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TCW Talking Points

SECOND QUARTER 2025

TCW Fixed Income

2Q 2025: Business and Labor Market Outlook Muddled by Tariff Volatility

- Reciprocal tariffs announced on April 2nd or "Liberation Day" were much higher than expected. Highlighting the announcement was a proposed levy on Chinese imports of 145%, with steep tariffs also assigned to other countries deemed to be trade "offenders". The policy also saw a baseline 10% tariff rate on all imports, raising the effective tariff rate to levels not seen since pre-WWII.

- The aggressive tariff policy caught investors and other countries off guard, leading to escalating retaliatory tariffs, dramatically higher volatility, and widespread concerns about rampant inflation and slowing economic growth. Businesses struggled to provide forward earnings guidance or plan for capital expenditures under the new trade policy, leading to acute uncertainty that dominated the quarter as the ensuing 90-day tariff reprieve and de-escalation with China further confused the outlook for business leaders and consumers.

- Despite the volatility, labor markets remained reasonably resilient with the unemployment rate hovering around 4.2% for most of the quarter. Both anecdotal and hard data suggested that hiring has slowed while layoffs have yet to substantially increase. Meanwhile, a drop in the labor force participation rate, spurred partly by immigration policy, also supported the resilience of official data.

- Although the unemployment rate is historically a key barometer for labor market health, it is backward looking and typically lags economic conditions by at least a couple quarters. At the same time, monthly payroll numbers, which have only softened modestly, are subject to massive revision given all the necessary statistical adjustments included in those estimates. However, more consistent leading labor market indicators such as rising initial and continuing jobless claims, falling temporary worker employment, stagnating wage growth, and the labor market differential (share of respondents indicating jobs are plentiful minus those saying jobs are hard to get) falling to the lowest level since 2021 point in a different direction.

Our View: Forward looking labor data suggests the labor market is set to continue softening, with higher unemployment rates the likely outcome. Uncertainty created by the on again/off again nature of tariffs exacerbates already difficult conditions for companies in the current environment, and to the extent rising input prices put pressure on profit margins with companies unable to pass along all those costs to consumers, companies will likely be forced to resort to layoffs to defend margins, increasing the risks to employment going forward.

2Q 2025: Resilience of the Consumer Called into Question

- Consumer sentiment cratered in April as equity markets tumbled and fears of a global trade war grew, with large declines in sentiment evident across income cohorts, age groups, and political affiliations. The University of Michigan's Consumer Sentiment Survey fell to 52.2 in both April and May, down from 74.0 at the start of the year and the second-lowest reading this decade. Meanwhile, the "expectations" component of the survey fell to 47.3 – the lowest level since 1980, a telling sign of what is likely to come as "soft" survey-based data results typically precedes actual "hard" data.

- The drop in confidence is especially important as recent research suggests that the top 10% of income earners drive 50% of the overall consumer spending in the U.S., a record high in Moody's data going back to 1989. While no one expects that top 10% to suddenly file for bankruptcy or to see delinquency rates on credit cards or auto loans jump higher, given the reliance on that upper income cohort, a shift in behavior to be more careful with spending given rising uncertainty has serious negative implications for U.S. economic activity.

- To that end, consumer spending faltered over the quarter as U.S. retail sales fell by 0.9% in May on a month-over-month basis to mark the largest decline so far this year. Moreover, recent analysis by McKinsey & Co. showed that more than 60% of consumers have changed or expected to change spending habits given the introduction of tariffs, including cutting back nonessential spending and trading down to lower cost goods, a theme also evident on corporate earnings calls.

- Adding to the growing headwinds faced by consumers was the end of the moratorium on student loan payments implemented during COVID, which has seen the share of student loan borrowers more than 90 days past due rising to pre-pandemic levels of 8%. All borrowers must contend with the burden of payments that weren't made for 5+ years, while delinquent borrowers risk lower credit scores, less availability of credit generally, and those with federal loans could also see wages garnished, further hampering spending going forward.

Our View: Although consumer confidence improved later in the quarter as equity markets rebounded, it hasn't yet returned to pre-Liberation Day levels, suggesting that there remains lingering concerns about the durability of equity gains in the current uncertain environment. This uncertainty, coupled with comments from numerous retailers about wealthy consumers trading down to save money and the ongoing stress in lower income cohorts, should lead to lower levels of consumption, reduced consumer spending, and ultimately, slower economic growth down the road.

