Fixed Income Asset Allocation Insights

Stick With Quality as Economies Slow

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

With credit spreads now largely in a fair valuation range, our current allocations remain unchanged. After cutting the federal funds rate by the anticipated 25 basis points (bps) and lowering the target range to 1.5%-1.75%, the Fed intends to wait and see before resuming further rate cuts. The potential for a US-China trade cease fire and brighter prospects for a Brexit deal have buoyed investor sentiment, as did less pessimism over global growth. While the Eurozone remains weak, Asia appears to have stabilized and the US economy grew by a better-than-expected 1.9% in the third quarter as consumer strength continued. As a result, Treasury yields have moved higher and the yield curve inversion reversed. Earnings results for 3Q, so far, are in line with expectations, leading us to believe the most likely scenario is a slowdown, not a recession. We therefore maintain our preference for higher quality credits.

US Macro View

Markus Schomer, CFA, Chief Economist

Central case

We continue to expect moderate GDP growth and inflation, each at about 2%. The main drivers are steady consumption driven by full employment, wage growth in line with productivity growth, and moderate business investment driven by low interest rates. We continue to anticipate the Fed will steady rates around the neutral rate; the equilibrium real funds rate is 0.25% to 0.50%.

Market movers

One more cut? When the Fed cut rates in September, markets were confident at least three more cuts were coming through the end of 2020. Now, the Fed is more cautious in its public comments and deals on US-China trade and Brexit may limit its dovishness, despite US data confirming our expectation of a slowdown.

Tired consumers? Consistent with our "slowdown, no recession" theme, signs grow of cracks in the US consumer story. Growth in private payrolls has fallen meaningfully, wage growth is not accelerating, and consumer confidence indices are below prior highs.

Weaker dollar? The differentials in relative growth and interest rates, plus cautious sentiment indicators, which have propped up the US dollar over the past year may be quickly eroding. Manufacturing in emerging markets is growing faster than in the US, markets are more optimistic, and shorter-term interest rate differentials have narrowed.

Leveraged Finance

John Yovanovic, CFA, Portfolio Manager, High Yield Bonds
Julie Bothamley, Portfolio Manager, Leveraged Loans

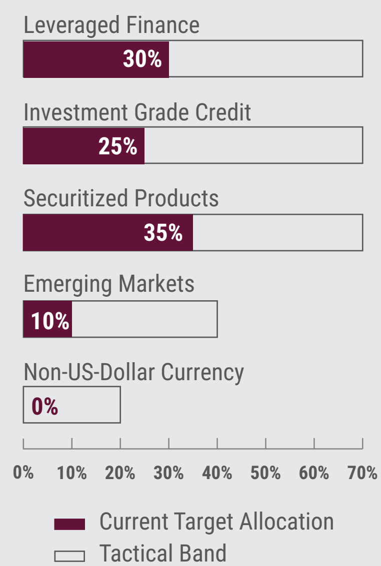
Fundamentals

Third-quarter earnings should be a trough followed by two quarters of ~0-5% growth until a rebound in Q3 2020. Fundamentals remain decent but "up in quality" trade continue in favor. While nothing is overly concerning on the default or fallen angel front, we remain cautious.

30 October 2019

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 30 October 2019)



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Valuations
Spreads are range bound, with higher quality back in favor and BB/B outperforming. Valuations appear tight to fair value dependent on macro view, with earnings weakness the base case. Loans continue to look attractive; positive convexity with the weighted average bid at approximately 95.7. Collateralized loan obligation (CLO) tranches below investment grade (IG) are holding at year-to-date (YTD) wides.

Technicals
High yield (HY) flows still volatile but positive. We've seen $5.1 billion of inflows in the last four weeks despite a $1.5 billion outflow last week dominated by ETFs. Loan technicals for lower-rated issuers remain challenging, and retail fund outflows continue, with almost $40 billion withdrawn YTD. European CLO demand is solid; US neutral at best.

Leverage Finance Allocation Decision
We maintain our allocation of 30%. Valuations are fair in HY, but better in floating rate, so we maintain our preference for bank loans and CLO debt tranches, although we continue to find attractively priced credits in the HY market where issuers have positive fundamentals and sector outlooks.

Investment Grade Credit

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

Fundamentals
Fundamentals remain relatively solid despite headwinds associated with the lack of trade resolution and weaker macro-economic growth backdrop.

Valuations
Credit spreads are now at the tight end of the range. Nevertheless select credits and parts of the credit curve remain attractive. The recent rate movement has made all-in yields more attractive.

Technicals
At present, broker-dealer inventories are relatively low, issuance is waning and demand remains firm. We expect the technical backdrop for credit to remain supportive for the rest of the year.

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

Fundamentals
Neutral. We see no major changes in credit metrics in Europe, as leverage has not increased while M&A activity and shareholder-friendly policies remain under control. Banks continue to have a strong capital base and have been reporting, on average, stable results.

