Fixed Income Asset Allocation Insights

Markets Keep Slowly Improving, but Risks Persist

27 August
2020

Robert Vanden Assem, CFA, Head of Investment Grade Fixed Income and Chairman of Fixed Income Asset Allocation Team

Risk asset classes outperformed in August, with credit spreads now largely around fair value. Duration played a significant role in the month's performance as Treasury rates sold off, but we don't expect this to be a significant driver in coming months. Instead, we expect to see continued improvement in markets, although at a slower pace than in prior months, on the back of persistent support from central banks, anticipation of additional fiscal stimulus in the US, and the agreement by EU leaders on a European recovery fund, along with better-than-anticipated earnings and further progress on the development of Covid-19 vaccines and treatments. That said, we still see a very small upside possibility of faster-than-expected growth as well as several possible recovery-derailing risks, including the recent surge of Covid-19 cases in the US and Europe, escalating tensions between the US and China, Brexit uncertainties, and the potential failure of the US to pass another fiscal package. Against this generally positive backdrop, our fixed-income allocations remain unchanged.

US Macro View

Markus Schomer, CFA, Chief Economist

Becoming less bearish in favor of the central case

We lowered our US Macro bear-case scenario and increased our central case scenario again this month, raising our central case probability by 10 percentage points to 65%. While the near-term risk of a recovery setback is increasing, the intermediate-term outlook suggests the economy will look more normal in 12 months. Our bearish and bullish scenarios now stand at 30% and 5%, respectively, and we anticipate strong growth in the third and fourth quarters, followed by more normal growth in 2021, although still dependent on continued fiscal and monetary stimulus.

Market movers

Consumer confidence. An August pause in the recovery due to lower US consumer confidence and the expiration of extra unemployment insurance may cause a brief recovery setback. While it's unlikely to materially affect third-quarter performance, it could more seriously depress growth in the fourth quarter.

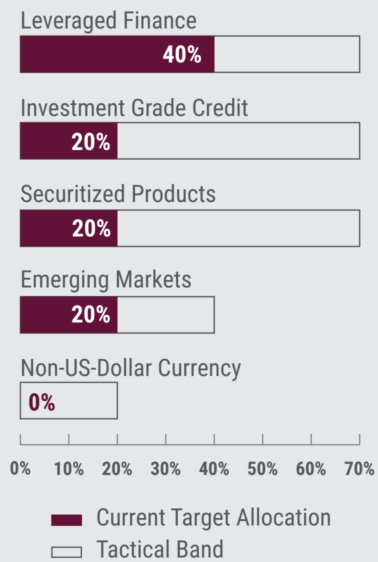
US dollar. The decline in the US dollar against other major developed market (DM) currencies may be just a cyclical response to improving macro conditions abroad and receding global uncertainty, or a more structural reaction to the massive increase in dollar debt, which would require higher yields to attract investors.

Fiscal stimulus. Absent another fiscal package, the risks of a recovery pause are rising. With the election rapidly approaching, it's quite irrational to stall on much-needed stimulus.

About This Report

Fixed Income Asset Allocation Insights is a monthly publication that brings together the cross-sector fixed income views of PineBridge Investments. Our global team of investment professionals convenes in a live forum to evaluate, debate, and establish top-down guidance for the fixed income universe. Using our independent analysis and research, organized by our fundamentals, valuations, and technicals framework, we take the pulse of each segment of the global fixed income market.

Target Portfolio Allocations
(as of 27 August 2020)



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Leveraged Finance

John Yovanovic, CFA, Head of High Yield Portfolio Management

Fundamentals
Second-quarter earnings exceeded dismal expectations. Anecdotally, companies expected to burn through cash spent materially less than feared and consumer-related sectors saw sharp revenue gains, indicating markets may have correctly anticipated a quick recovery.

