Global Fixed Income Perspectives

Brandywine GLOBAL

Global Market Outlook

- The history book closed one of its scariest chapters (2022), but the new chapter (2023) begins with the same policy debates as the previous one.
- Volatility reigned during the quarter as markets continue to debate the outlook for inflation, especially around goods inflation and the potential for services inflation to become more entrenched in the economy. Central bankers continue to guide markets toward prudence in fighting inflation while market-based indicators suggest interest rate cuts in 2023.
- Complicating matters is the adjustments to China's zero-COVID policy and its impact on global demand for goods and services. Their response is different than the approach taken by other countries around timing and levels of vaccination. Once again, China and the U.S. economic policies and momentum are moving in opposite directions.
- We anticipate a continuation of volatility at least through the first half of the year as the potential for policy errors continue to persist. While risk looms, we still see the chance of a Federal Reserve (Fed) pivot and a soft landing in the U.S.

About this Publication

The Global Fixed Income Perspectives discusses performance and opportunities for global fixed income markets by segment.

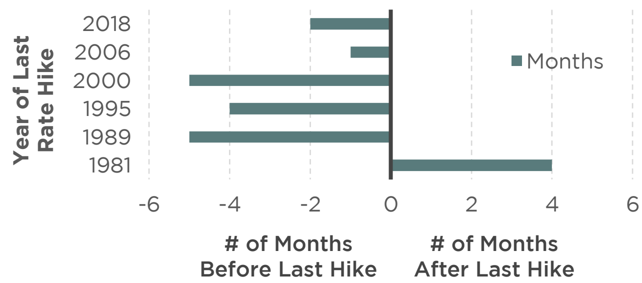
DM	Developed Market Rates	Have we've seen a peak in yields in U.S. and Europe? History and recent data would suggest the Fed and European Central Bank could be close to finishing their hiking cycle. With global inflation coming down, now may be the ideal time to buy duration.
IG	Investment Grade	Spread per turn of leverage has been increasing on an index level basis, driven by basic industry and consumer cyclicals where we see select opportunities. We also see potentially attractive entry points where spreads in some sectors are trading at their wides.
HY	High Yield	Corporate profits and consumer balance sheets are still the key metrics that will drive high yield spreads this year. If consumers continue to demonstrate a propensity to spend, the carry provided in high yield bonds should be viewed as an attractive investment opportunity, adequately compensating for risk.
EM	Emerging Markets	China's zero-COVID lockdown appears to be quickly abating. Emerging market inflation surprises continue to fall from their multi-decade highs and central banks may be able to relax monetary policy in 2023, driving yields in EM lower. The dollar will likely weaken in 2023, which could lead to some stability in EM currencies.
SC	Structured Credit	A significant decrease in new issuance should create a supportive technical backdrop in 2023. However, market volatility amid uncertainty over interest rates and the economy may challenge risk assets in the near term. We remain defensive while seeking to add risk selectively.

DM Developed Market Rates

- Over the last 40+ years, the Fed has administered six significant hiking cycles. In five of the six instances, 30-year U.S. government Treasury yields peaked prior to the final interest rate hike, with the average length of time of approximately two months prior to the final policy increase (see FIGURE 1).
- Given the creation of the Euro in 1999, there are less instances of the European Central Bank raising policy rates. However, the same trend holds true. German 30-year bonds also tended to peak prior to the final rate hike with an average of four months (see FIGURE 2).
- Inflation concerns will ultimately determine when each central bank feels it has sufficiently raised policy rates to slow down their economy. However, bond investors have been rewarded in the past by investing prior to that determination.

