

TCW

TCW Talking Points

SECOND QUARTER 2026

2Q 2026: YTD Markets – A Tale of Two Parts

Markets year to date have experienced two distinct and very different environments. The first was in January and February and was characterized by falling rates, weaker labor markets, and expectations for rate cuts. The second started with the conflict in Iran and involved higher inflation expectations, higher rates and expectations for rate hikes.

- **Rates:** After moving lower during the first two months of the year, U.S. Treasury yields surged in March alongside higher oil prices and more hawkish Fed expectations. Early-year expectations for rate cuts quickly gave way to anticipated rate hikes to combat energy-driven inflation, with energy-importing countries like the UK experiencing more drastic moves.

Portfolio Changes: TCW reduced durations to just slightly longer than benchmarks across styles in February as rates moved lower before adding it back in March, with additions focused on U.S. and UK front-end maturities given a view that hawkish repricing was overdone.

- **Credit:** Market participants largely ignored the potential demand destruction and growth implications of higher rates, with credit spreads only softening modestly as spread volatility proved short-lived and small in magnitude. During the peak of the conflict, U.S. IG and HY credit spreads widened by just 9 and 44 basis points (bps), respectively, closing the quarter close to the tightness of the year.

Portfolio Changes: Portfolios added high-quality credit in March at more attractive entry points, though the quick retracement of spreads informed subsequent trimming in line with our value discipline.

- **Agency MBS:** January's announcement that the government-sponsored entities (GSEs) would purchase up to \$200bln of agency MBS benefitted the sector and provided a catalyst for the current coupon spread to fall below 100 bps for the first time since 2022. The start of the conflict, however, saw much of this momentum get reversed as rate volatility spiked, though the sector stabilized as peace deals were announced, oil prices fell, and rate volatility moderated.

Despite weakness due to higher rates and elevated volatility, agency MBS performed better than expected, at least partially attributable to the impact of the GSE buying acting as a stabilizer. Consistent with corporate credit, small additions were made as spreads widened, though opportunities were limited given the modest moves.

Our View: Assuming the conflict in Iran continues to move in a positive direction and oil flows through the Straits of Hormuz increase, we expect oil prices should stay contained, rates will fall, and trends that were in place at the start of the year – including AI-related uncertainty, private credit hiccups, and mixed labor market signals – will return to the forefront. As the economy reverts to these underlying trends, positioning that was highly beneficial during that period should boost relative performance temporarily lost in the recent volatility.

2Q 2026: Inflation and the Labor Market

- The second quarter began with a classic energy-related inflation scare as headline metrics increased alongside higher oil prices, though core inflation remained contained and even showed signs of disinflation in demand-sensitive sectors. Moreover, trimmed mean inflation – which strips out the highest and lowest outliers – showed inflation closer to 2.4%, revealing a softer underlying trend.
- A series of cease fires and progress towards a more lasting resolution saw oil prices fall sharply from early-quarter peaks, with front-month Brent crude futures contract prices declining by more than 30%. This development pulled market-based inflation expectations lower as both breakevens and zero-coupon inflation swaps closed the quarter below pre-conflict levels, while the sharpness of the drawdown also hints at demand weakness and softer underlying global activity than widely acknowledged.
- Meanwhile, it appears that the labor market may be stabilizing amid upside surprises to job openings over the quarter, though it is likely still early to tell if this is truly a structural shift. Underlying components of the data, like voluntary quits and shrinking difference between those saying jobs are plentiful versus those saying jobs are hard to get, point to a broader employment backdrop that remains tenuous, with workers lacking confidence in the ability to quickly find new jobs.
- Despite the increase in overall job postings, wage growth has flatlined over the past several months, removing a key source of inflationary pressure and differentiating this energy shock from the one in 2022 when the labor market was significantly tighter. Real wages (wages adjusted for inflation) turned negative during the quarter, marking a clear shift in the pricing dynamic of wages away from the employee towards the employer – a development that is likely to continue alongside growing AI implementation.

