TCW

1Q 2024: Fore!

1Q 2024: Higher Rates Are Starting to Bite

- Although the unemployment rate at 3.9% remains low in an absolute sense, it is up 0.5% from the cycle low of 3.4% seen early in 2023. That puts us very close to a turning point in the cycle and an indicator of the impending start of a recession based on the Sahm Rule, which signals the onset of a recession when the 3 month moving average of the unemployment rate rises by 0.5% or more from the low over the previous 12 months.

- While the above rule applies at the national level it is also possible to look at the same data by state. When broken down that way, 20 states show unemployment at least 0.5% above the lows of last year, a distribution that looks significantly worse than the same data just before the Great Financial Crisis. While it's important to note this isn't a forecast, and state data doesn't necessarily imply national weakness, at the very least, it demonstrates vulnerability in different parts of the country.

- In addition to the unemployment data, other labor market indicators are also showing signs of weakness. Job openings, the quits rate, average hours worked, and job finding probabilities are all off meaningfully from their peaks of the cycle. Further, the anecdotal evidence all skews negative with multiple headlines of layoffs or reduced hiring across a wide range of industries.

- Finally, the number of temporary workers has fallen almost 14%, from nearly 3.2 million workers at the peak in early 2022 to less than 2.8 million workers today. Large moves in the number of temporary workers have historically been well correlated with the unemployment rate, suggesting that the unemployment rate is likely to increase going forward.

Our View: There are clear signs the labor market is softening, and the pace of that weakening looks to be increasing. We believe these are the necessary conditions leading to an increase in the unemployment rate, and ultimately to a recession. We expect to see clear evidence of that pending slowdown in the broader economic data within the next couple of quarters as still high rates continue to put the brakes on economic activity.

1Q 2024: Inflation Is On A Consistent Path Lower

- Pundits are quick to point to the strength in the labor market as an important support for the soft landing narrative. However, the relatively modest rise in unemployment thus far is consistent with historical experience. In the cycles since the 1970s, unemployment is typically fairly flat for the first 18-24 months following a yield curve inversion, but then rises materially from there.

- A substantial increase in the unemployment rate and the associated declines in consumer spending and aggregate demand would be inherently disinflationary. But, even without the negative impacts of a slowing economy, inflation is expected to trend lower simply due to the impact of falling rents on the calculation of inflation. With rents accounting for roughly 30% of headline CPI and almost 40% of core CPI, rapidly falling rents will drag reported inflation lower.

- Though the trend in inflation has been consistently lower, early year data saw surprising bumps in the series with reported CPI inflation at 0.3% and 0.4% for January and February, with PCE numbers also elevated in January, but much closer to trend in February. January data in particular is susceptible to revision and is often initially reported high in initial estimates due to persistent challenges in the seasonal adjustment factors around the holidays.

- With the noise in the inflation data, markets backed off expectations for the number of Fed eases this year, bringing the futures market very close to the expectations reported by the Fed in their regular dot plots. Both markets have coalesced around a June start to the easings and then 2-3 25 basis point cuts for the balance of this year, with another 3-4 cuts in 2025.

Our View: While we agree with markets that a first cut in June is the most likely (though certainly not guaranteed) outcome, we expect the Fed will end up easing much more aggressively than is currently priced in. Historically, the Fed cuts rates 2-4 times faster than they hike, and we anticipate this time to be similar as the Fed is forced to lower rates to support the economy, shore up markets, and inject liquidity into the system.

1Q 2024: Consumer Stress Materially Higher

- 2023 saw consumer stress as measured by credit card, auto, and other lending delinquency rates, move meaningfully higher, especially among lower income borrowers. Those rates remain substantially above pre-COVID levels and more recent data suggests the stress is spreading to higher FICO borrowers as well, with lower absolute delinquencies, but a more rapid pace of deterioration in those higher income cohorts.

- While the data suggests overall delinquency rates have mostly stabilized, it doesn't appear to be due to fewer borrowers missing payments, but rather, to more aggressive chargeoffs by lenders. Chargeoff rates have nearly doubled from the 6-8% range pre-COVID to 10-14% today. These borrowers are no longer delinquent, as their debt is expunged from the books, but their credit is likely impaired and future spending more limited.

- Also tellingly, recovery rates across consumer loan categories for loans that have been written off have also declined. Pre-COVID recovery rates were typically in the low to mid-teens on a percentage basis, and have fallen to the single digits in 2024. Lower recovery rates imply higher levels of debt and less cash to support that debt, reinforcing the narrative of stretched consumers.

- Additional signs of stress can be seen in declining savings rates and record high credit card usage as overextended consumers struggle with high prices. It should also be noted that even though inflation has been falling, it doesn't mean that overall prices are actually dropping, only that they are rising less quickly, with the burden on consumers still high.

Our View: Depleted savings, a weakening job market, the expiration of government transfer payments, and the recent renewal in student loan payment obligations present meaningful challenges to consumers, especially those in the lower income brackets. We anticipate that the stress that is clearly evident in these lower cohorts will continue to extend into the middle and perhaps even upper income brackets, particularly if the slowdown intensifies.