Valuations
Spreads continue grinding tighter despite record supply. Option-adjusted spreads of 502 on the Bloomberg Barclays US High Yield Index imply a 4.0% default rate (based on Bloomberg Barclays data and PineBridge calculations as of 20 August). We estimate default rates are peaking now at 7% (4.5% ex energy) and will move slightly lower into 2021. Spreads are fair near term and still moderately attractive on a 12-month basis.

Technicals
Month-to-date (through 14 August) new-issue volume of $40.3 billion (based on JP Morgan Securities data) made this August the most active on record. High-yield bond fund inflows of $1.54 billion for the week ending 12 August (the sixth consecutive week of inflows) brought average weekly inflows to $2.8 million over the past 20 weeks, which saw seven of the eight largest inflows on record (based on AMG/Lipper data).

Leveraged Finance Allocation Decision
We maintain our allocation of 40%. Valuations are fair value in the near term and attractive looking into 2021. We now slightly favor loans over bonds as we anticipate the technical picture will equalize. Collateralized loan obligation (CLO) spreads are reaching levels where CLO creation is on the horizon, which may provide a technical boost for loans.

Investment Grade Credit

US Dollar Investment Grade Credit
Dana Burns, Portfolio Manager,
US Dollar Investment Grade Fixed Income

Fundamentals
Fundamentals are under pressure as Covid-19 disruptions negatively impact the economy. Leverage and intra-investment-grade downgrades are likely to increase. Should a significant second wave of the virus be avoided, we expect fundamentals to gradually improve in the second half of 2020.

Valuations
Credit spreads have tightened inside of 130 basis points (bps), which is near long-term averages. Nevertheless, select credits continue to offer value and quality within their sectors.

Technicals
The technical backdrop for credit remains strong due to lower estimated supply for the remainder of 2020, Fed buying, and continued demand for higher-quality credits from nontraditional and foreign buyers.

Non-US-Dollar Investment Grade Credit
Roberto Coronado, Portfolio Manager, Non-US Dollar Investment Grade Credit

Fundamentals
Negative. Lockdowns and uncertainties about the effectiveness of fiscal support cloud the outlook for economies and corporate issuers. A second-half rebound hinges on whether we see a new wave of infections and lockdowns.

Valuations
Slightly Positive. Credit spreads have rallied over the past month and now are closer to fair value. We continue to be positive on the medium term and expect tighter spreads in six months.

Technicals
Positive. Given inflows, ECB buying, and a slowdown in supply over the summer, technicals remain very favorable. We expect a move closer to neutral as supply picks up in September.

Investment Grade Credit Allocation Decision
We maintain our allocation of 20%. Despite worries about an increase in US Covid-19 cases, deteriorating US-China relations, the upcoming US elections, and Brexit, we believe the technical backdrop remains supportive as persistent strong demand continues to absorb new-issue supply.

Emerging Markets

Sovereigns
Anders Faergemann, Portfolio Manager,
Emerging Markets Fixed Income

Fundamentals
As fundamentals slowly improve, we anticipate the emerging market (EM) contraction this year will be shallower than that in developed markets and that next year's bounce-back will be sharper. While recovery is uneven across countries and dependent on the stringency of lockdowns, EM growth should improve steadily through the remainder of 2020, with inflation not a problem and central banks still having more room to cut rates.

Valuations
Further spread compression has led to higher valuations. The JP Morgan Emerging Market Bond Global Diversified Index is trading at +419 bps (tighter by 43 bps), investment grade (IG) at +183 (-26 bps), and high yield (HY) at +755 (-65 bps) (JP Morgan as of 26 August). We expect a long, hard grind tighter. IG valuations are

close to fair levels and HY remains attractive, both in absolute terms and relative to US HY, and continues to be driven by country-specific developments that make us selective in our choice of credits.

Technicals

No change. Liquidity is normal, steady inflows continue, and new issuance experienced a summer lull, with more supply coming in September.

