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TCW Talking Points

FIRST QUARTER 2025

TCW Fixed Income

1Q 2025: New Year, New Administration, New Uncertainties

- The new presidential administration came in with an ambitious agenda and prior experience, hitting the ground running with a slew of executive orders, a list of structural changes to implement, and a clear desire to upend the status quo. In laying the groundwork for such changes, President Trump and other key cabinet members cited the possibility that short term pain may be necessary to achieve longer term goals, including a “detox period” as markets are weaned off massive deficit spending and trade policies are revamped.

- To that end, first quarter events and headlines were dominated by tariffs, with significant levies announced against two of the largest U.S. trading partners within weeks of the new administration taking office. These were subsequently walked back after extracting concessions from each country, but went into effect later in the quarter, with talks of reciprocal and further tariffs set to come in April.

- While the prospect of tariffs was widely expected given Trump’s campaign messaging, the lack of clarity around how, when, and the extent to which they would be implemented drove volatility higher as the economic policy uncertainty index jumped to its highest level since the pandemic, while the MOVE Index (a measure of Treasury market volatility) spent almost the entirety of March above 100. Meanwhile, real yields fell nearly 50 bps over the quarter, a reversal from December’s moves when robust growth projections pushed yields higher and supported lofty market valuations.

- In addition to tariffs, the administration emphasized a desire for lower rates, a weaker dollar, and stable unemployment rate. However, the prioritization of these elements appeared to have surprised some investors, which, when combined with heightened uncertainty, weighed on risk assets. Indeed, the revelation that a “Trump put” might be further out of the money than anticipated saw the S&P 500 Index decline over 10% from its mid-February peak and close the quarter in the red for the first time since 2023.

Our View: Market moves over the quarter highlight a key aspect that seemed to have been lost in the market rally immediately following the election results – that sequencing matters. Aspects of the administration’s pro-growth agenda (e.g. lower taxes and de-regulation) are likely to be longer term in nature, requiring time to work through the congressional system, while those things that can be done quickly (trade policy and immigration) are likely to be negative for growth. This drag, combined with expectations for continued volatility given Trump’s tendency to wield that volatility as a negotiating tool, complicates decision making for consumers and business leaders, ultimately hindering near-term growth potential and pressuring an economy already showing signs of slowing.

1Q 2025: Increased Volatility Weighs on Consumer Sentiment and Spending

- Reservations about the current and near-term state of the economy challenged consumer sentiment, with numerous survey-based indicators showing a decline to some of the lowest levels in years. The most prevalent theme across respondents' answers was fear of an uptick in inflation, while concerns of job losses and lower future income potential were also mentioned.

- In a notable departure from one of the most prevalent themes last year, sentiment and spending activity also dipped for those in the highest income decile – a consumer base that had grown to account for nearly half of all consumer activity, according to a February report published by Moody's Analytics. Likely adding to the growing uneasiness experienced by these households was the decline in equity valuations, blunting the impact of the "wealth effect" that supported consumption and sentiment during the equity bull market.

- This pullback in spending was evident in data releases throughout the quarter, with retail sales dropping by 1.2% in January and undercutting consensus expectations in February. Discretionary sectors experienced the largest slowing, though spending across service sectors also decelerated from the fourth quarter's pace. The pullback in outlays also translated to an increased savings rate, which increased from 3.3% in December to 4.6% by quarter-end.

- Meanwhile, the lifting of the student loan repayment moratorium added a further complication to consumer balance sheets, already challenged by rising credit card usage and higher delinquency rates across loan types. With some borrowers unaware of the requirement or unable to make the payments, credit scores were negatively impacted, suggesting additional challenges ahead for credit availability and financing rates, both of which are likely to weigh on economic activity.

Our View: There is clear evidence that consumers are growing increasingly apprehensive about the state of the economy and what it means for household wealth and spending. While this has been overwhelmingly expressed in soft (i.e. survey based) data to this point, shifts in sentiment are the first step towards a shift in behavior, and any downshift in spending behavior, especially among higher income consumers, will have meaningful negative consequences for the economy.

1Q 2025: Labor Market Remains in a Tenuous Position

- Employment at the headline level showed an ongoing softening over the quarter as the closely followed nonfarm payroll print undershot expectations in both January and February, while the final figure for 2024's payroll revisions showed that job gains were overstated by 610k last year. This follows a continued trend in government data, whereby flawed methods of estimating business formations and closures lead to figures that are often revised significantly ex-post.

- Despite this well-documented noise in the print each month, underlying details pointed to a continued weakening of the employment picture. The first quarter saw a drop in the average weekly hours worked, a metric that serves as a proxy for aggregate demand, since a drop in hours leads to lower total paychecks and less cash in workers' pockets, all else equal, leading to reduced future spending.