Our View: We believe that fears of rekindled inflationary pressures have been overblown, particularly given the state of the labor market, the trajectory of wages, and the fact that current elevated inflation readings have been concentrated in energy and related sectors, which should moderate as oil prices normalize. However, we remain wary of upside risks to inflation which could materialize if measured inflation starts to become more broad-based, inflation expectations move higher, or there is a meaningful fiscal response to higher prices in the form of transfer payments to consumers.

2Q 2026: A Fed Overhaul and Hawkish Tilt

- June's Federal Open Market Committee meeting and press conference were highly anticipated given it was the first chance for markets to hear from newly appointed Chair Kevin Warsh and his vision for the Fed. The meeting struck a more hawkish tone than many anticipated as FOMC members signaled a growing chance of rate hikes in 2026, while comments from the Chair did little to push back on this interpretation given an explicit and unwavering commitment to bring inflation back to the 2% target.
- We would argue that the bar to *sound* hawkish was low; Warsh's campaign was centered around lower rates and easing monetary policy. The press conference and promise to rein in inflation is therefore best viewed as a credibility building exercise, with apparent success given the market reaction and seemingly fewer concerns about Fed independence.
- Warsh also announced task forces to examine and reevaluate Fed operations and policy implications across five dimensions: Fed communication, the balance sheet, reliance on existing data sources, productivity/jobs, and the Fed's inflation framework. The initial timeframe for feedback from the task forces was year-end, though markets could see some changes before then.
- For example, a major theme during the press conference was Warsh wanting to move away from forward guidance, likely spelling an end to the dot plot and other official projections. This shift may already be underway as research from Citadel shows that from 2021 to 2026, in the week following a Fed meeting, there was an average of 16 public appearances by Fed officials. In the week following Warsh's meeting, there were just eight.

Our View: While the bar to sound hawkish was low, we view the bar to actually raise rates as high and expect the next Fed move to be a cut in rates. Though the Fed is likely to be patient with any moves, barring a re-escalation of the Iran conflict, or the risk of more entrenched inflation, we expect the economy will ultimately return to the broader trends that existed early in the year, which would be consistent with cuts to bring rates closer to neutral or even accommodative rather than the current restrictive stance.

2Q 2026: Muted Volatility in Credit Markets

- U.S. IG and HY corporate credit spreads, as represented by the Bloomberg U.S. Corporate and Bloomberg High Yield Corporate indices, finished the quarter 14 and 47 bps tighter, respectively. Spread tightening highlights not only how quickly credit rebounded from March's volatility, but also the enduring appeal of current yields across both sectors, which continues to attract yield-based buyers. Consistent demand has also helped to suppress spread volatility, with IG corporates trading in just a 12 bps range during the quarter.
- That said, spread as a percentage of yield – or how much extra compensation investors receive above the risk-free rate – remains at the lowest levels of this cycle, providing little cushion against adverse moves in spreads, and providing little incentive to hold corporate debt versus other sources of portfolio yield.
- As companies race to finance AI capability and capacity, capex needs have expanded meaningfully and YTD issuance in the debt markets has significantly increased year-over-year, with IG (\$1.2trln) and HY (\$184bln) issuance both up roughly 32% per data from Bank of America and J.P. Morgan. The AI capex buildout is among the largest industrial spending waves in history and has encompassed nearly every sector, though profitability on these massive investments has yet to be proven at scale, creating an uncertain picture of ultimate winners and losers, and the potential for downside risk if realized profits do not meet expectations.
- The spending frenzy has been met with even more robust demand from investors that has spurred a wave of initial public offerings (IPOs) and primary market activity. However, there is a growing divergence between primary demand and investor confidence, exemplified by the recent SpaceX IPO. Though it was oversubscribed and opened strong, it traded 7 to 30 bps weaker in secondary markets given no earnings history, negative free cash flow, and years of capex forecasted, eventually trading with a significant yield premium to other BBB rated peers.

Our View: With trillions of dollars being spent on AI capex over the next couple years, it is hard to imagine a scenario in which all of that money is invested prudently without waste or mishaps. History suggests that major industrial buildouts generate significant mal-investments and this one isn't likely to be different, and as a consequence there will almost certainly be winners and losers, underscoring the need for discipline when underwriting new deals and the borrower's place in the AI ecosystem. With broad credit valuations not reflecting any sort of risk – whether across AI or the economy in general – portfolios remain defensively positioned from an allocation perspective, focusing on bottom-up issue selection based on a foundation of solid company fundamentals.

