

TCW Talking Points

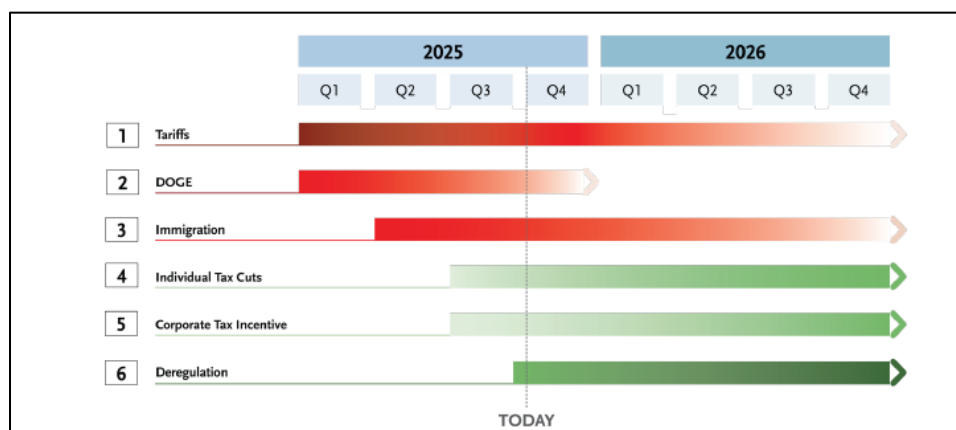
THIRD QUARTER 2025

3Q 2025: Broader Economy Showing Signs of Cooling

- Substantially weaker payroll growth numbers underwhelmed expectations while previous figures faced significant downward revisions, suggesting a job market that was weaker than previously understood.
- Moreover, the job openings rate fell to multi-year lows as businesses, still facing an uncertain operating environment, curtailed hiring. While layoffs have yet to move markedly higher, the low-hiring low-firing state of the labor market has pressured those out of work and looking for a job, with nearly a quarter of the unemployed population still struggling to land a job after 27 weeks.
- The unemployment rate increased to 4.3%, which remains low by historical standards, though the forward-looking picture is somewhat unclear given the significant reduction in labor supply.
- Potentially lower overall employment levels come during a time where consumption has already decelerated, with year-to-date retail sales and personal consumption expenditures tracking well below 2023 and 2024 levels despite the pulling forward of purchase activity in tariff-impacted sectors.
- With the lower income cohort having been stretched for years given the impact of higher rates, the upper income tier of earners has accounted for an increasing share of overall spending. However, recent data from VantageScore shows that even these borrowers are also facing challenges as they now exhibit the fastest delinquency growth rates on major loan types (autos and credit cards).

Our View: Job markets remain key to the outlook, and we continue to expect further cooling of labor demand will weigh on overall economic activity and consumer spending. Despite a weakening job market, unemployment may not move significantly higher if the supply of labor through reduced immigration is similarly constrained. However, the economic result of either activity is likely to be similar – lower levels of consumer spending and a slowing economy.

3Q 2025: The Importance of Policy Sequencing



Source: TCW

- The Trump administration's policy goals are expected to have a mixed impact on the economy, with the more negative policies implemented first, while those with an anticipated positive impact expected to materialize as we move into 2026.
- This was prominently displayed in 1H25, where significant tariff hikes suppressed muddled outlooks and crushed confidence, the impact of DOGE halted years of government contribution to the employment ranks, and immigration policy suppressed the available workforce.
- There are, however, components of the administration's agenda that are decidedly pro-growth, including exemptions on tips and overtime that could bolster consumer spending, corporate tax incentives for research and development that should drive capital investment, and deregulation that stands to increase bank balance sheet capacity, infrastructure spending, and activity related to mergers and acquisitions.

Our View: We came into the year pessimistic about the economic outlook, and while we still believe the economy is set to slow, there are clearly pro-growth tailwinds on the horizon from a policy perspective, with the question being can the economy bridge the gap between then and now as headwinds from more aggressive early-year actions start to fade. This transition is made more complicated by the continued cooling of the labor market and general slowdown in consumption, leaving little room for error from both the administration and the Fed. The odds remain tilted toward an overall slowdown, but given the many crosscurrents in the economy and the penchant of this administration for headlines, we expect volatility to continue to be a feature of markets going forward.

3Q 2025: The Fed is Forced into Action

- With employment metrics worsening, the Fed resumed its easing cycle in September with a 25 bps cut, though this was a foregone conclusion by the time the meeting arrived. Instead, the more interesting development to come out of the quarter's Federal Open Market Committee (FOMC) meetings was the growing divide among committee members to perceived risks to the dual mandate.
- Some FOMC members cited upside risks to inflation as a case for keeping policy more hawkish, while others – particularly those vying for the upcoming Fed Chair opening – referenced the labor market as reason to turn more accommodative. This differing of opinions was reflected in the most recent dot plot (with drastic differences in the future path of Fed policy) as well as in the July FOMC meeting, in which two Governors dissented for the first time in nearly three decades.
- Away from internal FOMC debates, the quarter also saw increased pressure from the executive branch to lower policy rates, calling into question the notion of Fed independence. Though Chair Powell assuaged concerns numerous times with a commitment to acting in the best interest of the country based on incoming data, the addition of Trump-appointee Miran to the board did little to quiet the narrative.
- An independent central bank is critical to maintaining credibility and proper functioning of markets, and while speculation abounds regarding the next Fed Chair, the Chair is only one person in a voting committee and cannot make unilateral decisions. Even one or two more members sympathetic to the administration's agenda aren't likely enough to overwhelm the full committee and the Fed is widely regarded as a robust enough institution to maintain independence in the current environment.

