Touchstone Investments®
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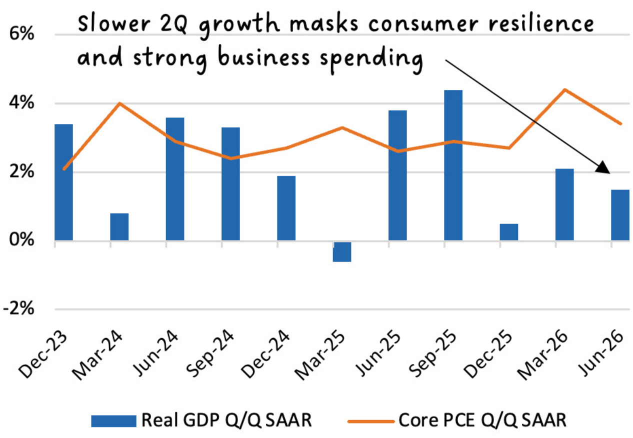
Fixed Income:
Economic Backdrop

Authors: Crit Thomas, CFA, CAIA / Erik M. Aarts, CIMA / Tim Paulin, CFA

August 4, 2026

- **Better Beneath the Surface:** Second quarter GDP growth slowed to a 1.5% annualized pace, but the headline masked continued economic strength as net exports and inventories accounted for much of the weakness. Consumer spending increased by an annualized 3.2% after a soft Q1, business investment remained robust, and final sales to private domestic purchasers rose 3.9%, the strongest pace since early 2023. AI-related investment includes industries beyond technology, such as power, industrials, transportation and infrastructure, supporting a wider base of economic activity and corporate earnings.
- **Inflation Isn't Finished:** June's PCE report was a step in the right direction, reflecting lower energy prices during the brief ceasefire in the Middle East. Whether that marks the beginning of a sustained disinflation trend remains uncertain as renewed hostilities threaten to push energy and transportation costs higher. With inflation still well above the Federal Reserve's 2% objective, policymakers are likely to remain on hold while assessing whether tighter financial conditions are sufficient to restore price stability.
- **Scrappy Consumer:** Consumer spending remains surprisingly resilient, supported by a balanced labor market and historically low layoffs. Beneath the surface, however, some households are becoming increasingly resourceful—seeking value, delaying discretionary purchases, drawing down savings and stretching household budgets. The temporary support from larger tax refunds has largely faded, leaving consumers more exposed should gasoline prices remain elevated.
- **Stagflation Risk Persists:** Expanding hostilities in the Middle East have renewed uncertainty around energy prices, transportation costs and global supply chains. While the U.S. economy has absorbed these shocks remarkably well, a prolonged conflict could slow growth while keeping inflation elevated, preserving the risk of a stagflationary outcome.
- **Resilience Still Wins:** Economic resilience remains the defining characteristic of 2026. Stronger-than-expected growth, broadening corporate earnings and an expanding business investment cycle that now extends well beyond AI support our moderate overweight to equities relative to fixed income. We continue to believe the economy is proving more resilient than many investors anticipated, supporting corporate earnings despite an increasingly uncertain geopolitical backdrop.

Real GDP and Inflation

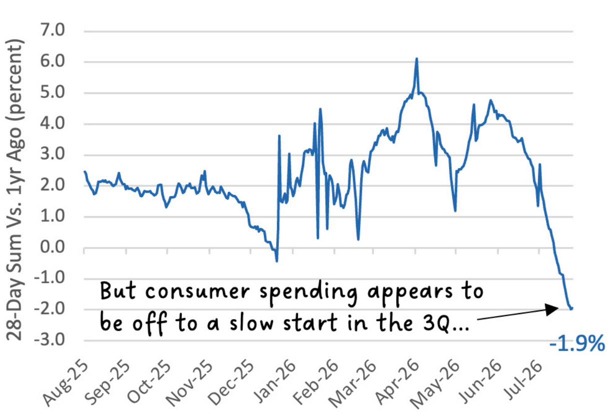


Source: Bloomberg. 3 years of quarterly data through Jun 2026.
SAAR = Seasonally Adjusted Annual Rate