2Q 2025: The Yield Curve Steepens Amid Lower Inflation and Elevated Term Premium

- Inflation expectations soared over the quarter with increases expected over both the short and long term. This contrasted with realized inflation where headline CPI came in below consensus expectations in both April and May, with prices in core goods and shelter both decelerating. Meanwhile, TIPS breakeven inflation rates remained relatively well contained, reflecting an investor base that assumed tariffs would lead only to a temporary increase in prices rather than longer-term effects.

- Despite encouraging inflation prints, the Federal Open Market Committee (FOMC) opted to remain patient and keep rates steady, though late-quarter comments from key FOMC officials hinted at the possibility of resuming cuts in the near future. Combined with weakening macro data, this led investors to price in a more active Fed and caused short rates to fall, though long rate rose as the curve steepened, reflecting a combination of tariff driven inflation fears, rising term premiums likely due to elevated volatility, and heightened concerns about the sustainability of U.S. deficits given increasing fiscal spending.

- Concerns about fiscal deficits aren't new, but the issue has taken on renewed importance with many market participants expressing angst around Treasury issuance, liquidity, and foreign demand. However, there have been no substantive signs of meaningful foreign selling of Treasuries, with the most recent data from the Treasury Department showing the amount of Treasuries held by foreign investors remained near the record high set in March.

- If a substantial mismatch between supply and demand for Treasuries were to materialize, presumably it would show up in various ways – rising bid/ask spreads, failing auctions, elevated collateral or repo rates, or dislocations in the difference between cash bond and futures market pricings, and we have seen none of those. Moreover, the amount of Treasury futures open interest – a proxy for the size of the widely speculated about basis trade – relative to the size of the overall Treasury market has remained within historical norms, suggesting that rate moves were not driven by an unwinding of the basis trade, as was speculated by many during the quarter.

Our View: We believe the underlying trend in inflation is lower, and while tariffs may lead to short-term increases in prices, they are primarily a tax on consumption and are expected to be disinflationary over the medium to longer term. This dynamic should provide the Fed cover to ease more aggressively than is currently expected if and when the labor market shows more concrete signs of weakening. These fundamentals are expected to be far more influential on rates over the next few quarters than any issues with increasing deficits. While ever-rising debt levels create existential challenges for U.S. fiscal policies and taxpayers in the decades ahead, as long as the U.S. dollar remains the world's reserve currency and Treasuries remain the pre-eminent risk off asset, those challenges are manageable.

2Q 2025: Portfolio Positioning Themes and Outlook

Portfolios are broadly positioned in expectation of a slowing economy with periodic bouts of volatility:

- Long duration overall with an emphasis on 2-5 year maturities, and an underweight to the 30 year part of the curve
- Overweight non-government sectors overall vs. benchmarks
    - Large overweight to agency mortgage-backed securities (MBS), non-agency MBS, select ABS sectors, and high quality CMBS which are anticipated to be more resilient in a slowing economy
    - Underweight to corporate credit given tight credit spreads and poor relative value with a minimal allocation to high yield credit

What are some potential catalysts that could push credit spreads wider, boost relative performance, and drive higher allocations in both investment grade and high yield credit?

- Higher tariff rates will likely put pressure on corporate profit margins, either reducing earnings and profitability or forcing more layoffs to protect margins
- Higher unemployment and weaker labor markets should lead to declines in consumption and spending, slower overall growth, lower earnings, and ultimately wider spreads given increasing risks
- Trump induced volatility due to tariffs or any of a number other issues. President Trump wields uncertainty as a weapon to extract concessions from counterparties, so we believe further bouts of volatility are to be expected.
- With equity markets priced well above historical norms, there is meaningful downside should today's ebullient expectations fade whether due to trade tensions, geopolitical events, oil prices, or some other exogenous shock
- If and when the Fed cuts rates due to any of the above, interest rates will fall substantially and all-in yields for corporate bonds will also drop, even as spreads widen. Lower overall yield is likely to limit demand from yield-based buyers, exacerbating the move wider in spreads

Our View: While wider credit spreads is our base case view, we don't require that outcome to generate positive excess return. As currently constructed, given the greater overweight in securitized sectors relative to the underweight in corporate credit, TCW portfolios generally carry meaningful yield premiums versus their benchmarks, providing opportunities for outperformance even in relatively stable market environments.

2Q 2025: Credit Markets Shrug Off Early-Quarter Volatility

- Credit spreads for both investment grade and high yield corporates finished the quarter 11 and 56 bps tighter, respectively, though these ending levels mask the sharp widening that occurred following Liberation Day. In the days immediately following the April 2 announcement, investment grade corporate spreads widened 25 bps from start-of-quarter levels, ultimately reaching 119 bps at the wides, while high yield spreads widened 106 bps to 453, though neither reached long-term average spread levels despite the large move.

