TCW

2Q 2021 Market Review – Fed's Largess Decouples Markets from the Economy

- In seeking to achieve its dual mandate of full employment and stable inflation, the Federal Reserve has flooded the market with liquidity and pushed asset prices far beyond where a recovering economy would normally suggest. Capital markets look late-cycle given aggressive underwriting, tight spreads, and increased speculation. All the while, the economy, bolstered by stimulus, with high unemployment and rapid growth, looks early cycle. Regardless of which scenario prevails, history suggests that with equities at all-time highs and credit spreads at all-time tights, prospective returns in credit markets are not especially compensatory and elevated valuations provide little margin for error for any downside risks that may occur. Additionally, the risk of higher inflation and higher rates, combined with the prospective decline in the level of fiscal stimulus should create bouts of volatility and may increase the odds of slipping back into recession.

TCW

2Q 2021 Market Review - Markets Mull "Transitory" Inflation Risks

- Over the past several months, as vaccine deployment has ramped up and economic reopening expanded, concerns about inflation monopolized headlines. While this translated into sharply higher interest rates in the first quarter, over the last several months the reflation trade appeared to stall as markets seemingly bought into the Fed's narrative that higher recent inflation is transitory. As such, this scenario along with the assumption of a rosy economic outlook is fully reflected in market pricing.

- Inflationary pressures did manifest in a significant surprise to the high side for the Consumer Price Index (CPI), which jumped in both April and May nearly 5.0% (year-over-year), the highest level since 2008. Despite this, the 10-Year Treasury rallied from a peak of 1.7% in March to as low as 1.4% and Treasury breakeven inflation rates continued to price prospects of near-term inflation at higher levels than longer-term inflation, evidence that the market is accepting of the transitory thesis.

- A narrowed trading range of Treasury rates resulted in settled levels of market volatility. The Cboe Volatility Index (VIX) dropped to 15.5, the lowest since February 2020, compared with a surge above 80 in March 2020. At the same time, the ICE Bank of America MOVE Index, which measures volatility in the Treasury market, has fallen nearly 20% since March's peak in 2021 rate levels.

- Risk assets were undeterred by signs of inflation, with equity indices hitting new highs. The S&P 500 has gained over 14% so far this year. Across credit markets, demand continues to drive spreads to historically low levels, despite record levels of issuance and increased signs of late-cycle behaviors, such as share-buyback activity and weakening underwriting standards.

Our View: For the moment, evidence (softening commodity prices and contained inflation expectations) suggests that the transitory narrative is correct. In the TCW view, base effects will roll off and supply pressures will likely ease over the next few months as some disinflationary forces remain in play likely keeping inflation risks contained in the near to intermediate term. However, there remain potential drivers to upward price pressure, with a possibility for temporary inflation to become more permanent, particularly if the labor force is slow to normalize and inflation expectations become unanchored.

TCW

2Q 2021 Fed Policy Review - Improved Outlook with Long-Term Inflation on Target

- At the June Federal Open Market Committee (FOMC) meeting, the Fed maintained an accommodative policy stance, leaving rates and the pace of bond buying unchanged. However, revised interest rate projections were more hawkish, i.e., higher, than markets anticipated. The median policy rate, or “dot plot”, forecast two rate hikes by end-2023, a faster than anticipated pace of tightening due to upgraded estimates for growth and inflation. However, the outlook for inflation in 2023 remains unchanged at 2.1%.

- Despite the surprise on the Committee’s rate hike projections, hikes are typically preceded by a tapering of asset purchases. On this point, Federal Reserve Chair Powell did not suggest any pull-forward in the timeline for tapering, noting instead that in June the Fed “talked about talking about tapering” (i.e., beginning the conversation among Committee members).

- Following the meeting, Chair Powell emphasized that the dots should be taken with "a big grain of salt" as they were highly uncertain individual projections, not an FOMC commitment. Market moves following the meeting saw a flattening of the Treasury curve, as short-term rates rose and longer maturities fell, unwinding the 5- and 30-Year Treasury curve steepening witnessed earlier this year. In addition, the dollar strengthened modestly, and equity markets were down on the day, though market moves largely retraced by quarter-end.

- Outside of the post-FOMC market moves, financial conditions remained remarkably, if not exceptionally, accommodative. According to the Goldman Sachs Financial Conditions Index (FCI), which factors in current interest rates, the dollar, credit spreads, and equity prices, current financial conditions are close to the easiest they have been on record.

Our View: While the Fed’s assessment of the economy is better, there remains tremendous uncertainty ahead, particularly as fiscal stimulus is set to expire this summer. Risk assets priced to perfection are vulnerable to a faster liftoff than expected by the Fed, while a patient Fed that stays on the sidelines too long risks higher inflation and more drastic rate hikes down the road. Both circumstances create challenges for markets. Having concluded they hiked too early during the last cycle, along with their confidence in being able to deal with higher inflation, the Fed will likely err on the side of being too late to hike rather than too early.

