TCW

TCW Talking Points

FOURTH QUARTER 2025

4Q 2025: The Crosscurrents of Policy Change

- While it was widely understood a new administration would seek to affect policy change within a short time of taking office, the sweeping tariff overhaul in April was one of the defining moments of 2025 given its magnitude and reach. Though the ensuing market selloff proved short lived, the action suggested that policy changes would be ambitious, and that the sequencing of those changes would likely spur volatility and headwinds before potential pro-growth impacts were felt.

- Fiscal spending was also a point of both emphasis and contention in 2025 as a deep dive into government spending by DOGE early in the year, and longest government shutdown on record later in the year, both highlighted the administration's desire to reshape and reduce government outlays. The recent shrinking of the federal deficit as a percent of GDP indicates that early efforts to pare spending are having an impact, though it is likely too early to tell if this is the start of a new long-term path towards fiscal sustainability.

- On the other hand, the signing of the One Big Beautiful Bill Act permanently extended temporary tax provisions aimed at stimulating economic activity. Business friendly components like changes to depreciation and R&D could improve cash flow and reduce taxes, while consumer-focused provisions like tax exemptions on tips and overtime wages stand to benefit household balance sheets.

- In addition to shifting policy initiatives, markets grappled in the fourth quarter with diminished and delayed official economic data given the shutdown. Though the flow of information has resumed, it will likely still take a few months for things to settle down fully given expected revisions and challenges in backfilling data, potentially creating further uncertainty and volatility to start the year.

Our View: We head into 2026 at an inflection point as the initial headwinds from tariff and immigration policy appear to be fading, while pro-growth developments are on the horizon. Valuations across risk assets reflect pronounced investor optimism, though our view is more balanced given the current state of the labor market and potential for further weakening that could hamper full year growth potential. Moreover, as 2025 demonstrated, the administration has a penchant for volatility that shouldn't go underappreciated and will likely be a feature of markets moving forward.

4Q 2025: Labor Market in a Downward Trend

- Away from policy, a development that became more pronounced over the year was a weakening of the labor market. The unemployment rate rose from 4.3% to 4.5% in the fourth quarter and 0.4% over the entire year, signaling a reduction in labor demand. In addition, the underemployment rate, which captures those marginally attached to the workforce or working part time for economic reasons, came in at 8.4% in December to mark the second-highest reading since 2021.

- Leading indicators suggest the employment picture could continue to worsen in the early months of 2026, with the Conference Board's Labor Differential falling to a three-year low of 5.9%. This metric measures the share of consumers stating jobs are plentiful minus those saying jobs are hard to get, and has historically moved inversely with the unemployment rate, a relationship that held throughout the year.

- Worsening employment prospects also weighed on consumer activity as personal consumption expenditures and real retail sales finished well below the pace set in 2023 and 2024. Notably, this decrease in the pace of outlays arose despite what was likely pull-forward behavior to front run tariff impacts, while overall spending was also supported in part by a substantial reduction in household savings rates, which fell from 5.5% in April to 4.0% just five months later.

- Aside from dipping into savings, a cooling in wage growth forced consumers to tap into other means to support spending. Buy-now-pay-later programs have increased in popularity, while the NY Fed reports that in the most recent quarter, credit card balances rose by $24bln with serious delinquency rates for credit cards (more than 90 days) remaining at the highest levels since 2011. Homeowners, who have recently benefitted from home price appreciation and are viewed commonly as the "haves" in the current K-shaped economy, also increasingly tapped into home equity to generate additional cash flow.

Our View: The ability of the economy to deliver on currently optimistic expectations depends heavily on stabilization of the employment picture. The rise in the unemployment rate and other measures of softening labor demand suggest to us that risks to the labor market remain skewed to the downside, with a materialization of these risks likely reducing full-year growth potential and putting pressure on near-term consumer activity.