Valuations
Slightly positive. Credit spreads are not far from fair value but we expect them to go tighter thanks to the new buyer in town (the European Central Bank). We are currently overweight industrials and corporate hybrids.

Technicals
Positive. The start of the new QE program provides strong technical support. Continued inflows to the European credit market has been partially offset by a higher than normal primary supply.

Investment Grade Credit Allocation Decision
We maintain our allocation of 25%. Overall, fundamentals remain sound and demand for credit is likely to continue, keeping spreads at the lower end of the range.

Emerging Markets

Sovereigns
Anders Faergemann, Portfolio Manager
Emerging Markets Fixed Income

Fundamentals
Inflation within broader EM continues to be on a downward path, enabling central banks to pursue easier monetary policy independent of the Fed. Average real yields are in the middle of their five-year range, suggesting further room for EM central banks to lower interest rates.

Valuations
EM spreads at +329 bps are back to the pre-selloff July level after an August roller coaster and a small blip in early October. Index composition changes (GCC phases in, Venezuela phases out) help the down move. HY continues to offer attractive spread differential vis-à-vis IG, even though it is much less impressive ex-Argentina.

Technicals
Search for yield continues to outweigh growth concerns and policy uncertainty. Following a pickup in September, the supply outlook remains tempered. Coupons and amortizations are picking up into Q4 providing further technical support.

Corporates
Steven Cook, Portfolio Manager, Emerging Markets Fixed Income

Fundamentals
Credit trends have deteriorated slightly since the second quarter. While we don't expect further deterioration given flat capex and flat overall topline growth YTD, we don't expect leverage metrics to improve either.

Valuations

Month-to-date spread tightening has offset the move in US Treasuries, which clearly has been a factor in total return. We view overall spreads as fair given that idiosyncratic stories are likely to drive index spreads either way, yet still see pockets of opportunity.

Technicals

September's supply of $63 billion, after $44 billion in inflows, made the month the year's second largest after August's $11 billion. YTD supply is up 30% to $389 billion, with Asia continuing to be the driver, accounting for 65% of the total. Net financing is expected to be negative into yearend.

Emerging Markets Allocation Decision

We maintain our allocation of 10%. Overall valuations are generally fair at current levels and fundamentals remain in good shape as idiosyncratic stories continue to drive moves and sentiment in EM.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

The prepayment volumes that occurred in August showed the convexity response of the type of mortgage product that has been originated since mid 2018.

Valuations

Spreads are at wide levels, but should not be construed as an outright buy signal.

Technicals

Federal Reserve balance sheet expansion is happening without any benefit to mortgage-backed securities (MBS). That is a headwind. Cross-currency hedging has been coming down again, which could bring in more foreign buyers.

Securitized Products Allocation Decision

We maintain our allocation of 35%. The worst of MBS widening was seen, and relief came into higher rates, but it's hard to find signals that would result in more tightening.

Non-US Dollar Currency

Dmitri Savin, Senior Vice President, EM Fixed Income Portfolio Strategy/Risks

Fundamentals

With the Fed behind the curve in its effort to ease, it has been ineffective in weakening the exchange rate. The US economy slowing at a measured pace and the US-EU yield differential remaining in effect even if shrinking are providing support for the US dollar.

Valuations

Negative yields in the Eurozone and Japan together with negative growth views tend to overshadow any suggestions that the euro may be undervalued against the US dollar for the medium term.

Technicals

Following the US-China handshake, International Monetary Market data show net US dollar positioning is long at $20.4 billion, up $5 billion in the past month.

Non-US Dollar Currency Allocation Decision

We maintain our 0% non-dollar allocation. We continue to favor the US dollar since yield and growth differentials support the currency.

Our Scenario Probabilities Were Unchanged During the Month

Fixed Income Scenario Probabilities – Next 12 Months (as of 30 October 2019)

Increase / Decrease / Unchanged

					Scenario Probabilities				
Scenario	US GDP Growth	Inflation	USD Basket	Avg. Scenario Probability	USD Inv. Grade	Securitized Products	Leveraged Finance	EMD	Non-USD IG
Recession; Deflation	< 1%	< 1%	Breaks 5% band on the downside	**24%**	20%	20%	30%	30%	20%
Central Case	1-3%	1-3%	Maintains -5% to +5% band	**70%**	70%	75%	70%	60%	75%
High Growth; Inflation	> 3%	> 3%	Breaks 5% band on the upside	**6%**	10%	5%	0%	10%	5%

Source: PineBridge Investments. For illustrative purposes only. Any opinions, projections, forecasts and forward-looking statements are based on certain assumptions (which may differ materially from actual events and conditions) and are valid only as of the date presented and are subject to change.

About PineBridge Investments

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 30 September 2019, the firm managed US$96.9 billion across global asset classes for sophisticated investors around the world.

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