1 U.S. 30 Year, Peak Fed funds

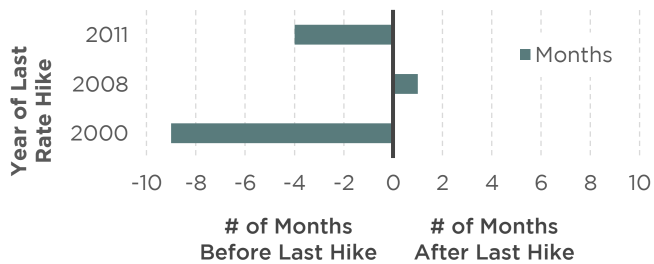
Months From Last Policy Rate Hike to Peak Yield (30yr US Treasury)



Source: Bloomberg

2 Europe 30yr, ECB Rate

Months From Last Policy Rate Hike to Peak Yield (30yr German Bond)



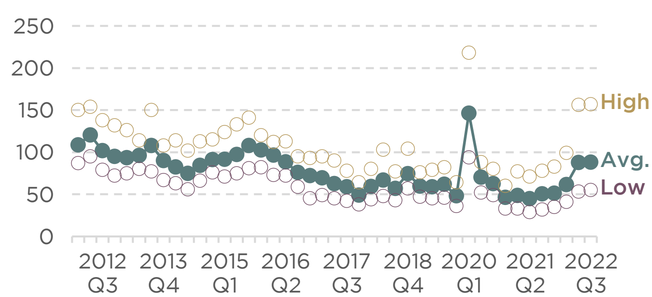
Source: Bloomberg

IG Investment Grade

- FIGURE 3 shows the spread (OAS) per turn of (net) leverage for IG credit and the high and low of the underlying sectors (minus technology, utilities, and financials). While there has been widening, it is driven by basic industry and consumer cyclicals, mostly by spread widening rather than leverage increase. We see select opportunities in these sectors.
- Earnings reports from the last quarter of 2022 are starting soon and will be closely watched for evidence of upticks in leverage, especially in the more troubled sectors.
- FIGURE 4 shows the (OAS) spread ranges since 2012 of the various IG sectors, the last value, and the value at the start of 2022. While the index as a whole has widened, it is a very sector-specific story.
- Autos, consumer goods, media, real estate, and utilities are trading at the wides of their historic level and could provide attractive entry points, especially with a relatively high yield providing a cushion for further widening of spreads/duration moves. It is here where we are concentrating our research efforts.

3 IG Spread Per Turn of Leverage (SPTL)

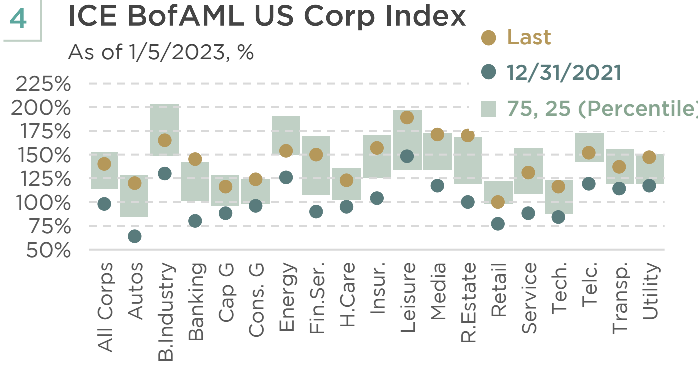
As of 2022 Q3



Source: Bloomberg (© 2022, Bloomberg Finance LP)

4 ICE BofAML US Corp Index

As of 1/5/2023, %



Source: Brandywine Global, Macrobond, ICE BofAML

HY High Yield

- While some forward-looking estimates are starting to weaken slightly, the reported data shows that corporate profitability is still well above pre-COVID-19 levels which should support high yield issuer access to capital markets (see FIGURE 5).
- Similarly, U.S. retail sales have come off record highs in the last few months but still remain elevated above pre-COVID-19 levels. Consumer willingness to spend excess savings accumulated during the pandemic will help support corporate profitability (see FIGURE 6).
- There lacks convincing arguments for any type of hard landing scenario playing out over the first quarter. As such, we view the carry provided in the high yield bond sector as an attractive investment opportunity in the near term.