2Q 2021 Economic Review - Stimulus Driven Recovery Continues

- As business restrictions lift and social activity increases, the U.S. economic recovery is gathering strength. The Fed raised its projections for economic growth, anticipating a 7% expansion this year, a number that is consistent with market forecasts, but is largely dependent on stimulus effects, which peaks this quarter. With stimulus money spent, fiscal policy is set to contract in the latter half of the year, with long-run growth declining to roughly 2%.

- Labor market conditions improved over the quarter, though the slow pace underscored the ongoing challenges. While recent non-farm payrolls increased by 559,000, this was below expectations, and a decline in the unemployment rate to 5.8% was overshadowed by a largely unchanged participation rate of 61%. Importantly, there remains a long recovery ahead; as 7.6 million jobs have been lost versus pre-pandemic levels and nearly 16 million people are still collecting unemployment benefits.

- Retail sales declined in May by 1.3%. Core retail sales, which excludes automobiles, gas, building materials and food services and corresponds most closely with the consumer spending component of GDP, dropped 1.5%. This decline suggests that as the economy re-opens, some of the pandemic-related spending on goods will begin to moderate.

- However, the retail sales numbers do not reflect broader measures of consumer spending on services, which saw a steady recovery as the economy opened further. The ISM Services PMI rose to a record high of 64 in May from 62.7 the month prior as demand for travel, hotel, and restaurants boosted the numbers. Despite elevated price pressures that were evident in the report, order backlogs continued to grow, and delivery times lengthened in a sign of pent-up demand.

Our View: The pandemic delivered an unprecedented shock to the U.S. economy and the recovery has proceeded in fits and starts, and with no historical precedent to draw upon, economic forecasting is particularly difficult. Nevertheless, the data suggest that the biggest price increases have been in those sectors most directly impacted by the shutdown, which have seen a snap back as the economy reopens. There is additional concern that demand for durable goods during the pandemic pulled forward consumption with an expected drop in demand as that impulse wanes. Finally, the impact of government stimulus efforts has been substantial, and the impact on consumer finances and overall demand is uncertain as that stimulus fades in the coming months. All of which implies that asset prices at all-time highs supported by relentlessly optimistic economic outlooks do not fully account for the myriad risks facing the economy today.

2Q 2021 Global Review - An Uneven Recovery Continues

- Even with regional outbreaks of COVID-19 in parts of Asia, Latin America, and the surge of a new variant in the UK, the global recovery is continuing as most major economies have begun the process of reopening. As a result, forecasters expect the global economy to expand by 5.8% this year, with global activity measures and trade improving concurrently and rebounding nearly 25% from March 2020 lows.

- Given the progress on recovery, some economies have started to roll back pandemic-related monetary support. While most major advanced economy central banks have kept a generally dovish stance, the Bank of England reduced bond purchases, as did the Bank of Canada. Several other countries, facing higher inflation, such as Brazil, Russia, South Korea, and Hungary, have either taken steps to hike rates or have turned more hawkish as a precursor to future hikes.

- China's economy remains central to the global recovery and data prints this quarter suggested that activity might be stalling. Export growth in May slowed more than expected, driven by a contraction in COVID-related goods exports. In addition, credit growth declined into negative territory, potentially sapping Chinese demand for commodities and further infrastructure development, most of which is financed.

- Recent data suggests that despite the improving outlook, it will take a while for jobs and living standards to return to pre-crisis levels. According to the International Labor Organization, global labor income was 8% lower and nearly 144 million jobs were lost due to the pandemic. The global jobs shortfall in 2022 is still estimated at 23 million jobs, even with the pace of the current global recovery.

Our View: The global economy continues to improve, yet unevenly, driven by progress in vaccination, control over outbreaks, and the extent of policy support. There is heightened uncertainty around the outlook, with mounting downside risks if growth slows in the U.S. or China later this year. Engineering a smooth exit from policy support or shifting to a more hawkish policy stance in the face of rising inflation poses a significant challenge for policy makers but may open opportunities for investors.

2Q 2021 Corporate Credit Review - No Margin for Error

- Continued fiscal and monetary support coupled with confidence in the economic recovery drove credit spreads to a post-Global Financial Crisis record low of 77 basis points over Treasuries. At the same time, the Credit Bond Index (CBI) has become incrementally riskier over the years given deteriorating quality, a lower average yield, higher levels of leverage, and longer duration. Adjusting for those changes in the Index composition suggests that today's credit spreads represent all-time lows in the level of compensation for credit risk.

- Stimulus measures helped propel a rebound in corporate earnings, as the S&P 500 constituents posted a weighted average earnings per share growth of 50% this quarter. Largely due to this improvement in earnings, investment grade corporate issuers saw a reduction in gross leverage to 2.5X, from a peak of 3.0X last year. Over 68% of investment grade companies saw an improvement in this metric, though leverage remains elevated compared to pre-pandemic levels.

- While key credit measures have continued to recover from pandemic lows, debt growth remains conspicuously positive, a unique characteristic of this recession, as corporates typically actively delever their balance sheets during the early stages of a credit cycle. Instead, corporate debt outstanding recently topped $11 trillion (~1/2 of U.S. GDP), the highest on record, and companies have used proceeds to engage in M&A activity and share buybacks, which is more suggestive of emerging late cycle vulnerabilities.

