, we intend to be vigilant in the second half as we determine whether the dynamics driving potential volatility pick up, requiring us to pull in or push out our horns.

Real Federal Funds Rate



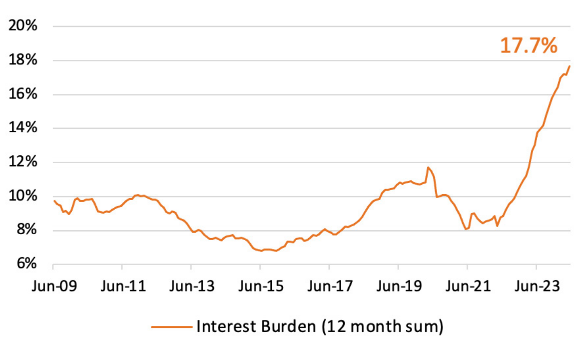
Source: Bloomberg. 30 years of monthly data through May 2024

U.S. Government Securities Liquidity Index



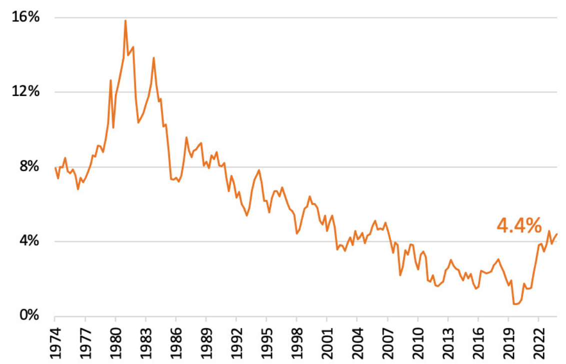
Source: Bloomberg. 10 years of weekly data through Jun 30 2024. The Liquidity Index as calculated by Bloomberg measures prevailing liquidity conditions in the U.S. Treasury market based on intra-day yield dislocations from fair value.

U.S. Budget Interest Expense/Total Revenues



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

10 Year U.S. Treasury Yield



Source: Bloomberg. 50 years of quarterly data through Jun 2024

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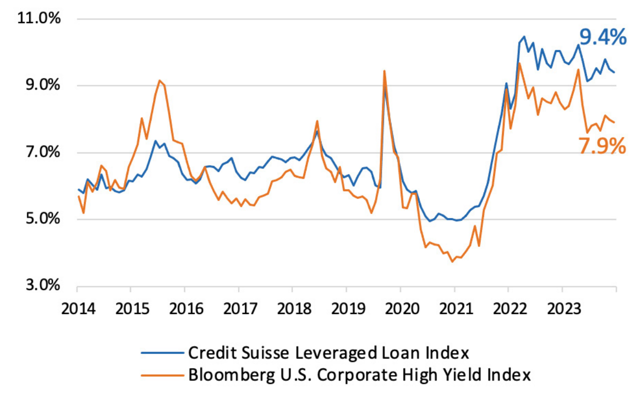
JULY | 2024

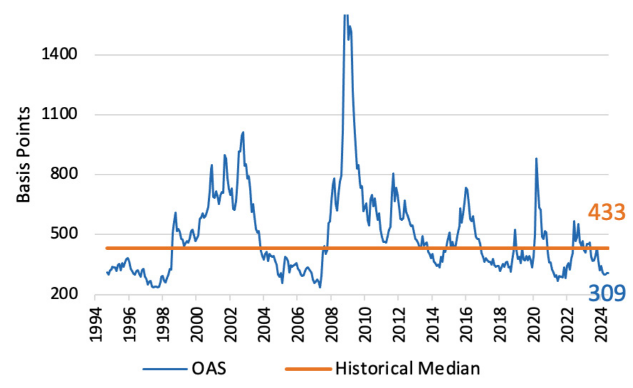
- Credit sensitive sectors posted positive returns last month, with higher quality investment grade corporates and securitized credit leading the way. Higher quality high yield credit posted positive returns as well.
- Our credit risk narrative remains unchanged. Absolute yields across credit sectors remain attractive, near the upper end of their 10-year ranges, while higher coupons from new issue bonds slowly close the gap between market yields and the average coupon rate. This sets up the potential for returns from both rising interest income and rising prices as bonds pull to par. Add the effect of compounding and we see the potential for good returns.
- Credit spreads look to be bottoming out, just above their 10-year lows, but well below their median levels over the same period. Investor objections continue to focus on the potential for spreads to widen, leading to losses.
- Yet, in our view, the macro environment doesn't support this concern for now. Corporate fundamentals remain strong with defaults contained. Slowing GDP growth is a threat, but could be offset by pre-emptive Fed easing, even if modest.
- We see the potential for today's higher yields to offset modestly wider spreads. Recent returns reflect this dynamic. Active risk management via bottom-up security selection will be key as we expect volatility may pick up in the second half.
- We intend to hold our neutral positioning for now given current conditions, as we await clarity around a soft landing and Fed policy to emerge later this year.