Wages and Salaries

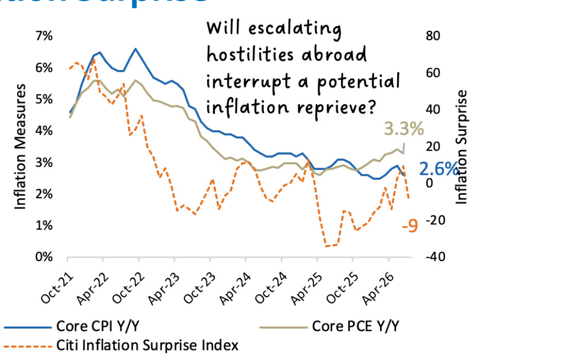
Source: Bloomberg. 20 years of quarterly data through Jun 2026.

Credit and Debit Card Transactions



Source: Bloomberg. 1 year of daily data through Jul 27 2026.

Inflation Surprise



Source: Bloomberg. 5 years of monthly data through Jun 2026. Core PCE through Jul 2026. The Inflation Surprise Index measures the difference between official inflation releases versus consensus expectations. Positive numbers indicate inflation has been higher than expected and vice versa.

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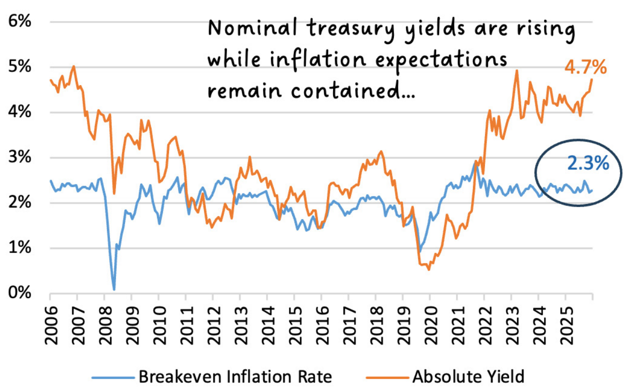
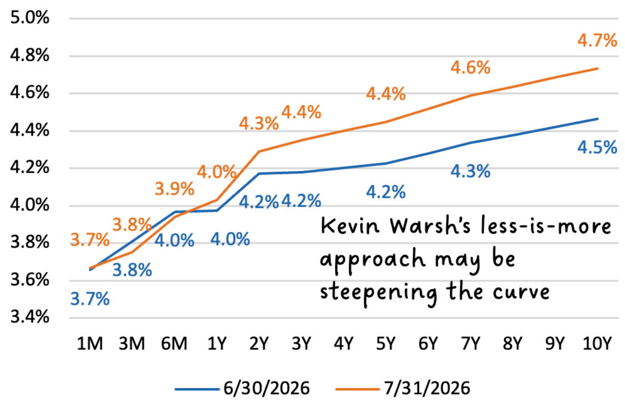
- **Bond Math Has Changed:** July was a reminder that higher yields do not eliminate interest rate risk. Rising Treasury yields weighed on most high quality fixed income sectors, leaving year-to-date returns modest and even negative for some longer duration sectors. The important difference today is that higher starting yields have fundamentally changed the return equation. Income has once again become the primary driver of expected returns, providing a meaningful cushion against future rate volatility and improving long-term return potential.
- **Real Yields Drive the Story:** The composition of Treasury yields has become increasingly important. Much of the rise in nominal yields reflects higher real yields rather than materially higher long-term inflation expectations. Markets increasingly appear to be pricing stronger demand for capital associated with resilient economic growth, AI-related investment, and persistent Treasury issuance, while inflation expectations remain comparatively well anchored. This represents a fundamentally different environment than one driven primarily by inflation fears.
- **A New Fed Means Greater Uncertainty:** Chair Kevin Warsh's less-is-more approach to communication marks a meaningful shift in how monetary policy is transmitted to financial markets. Rather than relying heavily on forward guidance, the Federal Reserve is placing greater emphasis on incoming economic data and market pricing. As investors adjust to the Fed's evolving reaction function, interest-rate volatility is likely to remain elevated.
- **Favor Intermediate High-Quality Income:** We continue to maintain a slight overweight to duration while remaining shorter than the broad market benchmark. Higher yields now provide greater compensation for assuming duration risk, and the normalization of the yield curve has restored positive roll-down in the intermediate portion of the curve. Combined with attractive carry, resilient corporate fundamentals, and consumer credit trends that remain broadly supportive despite growing dispersion, we continue to favor investment-grade corporates and securitized credit as attractive sources of income. Higher rate volatility should also create additional opportunities for active managers to add value through duration management and security selection.