5 Russell 2000 EPS

As of 1/2/2023

Source: Bloomberg (© 2022, Bloomberg Finance LP)

6 U.S. Retail Sales YoY%

As of 11/30/2022, %

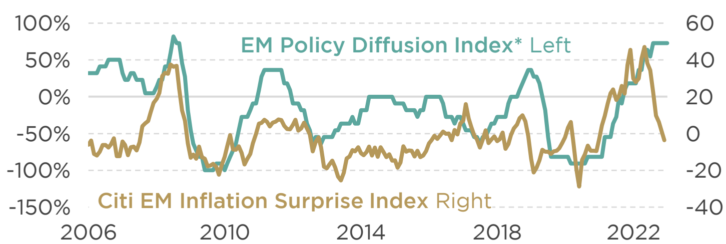
Source: Bloomberg (© 2022, Bloomberg Finance LP)

EM Emerging Markets Debt

- Further tightening of U.S. financial conditions and the persistence of inflation around the world could be continuing headwinds in 2023. China's zero-COVID lockdown appears to be quickly abating. We expect to see an increase in Chinese consumer demand and travel, which is one reason we like some of the Asian currency markets levered to the return of Chinese tourists.
- Emerging market inflation surprises continue to fall from their multi-decade highs (FIGURE 7). Weaker energy and food-related commodity prices over the last few months are taking pressure off inflation in a number of markets. This release could allow central banks to begin relaxing monetary policy, which would be a positive outcome for bond yields across EM.
- With U.S. relative monetary policy tightening set to peak coupled with decelerating U.S. growth outperformance, we believe the dollar will likely weaken in 2023. A weaker greenback will allow for some stability in EM currencies, which we think are broadly undervalued (FIGURE 8).

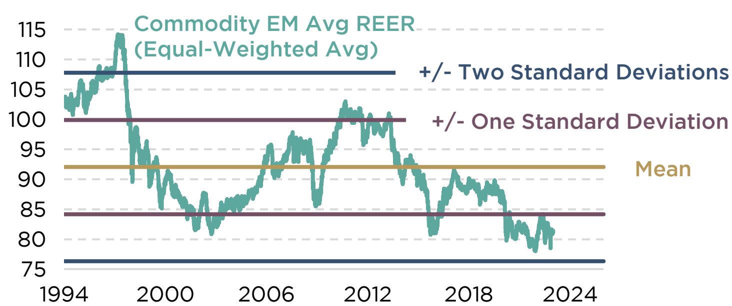
7 EM Inflation Surprises Declining, Could Allow for Some Rate Cuts in 2023

% Level, As of 12/31/2022



*% of emerging markets with policy rate higher than 6 months ago minus % of lower

8 Emerging Market Commodity Currencies* Are Attractive Level, As of 12/2/2022



*BRL, CLP, COP, IDR, MYR, PEN, THB, ZAR

Source: Brandywine Global, Bloomberg (© 2022, Bloomberg Finance LP)

SC Structured Credit

- Credit-risk transfer (CRT) securities are supported by resilient credit fundamentals, reduced net issuance, and floating coupons. We expect these favorable factors to drive further relative outperformance, but we favor mezzanine over B notes on recessionary risks.
- Commercial mortgage-backed securities (CMBS) offer attractive yields but with collateral credit risk, particularly among retail and office properties. These risks and a potential economic recession make us cautious. We prefer to remain up in credit and employ careful selection to take advantage of further spread widening (See FIGURE 9).
- Asset-backed securities (ABS) have held steady in spite of rising delinquencies, and their short durations make them a stabilizing factor for investment portfolios. We continue to monitor consumer credit indicators and expect to keep a nimble presence in this sector.
- Collateral loan obligations (CLOs) tightened slightly over the quarter, but spreads remain historically wide. We remain wary of liquidity risks and credit rating downgrades in collateral loans. Further spread widening may offer better entry points (See FIGURE 10).