- Other forward-looking indicators were also weaker as demand for temporary workers moved into negative territory, job openings fell, and the number of people working part time for economic reasons increased. It is taking longer for those that are unemployed to find work, with February seeing a decrease in the total workforce as some discouraged workers gave up the search, falling out of the calculation, implying a higher unemployment rate than the current 4.1% level had they stayed in the workforce.

- Meanwhile, the impact from the Department of Government Efficiency's (DOGE) campaign in federal workforce reduction showed up in government unemployment claim data, a separate series from the weekly jobless claims figure. Though only a few months since its inception, the program has already resulted in a smaller contribution to total monthly job creation from the government sector – a sector that had been responsible for a large share of payroll growth in prior quarters.

Our View: The crosscurrents created by heightened volatility and new government policies have muddied the picture for employers, resulting in a current state of the labor market best characterized as a low hiring, low firing environment. History would suggest that during economic slowdowns, companies stop hiring new workers first, and then eventually resort to layoffs. We are currently experiencing the first phase of that pattern, with the expectation that we will soon see the second phase of the pattern resulting in weaker payroll reports and higher unemployment broadly.

1Q 2025: U.S. Exceptionalism Fades, Global Markets Diverge

- The Federal Open Market Committee (FOMC) elected to keep benchmark rates unchanged at 4.25% to 4.5% during the first quarter, citing heightened uncertainty facing the economy. Comments from both Chair Powell and other Fed officials over the period pointed to a preference for a patient stance as it awaits the net effects from current and prospective changes to global trade, government spending, immigration, and regulation.

- Despite the lack of activity from the Fed, markets repriced future cuts with expectations rising from less than one cut in 2025 to roughly 3 cuts for the balance of the year, with the first one likely to happen in June. Implicit in these estimations is the view that a 4+% Fed Funds rate is still restrictive, and that the U.S. economy is poised to continue slowing as relatively high rates drag on overall economic activity.

- Conversely, both the European Central Bank (ECB) and Bank of England (BoE) lowered policy rates over the quarter given near-term concerns on growth, especially with looming tariffs. In total, the ECB reduced its main interest rate a further 50 bps over the quarter, while the BoE eased 25 bps. Those cuts were offset by a significant overhaul of German defense spending, marked by an exemption allowing for additional defense spending above the 1% of GDP level imposed by the country's debt brake, and a $500bln infrastructure fund. Yields on German bunds rose over 30 bps on the day of the announcement to mark the largest single-day increase since 1990, with spillover effects on yields across Europe as other countries signaled a willingness for increased spending.

- Meanwhile, above-expected inflation in Japan saw the Bank of Japan hike rates in a continuation of diverging global central bank policy actions in recent months. Rates in Japan moved materially higher during the quarter, with the 10-year reaching nearly 1.6%, the highest of this cycle, making the Japanese bond market the worst performer among developed markets for the quarter.

Our View: A Fed Funds rate above 4% is clearly restrictive, and will continue to weigh on economic growth in the U.S. While no one knows where the neutral rate is at any given point, we believe it is closer to 3% than to 4%, implying the Fed will have to cut rates more aggressively than currently anticipated simply to get to a neutral level. If the economy slows more than widely expected, additional cuts will be required to move to an actually accommodative stance.

1Q 2025: Credit Markets Remain Rich Despite First Signs of Weakening

- Credit spreads on the Bloomberg U.S. Investment Grade Credit Index widened 12 bps over the quarter amid the increase in uncertainty and souring of sentiment, though ending spread levels of 89 bps remain well below long-run average levels and are still extremely tight when viewed in a historical context. Regardless, spread widening resulted in underperformance of 76 bps relative to comparable duration Treasuries, though lower yields did help propel the Index to a 2.4% total return.

- Despite the uptick in volatility, spread widening was orderly as the difference between A and BBB-rated bonds only widened 4 bps, while the BBB and BB spread differential moved 25 bps wider. Spread moves between major sectors also moved largely in tandem as the basis between cyclicals and non-cyclicals only widened by 7 bps. Real divergence occurred across regions, however, as outperformance for European credit saw the difference between U.S. and European investment grade corporates fall to just 2 bps after starting 2025 at 30 bps.

- Riskier segments of the credit market were more affected by the shifting economic backdrop as the Bloomberg U.S. High Yield Corporate Index ended the quarter with credit spreads 60 bps wider. CCC rated bonds widened nearly 120 bps to underperform Treasuries by 250 bps, while single- and double-B issues underperformed by 130 and 73 bps, respectively.

- For leveraged loans, the reassessment of U.S. growth potential pushed headline spread levels over 25 bps wider and caused CLO managers to sell longer dated, lower rated issues, or those in tariff-related sectors to defend against macro volatility. Despite the selling, secondary loan prices proved relatively resilient as the average price for loans in the J.P. Morgan Leveraged Loan Index fell just 70 cents. Combined with still-elevated base rates, however, default activity over the quarter was once again higher in floating rates loans than more typically fixed rate bonds.