- A full recovery is also reflected in the price of bonds in the high yield market. Spread levels fell through cycle lows to 278 basis points, and average yields fell to another all-time low of 3.7%. The search for yield has sustained an unprecedented pace of issuance of nearly $50 billion per month and has helped drive down the number of bonds trading at distressed levels, with just 14 CUSIPs trading below $70. Sustained investor demand has also forestalled any fallen angels from investment grade to high yield this year.

Our View: Current market spreads reflect a goldilocks scenario of strong growth, contained inflation, and rising earnings. Yet debt has grown to record levels and the list of risks is mounting: faster-than-expected inflation, higher rates, lower growth, and a slower recovery. In the unlikely event the Goldilocks scenario plays out, the scope for further spread tightening is limited, reducing the potential upside to credit, while any of the numerous risks could lead to substantially wider spreads and poor performance. Given that range of outcomes, there tends to be a scarcity, though not an absence, of value in credit overall. Nevertheless, a recognition of strong technical factors and a reliance on solid credit underwriting and idiosyncratic opportunities will inform positioning in the space.

2Q 2021 Securitized Review - A Broad-Based Recovery from Pandemic Lows

- Rising disposable income from stimulus payments, a favorable rate environment, and a surge in pandemic-driven demand paved the way for the current boom in housing. Home prices in April increased by 13% year-over-year, the highest annual gain in 15 years. The combination of housing tailwinds and a rebounding economic environment supported mortgage credit spreads, which tightened across non-agency MBS.

- Notwithstanding the broader improvement in the macro environment and robust demand from banks and continued Fed purchases, agency MBS struggled this quarter as prepayment speeds rose unexpectedly by over 12% in April, with higher coupon mortgages bearing the brunt of prepayments. This contributed largely to the sector's underperformance, as agency MBS trailed Treasuries by over 60 bps on a duration-adjusted basis.

- CMBS continued improving with the 30+ day delinquency rate falling to 6.5%, as the hardest-hit sectors of retail and hotel benefited from reopening. With the worst-case scenario of the pandemic behind us in the U.S., default and loss assumptions are being revised lower. However, CMBS losses still vary meaningfully across bull, base, and bear scenarios, highlighting the idiosyncratic nature of CMBS credits.

- Meanwhile, consumer ABS has benefitted from record low levels of delinquency as sizeable stimulus continues to support consumers. Credit card debt declined nearly 20% this year, as consumers used stimulus checks to pay down debt, while auto delinquencies fell to pre-pandemic levels, even after accounting for pandemic-related extensions.

Our View: Across securitized products, technical factors have driven spreads tighter and opportunities for attractive value remain scarce. Despite recent improvements, we expect more delinquent CMBS loans to emerge as appraisals are revised lower. For the moment, TBA exposure in the agency MBS market still provides attractive carry given ongoing Fed support, as does legacy non-agency MBS given high quality cash flows and better relative value. Further, despite the run-up in home prices, mortgage underwriting has remained solid with none of the aggressive affordability products like negative amortization loans, ultra-low teaser rates, no documentation loans, etc. seen in 2006 and 2007. As a result, the overall leverage in the housing market is much lower than it was pre-financial crisis and the risk of a wholesale collapse in home prices akin to what was experienced in 2008 and 2009 is also much lower, making well-structured non-agency MBS more compelling.

2Q 2021 Core and Core Plus Fixed Income Positioning Summary

Defensive positioning overall given historically tight spreads and abundant risks, while an ample level of liquidity is maintained to respond to potential volatility.

Characteristic	Positioning	Comments
Duration	Ended the quarter approximately 0.5 years short versus the benchmark	• Remain shorter than the Index with yields still relatively low
Curve	Underweight intermediate and longer maturities	• The curve is likely to steepen as the Fed anchors short-intermediate rates for the foreseeable future, while longer rates drift higher on increased Treasury funding needs and potential longer term inflation risks
Governments	Neutral with an emphasis on on-the-run securities	• On-the-run Treasury securities provide much greater liquidity • No exposure in TIPS given relatively wide breakeven inflation rates
MBS	• Agency MBS – overweight • Non-Agency MBS – maintain allocation, with bias to add on pricing dislocations	• Preference for current coupon agency MBS TBAs which remain attractive given relatively high carry of TBAs versus specified pools • Maintain emphasis on higher quality, shorter duration, currently amortizing non-agency MBS bonds • Look to add exposure in heavily discounted senior legacy non-agency MBS bonds with solid fundamentals
ABS	Small overweight	• Prefer AAA CLOs given better liquidity, robust structures and reasonable spreads • Maintain modest position in select FFELP student loan ABS
CMBS	Neutral	• Emphasis on non-agency CMBS holdings, in particular super senior single asset single borrower deals, but beginning to look down the capital structure for opportunities
Investment Grade Credit	Underweight	• Remain underweight given historically low yield premiums • Positioning remains concentrated in high conviction names, intermediate banks, and defensive sectors like communications and non-cyclicals, particularly healthcare • 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 with a bias to add high quality names on weakness	• An uneven pandemic recovery is likely to create more attractive entry points in the future for higher quality 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 June 30, 2021, 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

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.