U.S. 10 year Treasury Bond



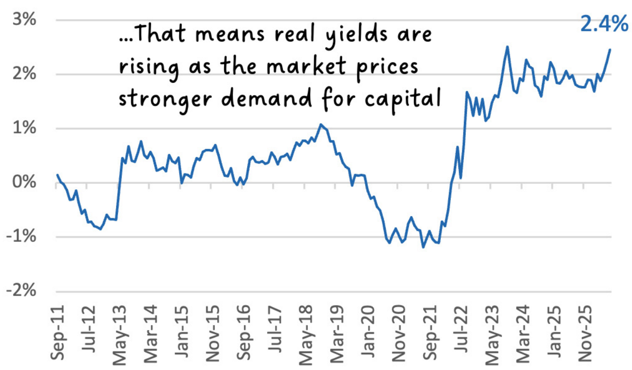
Source: Bloomberg. 20 years of monthly data through Jul 2026. Breakeven inflation rate is a measure of expected inflation derived from the difference between the 10-year Treasury yield and the 10-year TIPS yield.

Treasury Yield Curve vs Prior Month



Source: Bloomberg.

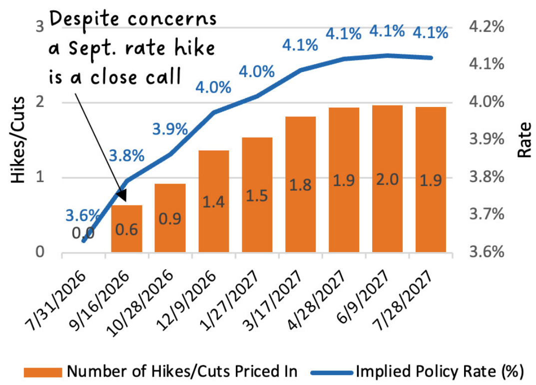
U.S. 10-year Treasury Inflation-Protected (TIPS) Yield



Source: Bloomberg. 15 years of monthly data through Jul 2026.

Federal Funds Rate

Implied Overnight Rate & Number of 25bp Hikes/Cuts



Source: Bloomberg. Data as of Jul 31 2026.

