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TCW Talking Points

FIRST QUARTER 2026

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1Q 2026: Beware the Ides of March

- The bombing of Iran dominated the headlines in March and became the quarter's primary concern among market participants given the significant impact on oil prices and associated economic risks. ICE Brent Crude futures prices surged by more than 60% in March and 94% for the quarter to mark the largest quarterly gain since 1990, finishing above $118/bbl for the first time since 2022.

- Away from oil, the most consequential impact was felt in the global rates markets as fears of 2022 style inflation surged and sovereign yield curves flattened alongside hawkish repricing of central bank activity. This was particularly acute in European regions like the UK given its status as a net energy importer, where investors early in the quarter anticipated two rate cuts in 2026 which flipped to expectations of two rate hikes by year end, driving the yield on 2-Year UK gilts higher by 89 basis points (bps) in March alone.

- U.S. markets experienced similar volatility as expectations for inflation rose and Fed rate cuts were removed, causing the 2-Year yield to rise 42 bps over the month and 32 bps for the quarter. The 10-Year yield experienced the largest monthly increase since 2024 (+38 bps) while the MOVE index, a measure of interest rate volatility, rose to the highest level since Liberation Day. However, there was little change to long-run inflation expectations, as markets anticipated a quick end to the Middle East conflict and the potential for higher fuel prices to be a meaningful drag on longer term growth.

- Risk assets were somewhat weaker, but more stable than rates markets, with the S&P 500 Index registering five consecutive weeks of negative total returns to finish the quarter with a 4.4% loss. High yield credit spreads widened by 26 bps in March and 51 bps over the quarter, while investment grade credit spreads finished the quarter only 11 bps wider (+3 bps in March).

Our View: We believe the conflict in Iran will be resolved in weeks rather than months, making the inflationary impact modest, particularly given that the economy is very different than it was in 2022. We are later in the cycle, rates are already restrictive, there is no fiscal stimulus in place to support consumption, and labor markets are clearly softening. Persistently higher energy costs instead are a tax on consumption and increase the risk of demand destruction that is inherently disinflationary and that could force a quicker return to easing. However, a large-scale fiscal response could raise the risk of demand-driven inflation, and is a development we are closely monitoring.

1Q 2026: Beneath the Fog of War

- With the Middle East conflict dominating headlines and capturing investor attention, economic fundamentals were overlooked as inflation fears grabbed the spotlight. Key indicators like labor market data showed volatility in the headline figures and continued weakness in the underlying details, while survey-based data highlighted a growing bifurcation in consumer sentiment.

- Nonfarm payroll growth turned negative in February with the economy shedding 133k jobs per BLS data, a development that would likely have spurred dovish expectations absent the war. This follows a stretch of flat payroll growth over the past year, and 24 of the past 25 payroll releases being revised to the downside in subsequent updates.

- Early in the quarter, the administration put forth a targeted affordability agenda to support U.S. consumers and build on the momentum from the passing of the OBBBA last July. Features like lower gas prices and mortgage rates were primary tenets of the agenda, though the progress made on those fronts was quickly reversed by the fallout from the war. The nationwide average gas price rose from $2.83 a gallon to $4.06 over the quarter according to the American Automobile Association, while the 30-year mortgage rate rose by over 50 bps in March after briefly dipping below 6% earlier in the quarter.

- At the same time, the first quarter saw favorable developments from OBBBA tax overhauls like larger consumer tax refunds, with the U.S. Government estimating the average refund amount to increase anywhere from $300 to $1,000 per household. Deregulation efforts also resulted in increased M&A activity, while depreciation changes and interest expense deductions resulted in growing business capex plans.

Our View: Chances of a recession entering the year were decreasing given a benign fiscal path and easing monetary policy, with our base case evolving to an economy likely to keep growing, although slowly. However, the tightening of financial conditions stemming from the war, and reversal in the progress towards better affordability, complicates the near-term outlook. We view risks to consumer activity and economic growth as skewed to the downside, particularly given weaker labor markets the potential fallout from higher fuel prices if the war is longer than expected.

1Q 2026: The AI Divide Grows Wider

- Continued evolution of AI capabilities and swelling AI-related capex spending plans created significant uncertainty throughout the quarter given shifts in investor sentiment, assessments of ultimate winners and losers, and concerns of obsolescence among sectors like software that were deemed to be most heavily affected.

- For high-quality hyperscalers, the dramatic increase in capex spending plans was met with little resistance as Amazon brought a $37bn deal to market that was easily absorbed by end investors, with the deal marking the largest non-M&A offering on record. Hyperscaler capex is projected to surpass $600bn in 2026 per Bloomberg, a significant increase over 2025 levels that marks a shift from self-funded expansion towards a sustained reliance on capital markets.

- AI is also introducing a new dimension of credit differentiation within software, where credit risk is increasingly influenced by perceived long term business model durability rather than near term earnings performance. Certain software categories—particularly those providing workflow, data processing, or service functions that are more easily replicated or compressed by AI enabled tools—face heightened scrutiny from credit investors, and hence, wider spreads.

- While software skepticism crept into most corners of credit markets, the scrutiny was heavily directed towards broadly syndicated loans (BSL) given the typically smaller size and lower quality nature of BSL borrowers and concentration of software companies in that market. The resulting selloff drove an increase in the share of software loans trading at stressed levels with short remaining maturities, factors which have historically corresponded to higher default rates.

Our View: As debt investors, AI spending plays a relatively small role in our markets, though that may change, particularly as hyperscalers increase leverage to fund ever-increasing capex plans. However, should the return on that massive investment fail to materialize or take longer to realize than expected, sky-high equity valuations could plummet back to earth, potentially creating a negative wealth effect that could crimp high-end consumer spending and have meaningfully negative implications for the economy.