1Q 2024: Credit Market Valuations Are Increasingly Aggressive

- Credit spreads narrowed consistently in the first quarter, ending the period at 85 bps, only 8 bps above the post-GFC tights of 76 bps seen in 2021. Long dated issues were especially impacted in January, with the difference between the long credit index and the credit index tightening to just 16 bps, before easing somewhat into the end of the quarter to end at a still very low 21 bps.

- Struggles in the regional banking system continued in the 1st quarter with New York Community Bancorp (NYCB) in the headlines for excessive exposure to commercial and multifamily loans at a time when commercial real estate remains challenged and multifamily buildings are also showing signs of weakness. While markets have treated NYCB's issues as idiosyncratic, regional banks generally have higher allocations to commercial real estate, with negative ramifications should stress in that sector intensify.

- High yield and loan spreads also tightened significantly in the first quarter, with both sectors posting positive excess returns. However, fundamental stress remains evident, especially in the loan sector, which has felt the impact of higher rates much more quickly given the primarily floating rate nature of the debt.

- Elevated default rates in the loan sector have been magnified by increasingly frequent distressed exchanges, which have similar economic consequences as default for end investors. At the same time, recovery rates have fallen precipitously as weaker loan covenants offer investors less protection from aggressive borrowers.

Our View: Credit spreads at these levels provide scant compensation for risk, especially in a slowing economy with any potential further tightening likely to be limited. Banks generally, and regional banks in particular, are susceptible to volatility with the potential for CRE challenges to push spreads wider. Finally, we expect that recent management versus lender violence in the leveraged loan market will continue as increasingly aggressive borrowers and sponsors extract maximum value from investors by exploiting permissive covenants.

1Q 2024: Securitized Sectors Are A Mixed Bag

- With mortgage rates still high, the supply of new agency mortgages has plummeted, which has been balanced by similarly tepid demand for the asset class over the last couple years. Though the Fed is unlikely to return soon as a large investor, there are signs that both overseas investors and banks, two of the other stalwart sources of demand over time, have started to increase allocations or are expected to add more exposure this year, a likely necessary requirement for meaningfully tighter spreads.

- Non-agency MBS performed well in the first quarter, with longer dated/lower rated tranches posting the best relative performance. Pricing continues to be buoyed by resilient home prices, greater confidence in the soft landing scenario, and investors' thirst for yield, all factors driving elevated demand for more subordinated exposures offering higher spreads, even if at greater risk.

- Consumer delinquencies have begun to move up the credit spectrum, with even high-FICO borrowers seeing higher levels of stress across ABS collateral types. Marketplace lending outcomes provide the clearest picture, with delinquencies moving well above pre-COVID levels across all FICO cohorts. While lower income consumers have much higher absolute levels of delinquencies, the rate of increase is higher for more affluent borrowers, a worrying trend for investors.

- CMBS remains a sector in transition. Ongoing declines in office property valuations and growing stress in the multifamily sector suggest negative headlines for the foreseeable future. CMBS special servicers, who deal with properties in distress, remains critical to favorable investor outcomes and with the rise in defaults and foreclosures, the role has taken on increased prominence.

Our View: Agency MBS remains one of the most attractive sectors in fixed income today, offering high quality, liquid exposures at favorable spreads relative to corporate credit or other sectors. Similarly, certain parts of the non-agency MBS market like legacy, pre-GFC collateral continues to provide compelling return opportunities albeit with less liquidity. Much of the CMBS market remains too optimistic about potential outcomes, while select, trophy properties in certain areas are likely to provide solid downside protection.

1Q 2024 Core and Core Plus Fixed Income Positioning Summary

We remain cautious overall given the likelihood of recession and the potential for higher volatility, but that caution is tempered by longer than index duration and higher quality security exposures which should provide ballast in a risk-off scenario. As always, we will look to capitalize on opportunities created by a slowing economy and stressed markets.

Characteristic	**Positioning**	**Comments**
Duration	Approximately 0.7 years long versus the benchmark	Rates are still restrictive and above fair value, especially in a slowing economy with inflation falling steadily
Curve	Expectations for a steeper curve	Overweight to the 2-Year and 5-Year part of the curve given expectations that the Fed will overshoot and have to ease aggressively to support the economy
Governments	Small underweight, with an emphasis on on-the-run securities	On-the-run Treasury securities provide much greater liquidity
MBS	• Agency MBS – large overweight • Non-Agency MBS – maintained allocation, with bias to add further	• Preference for agency MBS TBAs given attractive spread levels and strong liquidity • Favor lower coupon (<3.5%) issues given price upside and middle coupon (4%-4.5%) given attractive spreads and better convexity profile than current coupons • Maintain emphasis on high quality legacy non-agency MBS bonds as well as new issues, especially those backed by legacy collateral
ABS	Small Overweight	• Prefer AAA and AA rated CLOs due to better liquidity, robust structures, and attractive spreads • Reduce senior FFELP student loan ABS, with a preference for higher yielding subordinates
CMBS	Small Overweight	Cautious overall with an emphasis on super senior single asset single borrower non-agency CMBS holdings
Investment Grade Credit	Large Underweight	• Positioning remains concentrated in high conviction names and defensive sectors like communications, healthcare, and consumer non-cyclicals • Underweight banks given potential for spread widening in a recession • Minimal exposure to cyclical credit sectors and non-corporate credit
High Yield	Small allocation	Emphasize defensive credits and select, high conviction idiosyncratic issuers
International	Small allocation	• Trim select Euro denominated corporate issuers given spread tightening relative to US markets • Slowing growth presents challenges for EM issuers