4Q 2025: Fed Activity Picks Up Steam

- The Federal Open Market Committee (FOMC) continued monetary policy easing with two 25 bps cuts in the fourth quarter to bring the policy rate to 3.5%, citing downside risks to the labor market as the key driver. However, with inflation still above the long-run target of 2%, the decisions also brought dissent at each meeting as some members voted to hold rates steady in fear of rekindling inflationary pressures. Even so, the FOMC anticipates one more cut in 2026 while markets are priced for two additional rate cuts.

- Investors did not appear to share these inflation concerns, however, as market-based indicators like long-term inflation breakevens remained well-anchored around the 2% level for much of the year. Core CPI also trended lower, reaching 2.7% in December after starting 2025 at 3.2%, with expectations that it will continue to fall given the steady decline in the shelter component and the likely impact of higher tariffs as a tax on consumption.

- Away from policy rate decisions, the Fed also announced an end to its years-long quantitative tightening (QT) program in December. Following years of QT, bank reserves began to dip and overnight funding rates edged higher in the fourth quarter, prompting the Fed to implement reserve management purchases in December. Though the move was framed as a simple exercise to support reserves, it could be viewed as another form of quantitative easing.

- With the FOMC resuming its easing cycle and with further cuts expected in 2026, the U.S. Dollar Index declined by 9.4% over the year. Part of the decline was also likely attributable to diverging global central bank policy, with countries like Australia, Canada, and Sweden apparently set to embark on hiking cycles, while the Bank of Japan is already relatively far along in its own cycle, having lifted its policy rate to the highest level in 30 years.

Our View: Our expectation is that any tariff-based price bumps will likely be a one-time adjustment and that inflation will continue moderating, with Fed activity in 2026 therefore more heavily influenced by labor markets. While 3% is probably close to neutral, if the administration's forthcoming policy changes do little to spur a rebound in labor demand, the Fed will likely have to move through neutral and into accommodative territory – or at least get to neutral more quickly than widely expected – making the front end of the yield curve attractive.

4Q 2025: AI Investment Shows No Sign of Slowing

- With 2025 marking three years since the launch of ChatGPT, AI-related expenditures showed no signs of slowing. Large tech companies in the U.S. spent nearly $450 billion on AI investments in 2025 per both Deutsche Bank and J.P. Morgan, with estimates of the contribution to GDP from AI capex ranging from 1.2% to 1.3%, though the final flow-through impact was somewhat reduced by imported equipment.

- The building of data centers was partially financed through asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). Full-year data center issuance reached nearly $20bln in 2025, represented by $11bln in ABS securities and nearly $9bln in CMBS securities, per Bank of America, creating a multitude of ways for debt investors to gain exposure to the broader AI trend.

- While the buildout of AI infrastructure supported economic activity despite softening consumption, reliance on a single investment area to drive growth creates potential vulnerabilities should return on investment and demand not meet the lofty expectations. Widespread adoption should bolster efficiency and innovation, but those effects will take time to materialize, potentially creating market and economic volatility should that transition prove rockier or more prolonged than anticipated.

- There are likely to be winners and losers over the coming quarters and years, though it is still too early to ascertain the ultimate hierarchy of the AI landscape. Hyperscalers and other large tech companies that can fund expansion and capex through free cash flow are likely to remain resilient and well-sponsored by the markets, though those that finance through significant debt issuance and higher leverage – an increasing development in the second half of 2025 – will be more susceptible to downturns should those expenses not lead to substantially greater revenues.

Our View: The magnitude of corporate spending, combined with the evolving and complex AI ecosystem, provides both opportunities and potential risks to investors. Positions across TCW portfolios are focused less on broader AI beta and instead emphasize on-balance sheet bonds of high-quality tech names. Indirect exposure is also achieved via data centers and electric utility providers to capture attractive return potential from what we expect to be growing power generation and consumption needs over the secular horizon.