2Q 2026: Securitized Markets Also Tight, But Offer Better Relative Value

- Agency MBS registered 30 bps of excess returns versus risk-free Treasuries in the second quarter, supported by moderating rate volatility that helped nominal spreads tighten from 125 bps to 109 bps. The broader sector continues to trade directionally with rate volatility, though opportunities for differentiated exposures remain given the breadth and varying characteristics across the coupon stack, with lower coupons offering upside price potential on lower mortgage rates and upper coupons providing better carry (though with greater prepayment risks).
- The non-agency MBS (NMBS) sector recovered from March volatility with spreads tightening across capital structures and credit curves flattening as lower rated and more subordinated tranches experienced a more pronounced tightening. NMBS offers attractive yield and spread premiums and solid underlying collateral given the downward trend in loan-to-value ratios and home price appreciation, resulting in positive excess returns across collateral types year-to-date.
- Similarly, non-agency commercial mortgage-backed securities (CMBS) have performed well on a duration-adjusted basis this year, though bifurcation remains at the property level. Rating actions across major rating agencies have remained elevated in recent quarters and are primarily downgrades as some property types and borrowers are struggling with higher rates and vacancies. This has also led to a growing share of CMBS loans being liquidated at losses, with the severity of losses highest across office and retail.
- The asset-backed security (ABS) sector continues to grow and evolve, with major sectors broken down into consumer and commercial ABS types. Commercial issuance and opportunities have been most topical given the amount of data center spend that has been financed through the ABS market, including from weaker sponsors or more risky profiles that are capitalizing on receptive capital markets to get deals done at tight valuations reinforcing the need for detailed diligence work.

Our View: We remain constructive on securitized markets given better relative value and generally wider spread levels than similarly rated corporate counterparts, though issue selection remains critical to managing downside risks and navigating a market backdrop marked by generally optimistic pricing. Agency MBS is a large allocation across portfolios given the liquidity and still-attractive spread levels, while positions in securitized credit are focused on high-quality collateral, utilizing the structured nature of the sector to add additional spread and yield premiums in subordinated tranches where appropriate.

2Q 2026: Core and Core Plus Fixed Income Positioning Summary

We view the range of possible market and economic outcomes as having broadened since the start of the year, warranting a continued focus on liquidity and discipline in portfolio construction. Securitized sectors currently offer more compelling relative value versus corporate credit and therefore remain a larger allocation across portfolios.

Characteristic	Positioning	Comments
Duration	Approximately 0.2 years long versus the benchmark	We believe the bar for rate hikes is high, informing a modest duration overweight to capitalize on rates gradually falling as inflation fears subside
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve given a view that the hawkish repricing of Fed policy is overdone
MBS	<ul style="list-style-type: none"> Agency MBS – large overweight Non-Agency MBS – large allocation 	<ul style="list-style-type: none"> Agency MBS position utilizes specified pools for better prepayment characteristics and TBAs for liquidity Emphasize middle coupons (3.5% - 4.5%) for an attractive combination of carry 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	<ul style="list-style-type: none"> Focus on senior tranches of CLOs for liquid carry and structural protection Diversified exposure across non-traditional ABS collateral offering attractive risk-adjusted yields
CMBS	Small overweight	CMBS position is focused on single asset single borrower deals for transparency into underlying collateral
Investment Grade Credit	Large underweight	<ul style="list-style-type: none"> Current credit spreads offer investors minimal protection against prospective volatility or spread widening, informing a continued underweight Exposure is diversified across industries with a general bias towards higher quality issues until more attractive entry points arise
High Yield / Loans	Minimal allocation	Focus on idiosyncratic opportunities and bottom-up issue selection to capture compelling yields, drive alpha potential, and minimize beta to broader risk assets
International	Moderate allocation	<ul style="list-style-type: none"> Explore opportunities in non-U.S. credit for incremental spread premium relative to domestic issues Maintain small position in high-quality, USD-denominated emerging market sovereigns Selective positioning in UK duration, where allowed

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