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Fixed Income:
Credit Risk

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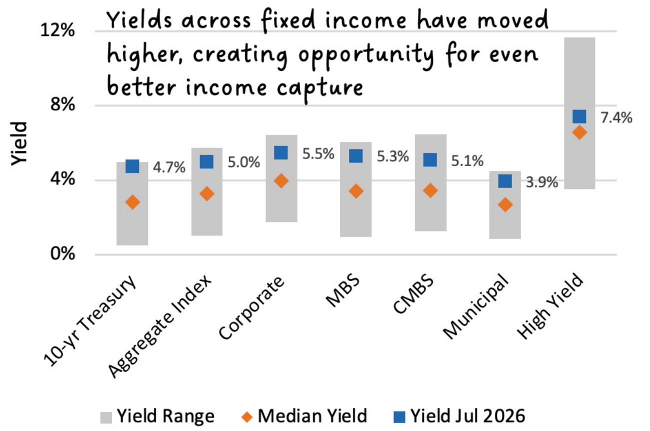
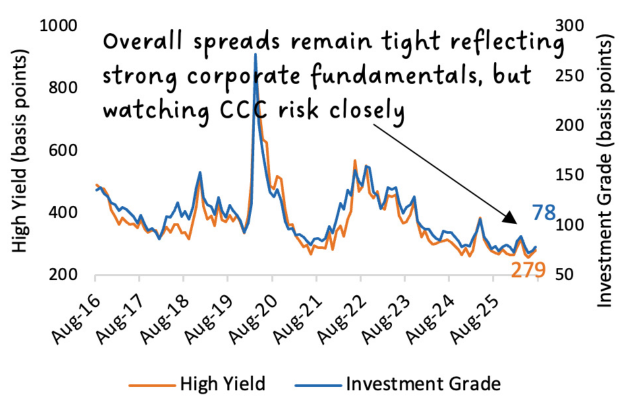
- **The Cost of Capital Is Resetting:** Credit markets are beginning to reflect the same structural forces reshaping the rates market. Strong economic growth, elevated Treasury issuance, and unprecedented AI infrastructure investment have increased demand for capital. While corporate fundamentals remain healthy, financing costs are increasingly being driven by the balance between capital supply and demand rather than company-specific credit quality. We believe this marks a shift away from an era of abundant liquidity and inexpensive capital toward one where markets increasingly determine the cost of capital.
- **Financing the AI Boom:** AI infrastructure spending is reshaping credit markets. Investment-grade issuance has already surpassed $1.25 trillion, matching the record pace established in 2020. Hyperscalers continue to raise capital to fund an expanding AI buildout, and recent upward revisions to capital spending suggest financing needs are likely to grow further. More broadly, hyperscaler debt has nearly doubled over the past year to $439 billion, increasing its weight in the investment-grade corporate index from 2.8% to 5.3%. AI-related credit has evolved from a niche allocation into a meaningful component of benchmark portfolios, making security selection increasingly important.
- **Capital Allocation Matters Again:** The market continues to absorb new issuance, but the clearing price for capital is rising. Investors are becoming more discriminating about where they deploy their liquidity. Demand for large AI-related bond offerings has cooled, with orders dropping from nearly five times the bonds offered earlier this year to less than twice today, requiring issuers to offer concessions to attract buyers. Hyperscaler spreads have widened to roughly 100–120 basis points over Treasuries versus approximately 80 basis points for the broader investment-grade market. Investors are no longer evaluating companies solely on earnings growth—they are increasingly asking whether today's capital investment will earn returns above a higher cost of capital.
- **Dispersion Drives Opportunity:** We remain modestly underweight high yield as spreads offer limited compensation for incremental credit risk, despite attractive starting yields. Instead, we favor areas where the repricing of capital has created better risk-adjusted opportunities, including higher-quality corporate credit, seasoned non-agency RMBS, select ABS and CMBS, and increasingly local-currency emerging market debt, where attractive real yields and differentiated monetary policy support the opportunity set. As the cost of capital resets, we believe excess return will increasingly come from security selection rather than credit beta.

10-year Yield Range for Fixed Income Sectors



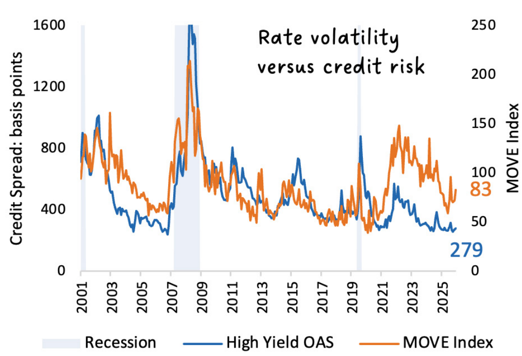
Source: Bloomberg. 10 years of monthly data through Jul 2026.

Bloomberg U.S. Corporate Bond Index Option Adjusted Spreads



Source: Bloomberg. 10 years of monthly data through Jul 2026.

