Fixed Income Asset Allocation Insights

PineBridge® INVESTMENTS

From a Big Year-End Rally to Thoughtful Optimism

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The fourth quarter ended on a strong note, with most risk assets rallying significantly into year-end and fixed income spreads at or near their tightest levels of the year. Risk assets gave back some of these gains and yields moved a little bit higher to start January, but credit spreads remain on the tight end of anticipated valuation ranges. The fundamental backdrop remains constructive despite the tight valuations.

Expectations that the Federal Reserve will cut rates are helping drive investor optimism, with markets pricing in five to six cuts in 2024. The Fed strengthened its "pivot" language at its December meeting, with Chair Powell's press conference incorporating more reminders of its dual mandate. The Fed's assessment that inflation is moderating, subject only to a couple more months of confirmation, marks a shift in the conditions under which rate cuts may occur. If the Fed is correct in its assessment that "sticky" core inflation has come unstuck, this opens the door for a more constructive 2024, with the possibility of a strong US economy alongside rate cuts. However, the market is pricing in twice the number of rate cuts than the Fed's forward guidance indicates, and while we do expect rate cuts this year, we believe they will be fewer and start later than the market anticipates.

While the probability of a US recession has subsided, the picture outside the US has continued to weaken. Contrary to the more dovish language coming out the Fed, the European Central Bank (ECB) maintained its commitment to data dependence and did not demonstrate a similar readiness to contemplate rate cuts. This stance persisted even as inflation declined more rapidly than anticipated and growth data indicated weakness. In China, weakness in the property sector continues to worry investors, and the fundamental picture now looks weaker, with a rebound expected to come later than originally thought. In addition, risks are emanating from the shipping disruptions in the Red Sea and the ongoing conflicts between Russia and Ukraine as well as Israel and Hamas. Their potential for regional spillover and unforeseen fall-on effects adds considerable uncertainty to the global outlook.

Into this backdrop, we expect fixed income assets to generate decent total returns during the year, driven primarily by carry. We expect to see heightened periods of volatility given the various geopolitical risks and potential for disappointing inflation prints, but ultimately, we think the trend will be for range-bound rates and marginally tighter spreads. Given the expectation that central banks will ease policy, we believe new investors will come into the market, helping provide a backstop against any severe spread widening. As a result, we continue to act as buyers into short-term periods of weakness.

About This Report

Fixed Income Asset Allocation Insights is a quarterly 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.

Our Asset Class Outlooks

Investment Grade Credit
Fundamentals remain strong, with only a modest increase in defaults expected in 2024. Looking at technicals, we expect strong domestic demand to continue and interest from foreign buyers to increase, given signals of easier policy from the Fed, while all-in yields remain near historical highs. Net supply is expected to be lower compared to 2023, which should also be supportive. Current market conditions point to a continuation of recent supportive trends, and we maintain our positive outlook for US dollar investment-grade credit in the near term. Within non-US-dollar credit, we remain cautiously positive in the medium term and still prefer the euro over the sterling credit markets.

Securitized Products
Over the long term, we are bullish. Mortgage-backed securities (MBS) have tightened dramatically, but there is room to tighten further on a relative value basis versus investment grade (IG) credit. The Fed minutes and recent Fed speakers have indicated that the pace of QT is now under discussion. A slowing of Fed asset sales would be a boost for MBS.

Leveraged Finance
Markets are currently priced for a soft landing, but with tolerable downside scenarios. The resilient macro outlook supports our expectation for a modest increase (but not a major spike) in defaults. The fundamental strength in credit metrics appears to have peaked but started at a strong level. 2024 public earnings estimates indicate that the first quarter will be the earnings trough, with moderate sequential growth from there. Tighter spreads leave assets fairly valued at the bottom of our 350-550 bp trading range. We expect spreads to remain range-bound.