Portfolio characteristics and holdings are subject to change at any time. Past performance is no guarantee of future results. The views and forecasts expressed in this quarterly review are as of March 31, 2024, are subject to change without notice and may not come to pass. TCW reserves the right to change its investment perspective and outlook without notice as market conditions dictate. Source: Bloomberg, TCW

Fixed income investments entail interest rate risk, the risk of issuer default, issuer credit risk, and price volatility risk. Strategies investing in bonds can lose their value as interest rates rise and an investor can lose principal. Mortgage-backed and other asset-backed securities often involve risks that are different from or more acute than risks associated with other types of debt instruments. MBS related to floating rate loans may exhibit greater price volatility than a fixed rate obligation of similar credit quality. With respect to non-agency MBS, there are no direct or indirect government or agency guarantees of payments in pools created by non-governmental issuers. Non-agency MBS are also not subject to the same underwriting requirements for the underlying mortgages that are applicable to those mortgage-related securities that have a government or government-sponsored entity guarantee. The strategy's investments denominated in foreign currencies will decline in value if the foreign currency declines in value relative to the U.S. dollar. The securities markets of emerging market countries can be extremely volatile. Securities prices and returns will fluctuate with market conditions, currencies and the economic and political climates where the investments are made.

NOTICE TO PROSPECTIVE INVESTORS WHO INVEST THROUGH INTERMEDIARIES

Certain unaffiliated intermediaries, including, but not limited to, registered investment advisers, broker-dealers, banks, and consultants (each, a "Firm"), may offer/recommend private funds or strategies sponsored by The TCW Group, Inc. and its affiliates ("TCW" and together with the private funds and strategies, the "TCW Accounts") to Firm clients. The Firm does not receive any compensation from TCW if a client invests in the TCW Account. However, the client may pay the Firm a fee (e.g., advisory fee, consultancy fee, due diligence fee, etc.) and indirectly pays TCW a management fee through the investment in the TCW Account. As a result of this arrangement, a conflict of interest may exist in that the Firm may have an incentive to endorse and make positive statements about TCW. The Firm, its clients or personnel may be or have been invested in vehicles managed, advised, or sponsored by TCW, and the Firm, its clients or personnel or affiliates potentially may invest in such vehicles in the future.

NOTICE TO PROSPECTIVE INVESTORS WHO INVEST THROUGH A WRAP FEE OR OTHER PLATFORM

Certain unaffiliated firms that sponsor a wrap fee program or other platform (each, a "Sponsor") may include private funds or strategies offered by The TCW Group, Inc. and its affiliates ("TCW" and together with the private funds and strategies, the "TCW Accounts"). The Sponsor charges TCW an administrative or service fee to make a TCW Account accessible to the Sponsor's clients through the program or platform. The Sponsor may also pay the management fee charged by the TCW Account on behalf of the Sponsor's clients. As a result of these arrangements, a conflict of interest exists in that the Sponsor may have an incentive to endorse or recommend a particular TCW Account to its clients rather than other products accessible on the program or platform. The Sponsor, its clients or personnel may be or have been invested in vehicles managed, advised, or offered by TCW, and the Sponsor, its clients or personnel or affiliates potentially may invest in such vehicles in the future.

All information is as of the date of this presentation unless otherwise indicated.

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. Any issuers or securities noted in this document are provided as illustrations or examples only, for the limited purpose of analyzing general market or economic conditions and may not form the basis for an investment decision, nor are they intended to serve as investment advice. Any such issuers or securities are under periodic review by the portfolio management group and are subject to change without notice. TCW makes no representation as to whether any security or issuer mentioned in this document is now in any TCW portfolio. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which are subject to change without notice. Any information and statistical data contained herein derived from third party sources are believed to be reliable, but TCW does not represent that they are accurate, and they should not be relied on as such or be the basis for an investment decision.

An investment in the strategy described herein has risks, including the risk of losing some or all of the invested capital. An investor should carefully consider the risks and suitability of an investment strategy based on their own investment objectives and financial position. There is no assurance that the investment objectives and/or trends will come to pass or be maintained. The information contained herein may include preliminary information and/or “forward-looking statements.” Due to numerous factors, actual events may differ substantially from those presented herein. TCW assumes no duty to update any forward-looking statements or opinions in this document. This material comprises the assets under management of The TCW Group, Inc. and its subsidiaries, including TCW Investment Management Company LLC, TCW Asset Management Company LLC, and Metropolitan West Asset Management, LLC. Any opinions expressed herein are current only as of the time made and are subject to change without notice. The investment processes described herein are illustrative only and are subject to change. Past performance is no guarantee of future results. © 2024 TCW