Our View: Despite all the noise surrounding independence, the Fed's hardest challenge is balancing their competing mandates of full employment and price stability. With weaker labor data, investors have turned more aggressive in the pricing of future policy with the Fed expected to reach "neutral" by end-2026, though we believe there is more room to run, particularly in the front end, as the economic backdrop weakens further and the Fed needs to get to neutral – or even accommodative – more quickly.

3Q 2025: Credit Markets Offer Unbalanced Risk/Reward Profiles

- In a continuation of this year's trend, spreads for both investment grade (IG) and high yield (HY) issues tightened over the quarter by 9 and 23 basis points (bps), respectively, supported in part by persistent demand for attractive all-in yields. In the IG market, strong sponsorship on behalf of insurers and other yield-based buyers saw spreads reach 68 bps intra-quarter – the lowest level since the mid-1990s.
- This demand translated to robust supply as both IG and HY issuers capitalized on receptive markets. While the week after Labor Day typically sees elevated activity, this year brought the third-largest IG issuance day on record with \$43bln priced. Meanwhile, HY issuance year-to-date reached over \$260bln, a more than 12% increase from this same time last year per BofA Global Research.
- While corporate balance sheets in general are in decent shape and the risk of an imminent default wave is low, valuations at historically tight levels provide minimal protection against future volatility and spread widening. In fact, empirical evidence suggests that forward excess returns (return over a risk-free Treasury of similar duration) are likely to be negative in both the IG and HY markets at current spread levels.
- There are, however, opportunities in non-traditional areas of the market to add incremental values to portfolios. One such area is in Australian semi-government bonds (akin to an agency or municipal issue in the U.S.), which offer a roughly 35 bps spread premium to the U.S. AA-rated corporate Index. Similarly, select European issues offer better relative value for similar levels of credit risk, despite a modest give up in liquidity given smaller markets overseas.

Our View: We continue to believe that credit spreads 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 variety of economic conditions. This more cautious positioning also provides liquidity that can be quickly deployed during bouts of volatility like in early April, where the team added significantly on better entry points and benefitted from the subsequent tightening.

3Q 2025: Securitized Markets Offer Better Relative Value

- With the FOMC delivering a rate cut and the future path of interest rates becoming clearer, interest rate volatility subsided during the quarter to greatly benefit agency mortgages. The agency MBS sector was the best performer in the securitized space, gaining over 2.4% and delivering 83 bps of excess returns as the current coupon spread tightened from 147 bps to 125 bps.
- The return pattern across the 30-Year coupon stack was not uniform, however, with the move lower in rates challenging performance for premium-priced higher coupons. On a duration-adjusted basis, 2.0 and 2.5 coupons performed the best, with 4.5 belly coupons also doing well as money managers rotated down in coupon, driving 7.0 coupons to negative excess returns. With this, the defining feature of the quarter for agency MBS was the reversal of the carry trade in favor of total return.
- This year, borrowers have exhibited an aggressive response to refinancing relative to moves lower in mortgage rates, with even modest declines in mortgage rates producing outsized refinance responses. This is especially true for pools issued in the last two years with typically higher coupons, which have exhibited much higher prepayment speeds than would be expected given higher loan balances and more efficient servicers.
- Other securitized sectors also performed well over the quarter as the spread tightening observed in credit markets carried over to structured products. The securitized components of the Bloomberg Aggregate Index generated positive total and excess returns, while out-of-benchmark areas like CLOs and non-agency MBS similarly exhibited strong performance.

Our View: Though spreads have moved tighter, 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, the securitized markets can provide strong structures to withstand volatility and ample opportunity for disciplined active managers to capture yield premiums given the variety of collateral, structures, and liquidity profiles available across sectors.

3Q 2025: Core and Core Plus Fixed Income Positioning Summary

Though cracks emerged in the labor market over the quarter, a large swath of the market, particularly in corporate credit, remains priced to more optimistic outcomes. Portfolios therefore maintain ample liquidity and prioritize more defensive corporate credit positioning to capitalize on better entry points ahead.

Characteristic	Positioning	Comments
Duration	Approximately 0.3 years long versus the benchmark	Though the Fed resumed easing, rates remain restrictive and above fair value, especially given the likelihood for further labor market weakening
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve should the Fed have to ease more aggressively than is expected by markets
MBS	• Agency MBS – large overweight • Non-Agency MBS – maintain allocation	• Prefer specified pools with better convexity characteristics as prepayment concerns re-emerge, 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 incremental 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	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, and large U.S. banks given attractive valuations and fundamentals • Minimal exposure to cyclical credit sectors and non-corporate credit; slightly overweight municipals given spread widening during the quarter
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 non-U.S. credit to capture incremental spread over domestic issues • Minimal emerging market exposure, focused on high-quality sovereign issues

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