Corporates

Steven Cook, Co-Head of Emerging Markets Fixed Income

Fundamentals

Second-quarter results have been slightly better than expected, with only 11 of 81 Latin American companies underperforming expectations. Outlooks also skew positive, and we expect similar results when Asian companies report. Optimism is supported by the 2.5% year-to-date (YTD) default rate (based on JP Morgan data as of 31 July).

Valuations

Spreads have continued to grind tighter, with the CEMBI Broad Diversified Index tightening another 20 bps month-to-date, versus tightening of 16 bps in IG and 19 bps in HY (based on JP Morgan data as of 19 August). Index spreads have retraced 70% of their first-quarter widening, when they peaked at 650 bps. We expect spread-tightening to continue on stronger fundamentals and supportive technicals.

Technicals

While YTD supply of $317 billion (based on JP Morgan data as of 14 August) tracks last year's levels and September supply should be large, longer-term technicals remain supportive, with supply below 2017 and 2019 levels and investors becoming more confident and seeking yield pickup versus developed markets.

Emerging Markets Allocation Decision

We maintain our allocation of 20%. Spreads continued to move tighter in August, with high yield taking the lead. After very strong primary issuance in May and June, new deals slowed in July and August. While valuations are still attractive both in absolute terms and relative to US high yield, we remain selective.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

Forbearance and buyout uncertainty have been a drag on mortgage-backed securities (MBS) performance. A recent 50-bp fee for refinance loans may serve as a small step in slowing serial refinancers.

Valuations

Ginnie Mae buyouts have been a drag on MBS index performance.

Technicals

The Fed minutes affirmed that the MBS buying program will continue and explicitly stated that the program is intended not merely to smooth market functioning but to accomplish "accommodative policy" as well.

Securitized Products Allocation Decision

We maintain our allocation of 20%. While greater MBS supply due to very strong housing demand and record-low rates are keeping spreads from tightening dramatically, even with the Fed's purchase program and stronger-than-expected Ginnie Mae buyouts, we still believe spreads are more likely to tighten than widen given Fed activity and the short-term nature of the buyouts.

Our Central Case Scenario Probability Slightly Increased While Our Recession Case Scenario Probability Decreased During the Month

Fixed Income Scenario Probabilities – Next 12 Months (as of 27 August 2020)

Increase | Decrease | Unchanged

Scenario	US GDP Growth	Inflation	USD Basket	Avg. Scenario Probability	Scenario Probabilities: USD Inv. Grade	Securitized Products	Leveraged Finance	EMD	Non-USD IG
Recession; Deflation	< 1%	< 1%	Breaks 5% band on the downside	32%	40%	30%	20%	30%	40%
Central Case	1-3%	1-3%	Maintains -5% to +5% band	65%	60%	70%	70%	65%	60%
High Growth; Inflation	> 3%	> 3%	Breaks 5% band on the upside	3%	0%	0%	10%	5%	0%

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Non-US-Dollar Currency

Dmitri Savin, Portfolio Manager, Portfolio and Risk Strategist, Emerging Markets Fixed Income

Fundamentals

The collapse of the US/EU interest rate differential, less safe-haven demand, political uncertainty, and a possible slow pandemic recovery are all short-term US dollar depressants. In Europe, nascent fiscal centralization is sparking optimism and raising the floor under the euro.

Valuations

The euro appears to have priced in a lot of the good news for the short term. EM currencies are largely undervalued against the US dollar despite an early summer rally, particularly in CE4 currencies.

Technicals

Euro net long positions are now 2.1 standard deviations higher than three-year averages (based on IMM data through 23 August). Current positioning is +197,000 contracts, versus +151,000 at the last peak in early 2018.

Non-US-Dollar Currency Allocation Decision

We maintain our 0% non-dollar allocation. We are neutral on the US dollar in the short term. Lower interest rates for longer and a continued decline in market volatility could weigh on the US dollar for the rest of the year since the broad search for yield had underpinned the rally in US credit markets and spilled over to other risk assets.

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