- Despite the initial widening, the 90-day tariff reprieve and progress towards a trade deal with China reignited investor risk sentiment, which when combined with resilient demand for still-attractive all-in corporate credit yields, drove excess positive total and excess returns for investment grade and high yield corporates. The Bloomberg U.S. Corporate Index advanced 1.8% and outpaced duration-matched Treasuries by 104 bps, while the Bloomberg U.S. Corporate High Yield Index gained 3.5% with 217 bps of excess returns as spreads retraced the April widening and then some.

- However, with spreads back to the extremely narrow levels where they ended 2024, corporate credit markets present an unfavorably asymmetric risk and reward profile. To provide context to this asymmetry, at a duration of around 7 years for the Bloomberg US Credit Index, and with the Index ending spread level of 79 bps it would take only about 12 bps of spread widening to erase a year’s worth of spread carry, with greater increases in spreads causing underperformance relative to a credit risk free Treasury bond.

- Receptive capital markets and robust investor risk appetite saw the return of more aggressive issuance from borrowers, including a PIK (Pay In Kind) toggle from a major apparel company to fund an acquisition by a private equity company. This structure is considered aggressive because the issuer can choose to pay the coupon in cash or in more bonds, with the latter saving cash, but increasing leverage. These structures are relatively rare – only a handful of them are issued annually – and only appear when markets are wide open, demand is high, investors are less discerning about risks, and power has shifted significantly in favor of issuers over bondholders.

Our View: We continue to believe that credit spreads at current levels are too tight and do not provide sufficient compensation for the risks being assumed in the current market. As such, allocations remain defensive, focused on higher quality, less cyclical issuers in sectors we believe will be more resilient in a slowing economy. We emphasize strong liquidity so that we are well positioned to be active during periods of dislocation and volatility to add quickly to exposures at more attractive levels, as we did in early April.

2Q 2025: Better Opportunities in Securitized Markets

- Despite a challenging April, agency MBS finished the quarter on solid footing alongside a steepening of the yield curve and reduction in rate volatility. The sector returned 1.2% and beat Treasuries by 17 bps on a duration-matched basis, with nearly every coupon across the 30-Year conventional coupon stack performing well absolutely and relative to Treasuries. Middle and upper coupons continued their run of strong returns this year as the demand for carry remained firm, while lower coupons benefitted from the duration effect of lower rates.

- While home prices are generally higher, the so-called "sand and sunshine states" of Arizona, Florida, and Texas have seen lower home price appreciation (HPA) than the national average. These locales benefited the most from COVID era migration and as a result, have seen higher supplies of new homes, which is correlated with lower levels of HPA. Because most prepayment models use national HPA expectations in their cash flow estimates, there is a likelihood that mortgage pools with greater concentrations in those states will prepay more slowly than the models predict, creating mispricings that can benefit knowledgeable investors.

- Consistent with the risk-on theme evident in corporate credit over the second half of the quarter, securitized credit also experienced spread tightening across sectors, particularly higher beta and more risky corners of the market. As a result, credit curves across sectors and structures flattened over the quarter, reversing much of the steepening that had occurred in early 2025. Illustratively, the spread between AAA and BBB rated CLOs and non-QM RMBS returned to the some of the lowest levels in two years.

- However, risks remain despite optimistic market pricing, particularly among consumer-related sectors. Data from Fitch shows that subprime auto delinquencies are up by 47 bps on the year, more than 300 bps higher than in 2021 and above the level seen during the Global Financial Crisis. Similarly, charge-offs in credit card trusts increased over the quarter, while the amount being rolled over on credit cards each month rose to the highest level since 2012, evidence that borrowers are struggling to keep up with regular expenses.

Our View: Securitized products generally trade at more favorable spread levels than corporates, making the relative value proposition attractive and informing sizeable overweight positions across portfolios. Further, in an environment where economic, policy, and market uncertainty remain elevated, the securitized markets can provide strong structures to withstand volatility and ample opportunity for disciplined active managers given the variety of collateral, structures, and liquidity profiles available across sectors.

2Q 2025: Core and Core Plus Fixed Income Positioning Summary

Portfolios remain positioned for ongoing volatility with a continued focus on liquidity and downside protection, with ample dry powder to take advantage of periodic dislocations like we saw in April.

Characteristic	Positioning	Comments
Duration	Approximately 0.4 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 • Non-agency MBS bonds backed by seasoned and re-securitized 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	• Though 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 across both loans and bonds
International	Small allocation	• Modest position in European corporates given slightly spreads versus 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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