Emerging Markets
Despite the recent tightening, we are more comfortable with emerging market (EM) corporate IG spreads considering the lag in 2023 against developed markets (DM) and sovereigns, along with the solid fundamental picture. We also expect the supply-side technical backdrop to remain strong. Meanwhile, hard currency sovereign spreads remain tight. Corporates continue to offer a better risk/reward proposition.

Non-US-Dollar Currency
Perceived monetary policy divergence between the Fed and the ECB has acted as a dampener on the US dollar in recent months. Given market positioning against the dollar, a countertrend may develop in favor of the currency. We believe the US dollar was punished too hard in December and should strengthen from these levels.

Segment Snapshots

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.

Investment Grade Credit

US Dollar Investment Grade Credit

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

Fundamentals
Fundamentals remain firm despite an uptick in interest costs due to improved cash balances as management teams reduced capex and share buybacks.

Valuations
Credit spreads are at the tighter end of the range. Nevertheless, appetite for primary issuance and the long end remains supportive given attractive all-in yields. "Story names" have started to catch up with the larger, more liquid credits. Intermediate financials remain attractive.

Technicals
Demand for US IG credit remains strong, with lower supply and a lack of bonds available for sale continuing to support the long end. Reduced concern over higher interest rates has lent support to intermediate and longer-dated corporates.

Non-US-Dollar Investment Grade Credit

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

Fundamentals
Companies in general continue to post decent results while balance sheets remain healthy and M&A activity remains low. Management teams, however, are providing cautious outlooks, citing limited visibility into future sales and margins as the economic outlook remains uncertain.

Valuations
We view credit spreads as close to fair value and expect the index to trade within a range in the coming weeks and months. We see a low probability of large index moves in either direction. For that reason, sector and security selection will be the key to outperformance, in our view.

Technicals
Flows into euro corporates have been strong over the past several weeks, while supply has been slightly below the high expectations for January. Investors continue to be better buyers of credit.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

The fundamentals of the MBS market continue to be strong. Most of the market is less negatively convex than historical levels and interest rate volatility (implied vol) has dropped since October.

Valuations

Even after the extraordinary performance of MBS over the past two months, it still has room to tighten versus IG credit and if implied interest rate vol continues to drop.

Technicals

Now that banks are past the SVB crisis and rate hikes and are clearly not in peril, they can focus once again on growing their balance sheets, which will likely mean adding MBS.

Leveraged Finance

John Yovanovic, CFA, Head of High Yield Portfolio Management

Fundamentals

The macro outlook continues to be resilient enough to support our expectations for a modest increase (but no spike) in defaults. Last-12-month par-weighted default rates now stand at 2.8%/2.1% (with and without distressed exchanges), with no new activity in December. This is an increase from 1.7%/0.9% in 2022. The par-weighted upgrade/downgrade ratio was 0.9 in November, versus 1.3 for the full year. (Fundamentals data based on JP Morgan data as of 2 January 2024.)

Valuations

The par-weighted upgrade/downgrade ratio was 0.9 in November, versus 1.3 for the full year. With a large portion of the loan market trading at or near par, we should see further repricing activity, which will continue to pressure nominal spreads. (Based on Morningstar LCD data as of 31 December 2023.)

Technicals

With the continued rally in rates through the end of the year, new issuance continued at a decent clip in December with $13.3 billion gross ($2.4 billion net). Full-year issuance came in at $175.9 billion gross ($59.5 billion net), up from $106.5 billion in 2022 but still well below historical levels. Fund flows were +$2.7 billion for the month, nearly all ETFs. Demand for loans from new CLO formation remains, while retail funds should see further outflows, although at a more moderate pace than last year. (Technicals based on JP Morgan Securities data as of 2 January 2024.)

Emerging Markets

Sovereigns

Ilke Pienaar, Head of Sovereign Research, Emerging Markets Fixed Income

Fundamentals

Fundamentals remain on an improving trend, driven by both structural and cyclical factors. Growth outperformed in 2023 versus expectations at the start of the year and is expected to hold up in 2024 despite a drop in DM growth and a slowdown in global growth. This highlights changing global trade trends, including near-shoring and EM-to-EM trading. Debt-to-GDP ratios will fall in the majority of countries – but a few heavyweights will cause the EM average to move sideways. A number of countries are near the end of restructuring their debt, which will also reset the macro outlook.