4Q 2025: Credit Spreads Remain Tight; Early Signs of Stress Visible

- Both investment grade (IG) and high yield (HY) credit registered positive total returns in the fourth quarter as measured by the Bloomberg U.S. Credit and Bloomberg U.S. High Yield Corporate Index, capping off a strong year that saw the indices return 7.8% and 8.6% for 2025, respectively. Partly contributing to the returns was a continued tightening of credit spreads as IG and HY ended at 73 and 266 bps, respectively, marking the indices' lowest year-end spread level over the past decade.

- A narrative that grew in 2025 suggested that credit spreads should be permanently lower, given fairly healthy balance sheets, consistent insurance buying, and the moderation of business cycles. While the probability of widespread IG defaults is low, IG credit spreads are primarily compensation for lower liquidity and the potential for higher volatility versus Treasuries. This argument is common during times of market complacency, though it has consistently been proven false by markets when unexpected volatility arises and liquidity dries up quickly.

- Budding signs of stress emerged in the below-IG segment of the market given two separate instances of alleged fraud that resulted in insolvencies and an increase in payment defaults. These payment defaults were different than distressed exchanges, which have been more common in recent years as management teams sought to opportunistically extract value and squeeze bondholders, with these activities not always reflecting true hardship. Notably, per J.P. Morgan, distressed exchange volume fell by 46% YoY through November while payment defaults increased by 22%, highlighting the challenges certain borrowers are having in servicing their debt.

- With increasing signs of weakness, bifurcation in both the HY bond and leveraged loan market appeared over the year as investors turned more discerning with challenged credits. Illustratively, though HY credit spreads at the Index level tightened, spreads on CCC-rated issues widened by 77 bps in 2025 and the cohort lagged B and BB rated bonds on a duration-adjusted basis. A similar return pattern was seen for the Morningstar LSTA Leveraged Loan Index, with the share of loans trading below $80 also steadily increasing in 4Q25.

Our View: Credit spreads at current compressed levels offer little value to investors and minimal protection against potential volatility. Even a modest normalization in spreads will lead to significant underperformance versus Treasuries, informing underweights to corporate credit overall and more defensive positioning within the sector broadly, but with the recognition that pockets of value will appear periodically and that we will look to aggressively take advantage of those opportunities.

4Q 2025: An Exceptional Year for Agency MBS

- Agency MBS was the best-performing major sector within the Bloomberg U.S. Aggregate Bond Index for both the fourth quarter and full-year periods with returns of 1.7% and 8.6%, respectively. Performance was similarly strong on a duration-adjusted basis with the sector outpacing comparable Treasuries by 69 and 171 bps over the quarter and year, respectively, to trail only HY corporates.

- After reaching the highs of the year in early-April following tariff announcements, the MOVE Index (a measure of implied interest rate volatility) finished at 64, marking the lowest level since December 2021. Volatility is a key input to the pricing of agency MBS and periods of falling volatility typically translate to tighter spreads, a relationship that was evident throughout the year as the current coupon agency MBS spread over Treasuries fell from 135 bps to 110 bps.

- A defining feature of this current interest rate cycle and attendant move lower in volatility was an increase in prepayment speeds and convexity risks that challenged higher coupon performance relative to middle and lower coupons. In fact, borrowers this year exhibited faster prepayment speeds for a given rate incentive as mortgages rates have come down from their highs, servicing has become more efficient, and loan balances have increased, a dynamic we expect to continue and one that puts higher coupon performance at risk.

- Through November, the government sponsored entities (GSEs) Fannie Mae and Freddie Mac combined to add more than $30bln of agency MBS holdings to their retained portfolios while also making investment personnel hires and reorganizing portfolios to facilitate a more active investment approach. With approximately $200bln of room for additional investments before balance sheet caps are reached, we anticipate increased purchase activity in 2026 - a potential catalyst for further spread tightening.