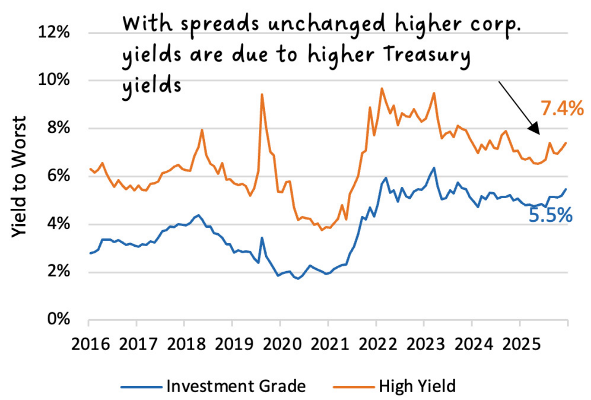
ICE BofA MOVE Index



The MOVE Index measures U.S. bond market volatility through a basket of OTC options on U.S. interest rate swaps.

Source: Bloomberg. 25 years of monthly data through Jul 2026.

Bloomberg U.S. Corporate Bond Indexes



Source: Bloomberg. 10 years of monthly data through Jul 2026.

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Fixed Income:

Market Characteristics

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The Indexes mentioned are unmanaged statistical composites of stock market or bond market performance. Investing in an index is not possible.

Total Returns

	July 2026	YTD	2025	2024	2023	Duration years
Bloomberg Long Term Treasury	-4.0%	-3.6%	5.6%	-6.4%	3.1%	13.9
Bloomberg U.S. TIPS	-0.7%	0.5%	7.0%	1.8%	3.9%	4.8
Bloomberg U.S. Aggregate	-1.3%	-0.7%	7.3%	1.3%	5.5%	5.8
Bloomberg U.S. Agg Corporates	-1.7%	-0.8%	7.8%	2.1%	8.5%	6.6
Bloomberg U.S. Agg ABS	-0.1%	1.0%	5.9%	5.0%	5.5%	3.0
Bloomberg U.S. Agg MBS	-1.4%	-0.4%	8.6%	1.2%	5.0%	5.7
Bloomberg U.S. Agg CMBS	-0.4%	0.4%	7.7%	4.7%	5.4%	3.7
Bloomberg Municipal Bond	-1.9%	0.4%	4.2%	1.1%	6.4%	6.7
Bloomberg 1-3 year Corporate	0.1%	1.3%	5.9%	5.3%	5.5%	1.9
S&P Preferred Stock	1.0%	1.0%	5.0%	9.2%	12.0%	NA
Bloomberg High Yield	-0.2%	1.7%	8.6%	8.2%	13.4%	3.0
S&P UBS Leveraged Loan	0.8%	2.2%	5.9%	9.1%	13.0%	NA
Bloomberg Global Agg	-0.5%	-0.7%	8.2%	-1.7%	5.7%	6.2
Bloomberg Emerging Markets USD	-1.3%	0.7%	11.1%	6.6%	9.1%	5.8

Yields

			Last 10 years			
	July 2026	YTD Change bps	Current Percentile	Median	Min	Max
10 year Treasury	4.7%	57	100	2.8%	0.5%	5.0%
2 year Treasury	4.3%	82	85	2.5%	0.1%	5.2%
10 year TIPS	2.5%	55	100	0.7%	-1.2%	2.5%
Bloomberg U.S. Aggregate	5.0%	66	95	3.3%	1.0%	5.7%
Bloomberg U.S. Agg Corporate	5.5%	65	92	4.0%	1.7%	6.4%
Bloomberg U.S. Agg ABS	4.8%	69	81	3.0%	0.4%	6.0%
Bloomberg U.S. Agg MBS	5.3%	67	96	3.4%	0.9%	6.1%
Bloomberg U.S. Agg CMBS	5.1%	64	80	3.5%	1.4%	6.6%
Bloomberg Municipal Bond	3.9%	33	94	2.7%	0.9%	4.5%
Bloomberg 1-3 year Corporate	4.8%	73	79	3.2%	0.5%	6.2%
Bloomberg High Yield	7.4%	88	71	6.6%	3.5%	11.7%
S&P UBS Leveraged Loan	9.4%	132	72	6.1%	3.6%	13.1%
Bloomberg Global Agg	4.0%	48	97	2.0%	0.8%	4.4%
Bloomberg Emerging Markets USD	6.3%	57	66	5.7%	3.5%	8.7%