Valuations

Despite widening again after the year-end rally, spreads are still tight. At 399, the EMBI is at a level last seen in April 2022 and is being kept wider than long-term averages by only a few credits. HY spreads are narrower by 119 bps from the end-October 2023 peak and about 15 bps wider than our fair value estimates. IG continues to trade through our fair value calculations, but only marginally so (roughly 5 bps). (Spread data from Bloomberg as of 15 January 2024.)

Technicals

Record issuance to date this year paints a constructive picture for the rest of 2024. Gross issuance in 2024 should be similar to 2023, but the amortizations and coupon payments should be larger, causing net financing to swing into negative territory. Hard currency inflows at the end of 2023 were short-lived, and outflows have resumed in early 2024 at a pace similar to 2023. Local currency flows have been positive for the last four weeks.

Corporates

Kim Keong, Trader, Emerging Markets Fixed Income

Fundamentals

J.P. Morgan recently published a report showing net negative corporate credit ratings for 2023 but nonetheless the best levels since 2018. Upgrade volumes increased, mainly driven by sovereign upgrades in the Middle East and Brazil, and downgrade volumes were the lowest since 2019.

Valuations

Over the last month, the CEMBI BD spread to worst tightened by 8 bps, with HY (-23 bps) outperforming IG (-5 bps). Beta performed better, and in terms of region, LatAm performed better in IG and CEEMEA outperformed the rest in HY. Argentina, Nigeria, Macau, Turkey, and Chile were the main outperformers, while South Africa, Colombia, Saudi Arabia, and Taiwan were the main underperformers. In comparison to DM during the same period, EM corporate IG outperformed US IG by 3 bps but lagged

23 bps in 2023, and EM corporate HY tightened against US HY by 26 bps in the past month but lagged 100 bps in 2023. We believe the current pickup offers value in EM corporate IG, especially in the A and BBB buckets. (Valuations data from Bloomberg based on the CEMBI Broad Diversified index as of 16 January 2024.)

Technicals

Gross supply in 2023 concluded at $245 billion, while net financing was at -$157 billion. January is typically an active month for primary markets, with an average issuance of $56 billion in recent years. So far this month, we've seen $19.2 billion in gross issuance. We anticipate $33 billion in scheduled cash flow for the month, which could result in a positive monthly net supply. Syndicate desks are optimistic about primary activity this year compared to 2023. However, with the theme of local issuance persisting, we still expect a positive supply-side technical in 2024. (Valuations and Technicals from JP Morgan EM Corporate Weekly Monitor as of 8 January 2024).

Non-US-Dollar Currency

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

Fundamentals

While US disinflation (as measured by the six-month average core PCE) has been faster in the last six months than previously envisaged, enabling Chair Powell to sound surprising dovish in the December meeting, US labor market conditions remain tight. With US unemployment below 4%, ultimately the Fed's scope should be limited for moving into emergency mode and starting its rate-cutting cycle in March. Instead, our base case is one where the Fed considers real yields too high and starts normalizing monetary policy halfway through the year.

Valuations

We are keeping our 12-month euro/US dollar forecast at 1.0500, in line with our "Stabilization" scenario. We have kept our 12-month US dollar/Japanese yen forecast at 1.4250 to reflect countervailing forces between the current yield differential and scope for the Bank of Japan to exit negative interest rate policy.

Technicals

According to IMM data as of 10 January, US dollar positioning is now net short at -0.7 sigma below the five-year average, well below the +0.5 sigma peak in November.

About PineBridge Investments

pinebridge.com

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 31 December 2023, the firm managed US$157.1 billion across global asset classes for sophisticated investors around the world.

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