Non Investment Grade Yields



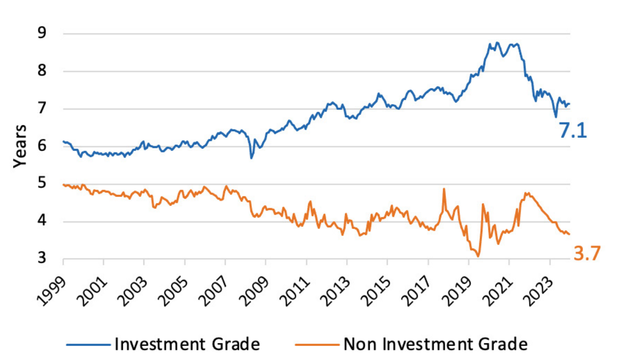
Source: Bloomberg. 10 years of monthly data through Jun 2024

Bloomberg U.S. Corporate High Yield Index Valuation



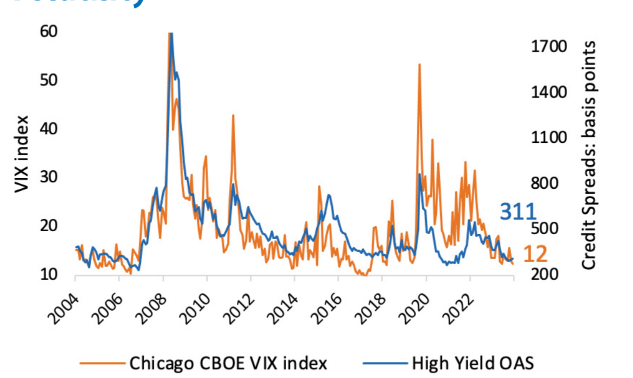
Source: Bloomberg. 30 years of monthly data through Jun 2024. Last observation percentile 14%

Bloomberg U.S. Corporate Bond Index Duration



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

Credit Spread versus Implied Stock Volatility



Source: Bloomberg. 20 years of monthly data through Jun 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

	June 2024	YTD	2023	2022	2021	Duration years
Bloomberg Long Term Treasury	1.7%	-5.0%	3.1%	-29.3%	-4.6%	15.3
Bloomberg U.S. TIPS	0.8%	0.7%	3.9%	-11.8%	6.0%	6.6
Bloomberg U.S. Aggregate	0.9%	-0.7%	5.5%	-13.0%	-1.5%	6.2
Bloomberg U.S. Agg Corporate	0.6%	-0.5%	8.5%	-15.8%	-1.0%	7.1
Bloomberg U.S. Agg ABS	0.7%	1.7%	5.5%	-4.3%	-0.3%	2.7
Bloomberg U.S. Agg MBS	1.2%	-1.0%	5.0%	-11.8%	-1.0%	5.8
Bloomberg U.S. Agg CMBS	0.9%	1.5%	5.4%	-10.9%	-1.2%	4.2
Bloomberg Municipal Bond	1.5%	-0.4%	6.4%	-8.5%	1.5%	6.1
Bloomberg 1-3 year Corporate	0.5%	1.9%	5.5%	-3.3%	-0.1%	1.9
ICE BofA Listed Preferreds	-0.5%	4.2%	9.8%	-18.1%	7.7%	NA
Bloomberg High Yield	0.9%	2.6%	13.4%	-11.2%	5.3%	3.7
Credit Suisse Leveraged Loan (discount margin)	0.3%	4.4%	13.0%	-1.1%	5.4%	NA
Bloomberg Global Agg	0.1%	-3.2%	5.7%	-16.2%	-4.7%	6.6
Bloomberg Emerging Markets USD	0.6%	2.2%	9.1%	-15.3%	-1.7%	6.3

Yields

			Last 10 years			
	June 2024	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.4%	52	97	2.3%	0.5%	5.0%
2 year Treasury	4.8%	50	94	1.3%	0.1%	5.2%
10 year TIPS	2.1%	40	98	0.4%	-1.2%	2.5%
Bloomberg U.S. Aggregate	5.0%	47	95	2.5%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.5%	42	93	3.3%	1.7%	6.4%
Bloomberg U.S. Agg ABS	5.3%	36	92	1.9%	0.4%	6.0%
Bloomberg U.S. Agg MBS	5.2%	54	96	2.8%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	5.5%	21	92	2.7%	1.4%	6.6%
Bloomberg Municipal Bond	3.7%	50	95	2.2%	0.9%	4.5%
Bloomberg 1-3 year Corporate	5.4%	33	92	2.1%	0.5%	6.2%
Bloomberg High Yield	7.9%	31	78	6.3%	3.5%	11.7%
Credit Suisse Leveraged Loan (discount margin)	9.4%	28	86	5.3%	3.6%	13.1%
Bloomberg Global Agg	3.9%	39	95	1.7%	0.8%	4.4%
Bloomberg Emerging Markets USD	7.2%	13	85	5.2%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	June 2024	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	93	-5	13	120	80	373
Bloomberg 1-3 year Corporate	60	-8	40	66	31	390
Bloomberg U.S. Agg ABS	56	-12	57	53	22	325
Bloomberg U.S. Agg MBS	48	1	78	32	7	132
Bloomberg U.S. Agg CMBS	97	-29	62	96	62	275
Bloomberg High Yield	311	-12	11	391	262	1100
Credit Suisse Leveraged Loan (discount margin)	507	-21	53	502	379	1275
Bloomberg Emerging Markets USD	266	-32	13	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.***

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