Option Adjusted Spreads (bps)

			Last 10 years			
	July 2026	YTD Change	Current Percentile	Median	Min	Max
Bloomberg U.S. Corporate Agg	78	0	7	109	71	373
Bloomberg 1-3 year Corporate	46	-5	15	57	31	390
Bloomberg U.S. Agg ABS	42	-10	31	49	22	325
Bloomberg U.S. Agg MBS	31	9	39	36	7	132
Bloomberg U.S. Agg CMBS	66	-9	18	85	62	275
Bloomberg High Yield	279	13	11	356	250	1100
S&P UBS Leveraged Loan (discount margin)	493	38	59	474	379	1275
Bloomberg Emerging Markets USD	167	-11	2	289	154	720

For Index Definitions see: TouchstoneInvestments.com/insights/investment-terms-and-index-definitions

2024 – Economic growth continued unabated, driven by consumer spending. Inflation moderated further. The Federal Reserve pause continued until September, after which it cut interest rates three times by a total of 1 percentage point. Bond yields rose in response, resulting in only modest gains for high quality fixed income but better returns for riskier areas of fixed income.

2025 – The economy remained resilient, and inflation stayed sticky, keeping yields elevated but allowing high-quality intermediate maturity bonds to generate solid returns as the Fed cut rates late in the year. Steady growth and improving liquidity supported tighter spreads, driving performance in credit-sensitive areas of the fixed income market.

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The Touchstone Asset Allocation Committee (TAAC) consisting of Crit Thomas, CFA, CAIA – Global Market Strategist, Erik M. Aarts, CIMA – Vice President and Senior Fixed Income Strategist, and Tim Paulin, CFA – Senior Vice President, Investment Research and Product Management, develops in-depth asset allocation guidance using established and evolving methodologies, inputs and analysis and communicates its methods, findings and guidance to stakeholders. TAAC uses different approaches in its development of Strategic Allocation and Tactical Allocation that are designed to add value for financial professionals and their clients. TAAC meets regularly to assess market conditions and conducts deep dive analyses on specific asset classes which are delivered via the Asset Allocation Summary document. Please contact your Touchstone representative or call 800.638.8194 for more information.

A Word About Risk

Investing in fixed-income securities which can experience reduced liquidity during certain market events, lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal. When interest rates rise, the price of debt securities generally falls. Longer term securities are generally more volatile. Investment grade debt securities which may be downgraded by a Nationally Recognized Statistical Rating Organization (NRSRO) to below investment grade status. U.S. government agency securities which are neither issued nor guaranteed by the U.S. Treasury and are not guaranteed against price movements due to changing interest rates. Mortgage-backed securities and asset-backed securities are subject to the risks of prepayment, defaults, changing interest rates and at times, the financial condition of the issuer. Foreign securities carry the associated risks of economic and political instability, market liquidity, currency volatility and accounting standards that differ from those of U.S. markets and may offer less protection to investors. Emerging markets securities which are more likely to experience turmoil or rapid changes in market or economic conditions than developed countries.

Performance data quoted represents past performance, which is no guarantee of future results. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than performance data given. ***For performance information current to the most recent month-end, visit TouchstoneInvestments.com/mutual-funds.***

Please consider the investment objectives, risks, charges and expenses of a fund carefully before investing. The prospectus and the summary prospectus contain this and other information about a fund. To obtain a prospectus or a summary prospectus, contact your financial professional or download and/or request one at TouchstoneInvestments.com/resources or call Touchstone at 800.638.8194. Please read the prospectus and/or summary prospectus carefully before investing.

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