Our View: TCW maintains a favorable outlook on the agency MBS sector given still-attractive valuations relative to high-quality corporates, the government guarantee, and strong liquidity – features that are typically supportive to the sector's performance, especially during risk-off environments. Exposures are focused on lower coupons for total return upside and belly coupons for a balance of spread and convexity, with more cautious allocations to higher coupons in light of expected lower rates and increased prepayment concerns.

4Q 2025: Securitized Credit Remains Resilient

- Lower rates and investor demand for the attractive yields of securitized credit supported returns across commercial mortgage-backed and asset-backed securities (CMBS and ABS, respectively), driving spread tightening in both sectors that also led to outperformance versus comparable Treasuries.

- CMBS benefitted from a surge in activity that was most notable in private label single asset single borrower (SASB) deals, which largely finance institutional sponsors and trophy properties. After falling as low as 43% in 2023 during the regional bank struggles, SASBs in 2025 accounted for over 70% of total private label CMBS issuance per Trepp, signaling both lender and investor preference for discrete collateral (versus Index-eligible conduit deals), transparent cashflows, and strong sponsors.

- Meanwhile, the non-agency MBS sector exhibited solid return profiles across collateral types given attractive yields, steady income, and strong underlying fundamentals, including a significant increase in homeowners equity over recent years that insulates bondholders from potential loss. In fact, data from the Federal Reserve estimates that U.S. homeowners currently have over $35trln in home equity, significantly reducing loan-to-value ratios and insulating bond investors from potential losses.

- Fundamental support for the non-agency MBS sector also comes from the overhaul to origination practices in the wake of the GFC, which translated into more stringent, conservative, and robust underwriting standards. Compared to pre-GFC offerings in which less than 40% of the collateral pool had documentation for a loan, 100% of the pool in a typical deal today has documentation. Current deals are also more structurally robust, with senior tranches offering 25% credit enhancement levels versus a pre-GFC figure of 7%.

Our View: Securitized products generally trade at more favorable spread levels than corporates at current valuations, making the relative value proposition attractive to inform overweight positions across portfolios. Further, securitized credit 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.

4Q 2025: Core and Core Plus Fixed Income Positioning Summary

Asymmetric risk-reward profiles across fixed income sectors informs a preference for securitized assets over corporate credit. However, as seen in April, volatility in the corporate markets can come quickly, and portfolios maintain ample liquidity to capitalize on better entry points.

Characteristic	Positioning	Comments
Duration	Approximately 0.3 years long versus the benchmark	Despite declining over the year, Treasury yields are still likely above equilibrium levels and therefore have the potential to settle lower
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve given a view that rate cuts are likely to happen faster or in greater magnitude than expected, should the labor market experience prolonged weakness
MBS	• Agency MBS – large overweight Non-Agency MBS – maintain allocation	• Prefer specified pools given better convexity characteristics but maintain some exposure to TBAs for liquidity • Emphasize lower coupon (<3.5%) issues for upside price potential, and middle coupons (4% - 4.5%) given a more favorable mix of spread and convexity relative to current coupons • 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 risk-adjusted spreads • Diversified exposure across non-traditional collateral like digital infrastructure and single-family rentals
CMBS	Small overweight	Targeted exposures to trophy property types via single asset single borrower non-agency CMBS deal structures
Investment Grade Credit	Large underweight	• Positioning emphasizes more defensive industries like communications and consumer non-cyclicals • Financials exposure is comprised mainly of insurance and large U.S. banking names given strong fundamentals and attractive value • Minimal exposure to cyclical credit sectors and non-corporate credit
High Yield / Loans	Minimal allocation	Target high conviction issuers and idiosyncratic credits for alpha generation potential rather than broad-based exposure given tight levels of spreads in aggregate
International	Small allocation, bias to add	• Explore opportunities in non-U.S. credit to capture incremental spread premium relative to domestic issues • Underweight emerging market beta on minimal relative value, with selective exposures in high-conviction stories

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