1Q 2026: (Private) Credit Markets Begin to Wobble

- Fears around the impact of AI on software companies, which also make up a significant percentage of private credit borrowers, drove sizable redemption requests from several private credit funds. Most of those funds invoked gates to limit withdrawals, doing little to reassure investors as many high-profile private credit managers experienced double-digit share price declines over the quarter.

- In addition to software concerns, investors in traditionally more levered credit vehicles like BSLs are also having to contend with permissive covenants and yearslong increase in liability management exercises, a combination that has driven recovery rates to historical lows.

- Despite the increased stress in private credit markets, there was little evidence that it had spilled into high quality public credit markets. Even with the increase in volatility associated with the war, investment grade market activity remained robust with total issuance for the quarter reaching $650bn per estimates from Bank of America, marking the highest total amount of first quarter issuance on record.

- Meanwhile, the large increase in yields during the quarter also spurred yield-based buying across IG and HY markets, which helped to mitigate the spread widening that would typically be associated with such a spike in volatility. The yield on the Bloomberg U.S. Corporate Index rose by 33 bps over the quarter while the Bloomberg U.S. High Yield Index yield rose 87 bps, leading to negative total returns of -0.54% and -0.50%, respectively.

Our View: Public credit markets held up remarkably well given all the negative headlines, while the locked-up nature of private credit vehicles significantly reduces the potential for forced sales in that sector, limiting the risk of an immediate and broadly-based contagion. However, the ripple effects of such an abrupt slowdown in the private credit markets are difficult to predict, and we remain very aware of the potential for further volatility as investors reassess the liquidity and risk backdrop across the credit spectrum.

1Q 2026: Securitized Markets Still Offer Better Relative Value

- Agency MBS got off to a strong start early in the quarter following President Trump's announcement that Fannie Mae and Freddie Mac would be buying $200bn of agency MBS securities, with nominal current coupon spreads immediately tightening by 20 bps. January duration-adjusted returns of +52 bps registered in the 93rd percentile going back to 2000, while the push for lower mortgage rates supported performance across lower and belly coupons.

- However, the Treasury selloff in March and associated rise in 30-year fixed mortgage rates saw agency MBS nominal spreads move to YTD wide levels of 129 bps as rate volatility increased, offsetting those gains. The sector finished the quarter with 16 bps of outperformance versus risk-free Treasuries, while wider spreads increased the relative value appeal versus investment grade corporates and other high-quality segments of fixed income markets.

- Spreads among collateralized loan obligations (CLOs) widened across the capital stack given the elevated volatility and concerns about underlying software exposure. Spreads on AAA tranches widened by 13 bps given increased trading for liquidity purposes, while BBB tranches finished roughly 30 bps wider on concerns of collateral weakness.

- Meanwhile, valuations across securitized credit more broadly followed a similar pattern over the quarter; the January tightening of agency MBS spreads also supported senior tranches of non-agency MBS and high quality CMBS/ABS issues, while the market moves in March saw increased dispersion across tranches, with lower rated issues generally widening more.

Our View: We remain constructive on securitized markets given better relative value and generally wider spread levels than broad-based corporate markets, where valuations there appear to still be priced for only a narrow range of possible outcomes. Agency MBS is a favored sector given its liquidity and government guarantee, while the diversification of collateral types, structures, and risk profiles across securitized credit provide opportunities for diligent underwriting to support differentiated return potential.

1Q 2026: Core and Core Plus Fixed Income Positioning Summary

Securitized sectors continue to be favored versus corporates given more attractive relative value, though portfolios maintain sufficient liquidity to protect against downside risks and capitalize on periods of volatility, which we expect to continue in the coming months.

Characteristic	Positioning	Comments
Duration	Approximately 0.3 years long versus the benchmark	We view the hawkish repricing of Fed activity and backup in rates to end the quarter as overdone, particularly in the context of a labor market that continues to operate at stall speed
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve given expectations that the Fed will resume easing and look to get to at least neutral in 2026
MBS	• Agency MBS – large overweight Non-Agency MBS – maintain allocation	• Small bias towards specified pools given better convexity characteristics, but maintain exposure to TBAs for greater liquidity • Emphasize middle coupons (3.5% - 4.5%) for a favorable mix of spread and prepayment protection • Legacy (pre-GFC) and newer issue non-agency MBS bonds benefit from solid fundamentals, including lower loan-to-value ratios, seasoned borrower profiles, and home price appreciation
ABS	Moderate overweight	• Focus on AAA CLOs for more liquidity and defensive carry • Diversified exposure across non-traditional collateral offering attractive risk-adjusted yields
CMBS	Small overweight	Bias towards non-agency CMBS single asset single borrower deals for transparency into underlying collateral
Investment Grade Credit	Large underweight	• Late cycle dynamics and minimal yield compensation inform defensive and selective positioning (up in quality, bias towards non-cyclical industries, emphasis on liquidity) • Continued allocation to electric utilities given growing demand for power generation and data storage
High Yield / Loans	Minimal allocation	Target high conviction issuers and idiosyncratic credits for alpha generation potential rather than broad-based exposure given still-rich valuations, even with the modest widening over the quarter
International	Moderate allocation	• Explore opportunities in non-U.S. credit to capture incremental spread premium relative to domestic issues • Geopolitical volatility created opportunities to add small positions in high-quality, USD-denominated EM sovereigns • Add small amount of UK duration, where allowed, given significant increase in short-term interest rates

Important Disclosure

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