Our View: The widening in spreads experienced in the first quarter is likely the first step towards a normalization of credit valuations. Even so, spreads remain tight by historical metrics and reflect little risk of a material slowdown in earnings or any kind of credit market stress. The moves were largely led by the shift in sentiment and the recognition that U.S. growth wasn't likely to follow the robust path anticipated immediately after the election, removing some of the upside potential from markets. However, markets don't appear to have really priced in any real downside at this point, suggesting there is further room to widen as uncertainty and slowing growth eventually flow through to have more pronounced effects on earnings, leverage, fundamentals, and ultimately, valuations.

1Q 2025: Securitized Sectors Still Present Better Relative Value

- With credit sectors bearing the brunt of the quarter's volatility, traditionally safe securitized assets like agency MBS exhibited better relative performance over the period as the Bloomberg U.S. MBS Index finished roughly in line with duration-matched Treasuries to gain 3.1%. Total returns across the 30-Year coupon stack were positive given the move lower in rates, though duration-adjusted performance favored the higher coupons given increased demand for the carry offered by high coupon pools, and for collateralizing the deluge of collateralized mortgage obligation (CMO) issuance throughout the quarter.

- Meanwhile, speculation grew throughout the quarter around the reality of privatizing Fannie Mae and Freddie Mac, something the administration has made clear it would like to achieve. However, the administration also reiterated their commitment to affordable housing and low mortgage rates, suggesting that any change would still involve some level of federal support for the agencies. Further, given the complexity of the issues, any significant progress made on this front is likely to take some time given how integral the government-sponsored entities are to facilitating activity in the housing and mortgage-backed securities market.

- Macro volatility translated to slightly wider spreads for the non-agency MBS and CMBS markets, leading to a steepening of credit curves as both markets normalize following months of sustained risk appetite. Fundamentals, especially for the U.S. housing market, remained solid, while the commercial real estate sector continued to show signs of bifurcation. For offices in particular, the highest quality properties have thrived and emboldened a wave of new issuance, while lower quality properties have seen valuations tumble.

- Asset-backed securities generally held up well over the period given their diversification potential, though the weaker market tone saw spreads widen for even well-structured assets like CLOs. Indeed, lower rates and growth concerns saw AAA spreads widen 15 to 20 bps, while down the capital structure and across managers spreads also widened. Adding to the move from a technical perspective were increased outflows from the asset class, including from retail investors, reversing the trend that had defined prior quarters.

Our View: Securitized products continue to generally trade at wider spreads than corporates of similar quality and duration, making the relative value proposition attractive and informing sizeable overweight positions in various sectors across portfolios. Further, in an environment where economic, policy, and market uncertainty are elevated, the securitized markets provide ample opportunity to uncover differentiated return potential given the variety of collateral, structures, and liquidity profiles available across sectors.

1Q 2025: Core and Core Plus Fixed Income Positioning Summary

Expectations are for continued volatility as markets recalibrate to the new administration's agenda, and more importantly, its sequencing. As such, liquidity and downside protection remain paramount, with ample liquidity to deploy into dislocations.

Characteristic	Positioning	Comments
Duration	Approximately 0.6 years long versus the benchmark	Rates remain restrictive and above fair value, especially given the likelihood for further economic slowing
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve given expectations that the Fed will eventually have to ease more aggressively than markets expect as growth cools
MBS	• Agency MBS – large overweight • Non-Agency MBS – maintain allocation	• Prefer specified pools given better convexity characteristics, but maintain exposure to TBAs for liquidity • Emphasize lower coupon (<3.5%) issues for upside price potential and middle coupons (4% - 4.5%) for a favorable mix of spread and convexity relative to current coupons, with small position in floating rate CMOs for additional income • Legacy (pre-GFC) and newer issue non-agency MBS bonds backed by legacy collateral benefit from solid fundamentals including lower loan-to-value ratios and delinquency rates given seasoned borrower profiles and home price appreciation
ABS	Moderate overweight	• Prefer AAA and AA rated CLOs that offer liquidity, robust structures, and attractive spreads • Diversified exposure across higher yielding non-traditional collateral
CMBS	Small overweight, bias to add	Cautious overall with targeted exposures to trophy property types via single asset single borrower non-agency CMBS deal structures, including some exposure down the capital structure
Investment Grade Credit	Large underweight	• Positioning emphasizes more defensive industries like communications and consumer non-cyclicals • Banks represent a sizeable position given attractive valuations and fundamentals, though underweight relative to the Index given potential for spread widening as consumer spending slows • Minimal exposure to cyclical credit sectors and non-corporate credit
Leveraged Finance	Minimal allocation	Target high conviction issuers and idiosyncratic credits over broad-based exposure given tight valuations, with the allocation slightly biased towards loans
International	Small allocation	• Reduced position in European corporates given spreads are now roughly equivalent to the U.S. • Minimal emerging market exposure, focused on high-quality sovereign issues

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

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