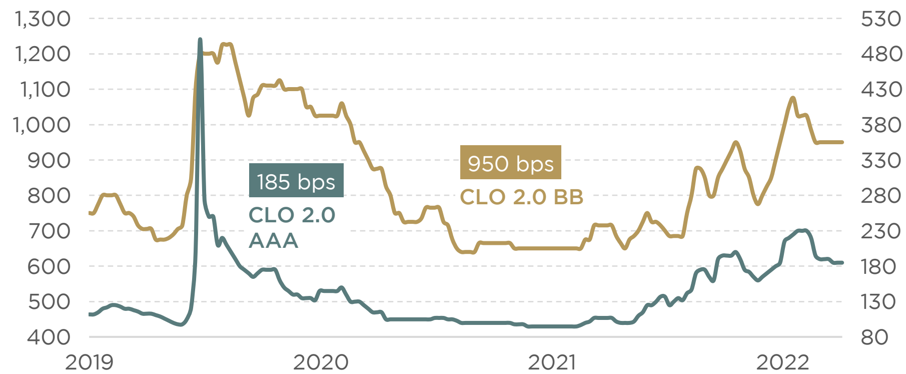
9 BBB- CMBS vs BB HY Corporate Credit Option

Adjusted Spread over USD LIBOR in Basis Points (bps), As of 12/30/2022

Source: BofA Merrill Lynch Global Research

10 CLO 2.0 BB vs. CLO 2.0 AAA

Spread to Swap/Discount Margin in Basis Points (bps), As of 12/30/2022



Source: BofA Merrill Lynch Global Research

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Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, and a fixed coupon schedule. The ICE BAML AA Global Corporate Index is a subset of the ICE BAML Global Corporate Index, including all securities rated AA1 through AA3, inclusive. The ICE BAML Single-A Global Corporate Index is a subset of the ICE BAML Global Corporate Index, including all securities rated A1 through A3, inclusive. The ICE BAML BBB Global Corporate Index is a subset of The ICE BAML Global Corporate Index, including all securities rated BBB1 through BBB3, inclusive. The ICE BAML U.S. Corporate Index tracks the performance of U.S. dollar-denominated investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule, and a minimum amount outstanding of $250 million. The ICE BAML Global High Yield Index tracks the performance of USD-, CAD-, GBP-, and EUR-denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets. The ICE BAML BB Global High Yield Index is a subset of the ICE BAML Global High Yield Index, including all securities rated BB1 through BB3, inclusive. The ICE BAML Single-B Global High Yield Index is a subset of The ICE BAML Global High Yield Index, including all securities rated B1 through B3, inclusive. The ICE BAML CCC & Lower Global High Yield Index is a subset of The ICE BAML Global High Yield Index, including all securities rated CCC1 or lower. The ICE BAML U.S. High Yield Index tracks the performance of USD-denominated below investment grade corporate debt publicly issued in the major U.S. markets. The ICE BAML European High Yield index tracks the performance of below-investment grade corporate bonds publicly issued in Europe. The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest-rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries. The ICE BAML U.S. Mortgage-Backed Securities Index tracks the performance of U.S. dollar-denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market. The ICE BAML U.S. Fixed Rate CMBS Index tracks the performance of U.S. dollar-denominated investment grade fixed rate commercial mortgage-backed securities publicly issued in the U.S. domestic market. The JP Morgan Corporate Emerging Market Bond Index (CEMBI) Broad is a global, liquid corporate emerging markets benchmark that tracks U.S. denominated corporate bonds issued by emerging markets entities. The JPM EM Bond Index Global Diversified is composed of U.S. dollar-denominated Brady bonds, eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities. The JPM Government Bond Index-Emerging Markets (GBI-EM) Broad Diversified is a comprehensive emerging market debt benchmark that tracks local currency bonds issued by emerging market governments. The unique diversification scheme ensures that weights among the index countries are more evenly distributed by reducing the weight of large countries and redistributing the excess to the smaller-weighted countries with a maximum weight per country of 10%. All data current as of the date at the top of the page unless otherwise noted. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction.

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