Global Fixed Income Perspectives

Global Market Outlook

- In 2022, risk assets posted one of their worst starts to any calendar year. Inflation remains elevated across much of the western world, and central bank policy remains focused on returning inflation to target levels using aggressive interest rate hikes.
- Leading and other economic indicators are showing signs of weakness, while labor markets, a lagging indicator, remain strong. Thus, an argument may be made to reduce the magnitude and pace of the Federal Reserve's (Fed's) monetary policy.
- U.S. midterm elections will be held in November with market consensus for a divided U.S. government, which would bring gridlock until the presidential election in 2024.
- Given the backdrop, we are watching for a potential monetary policy error (too tight) through the current quarter into 2023.

About this Publication

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

DM — Developed Market Rates

Record inflation has continued to propel global bond yields higher. We believe both macro and micro factors will weigh down inflation dramatically over the coming quarters, putting significant downward pressure on global bond yields.

IG — Investment Grade

Refinancing costs could be more than 200 basis points (bps) more expensive for corporates over their existing debt. However, due to solid fundamentals, spread widening could be less than in previous cycles. Many may choose to wait for improvements in market conditions, putting a break on capex and M&A.

HY — High Yield

Third quarter corporate earnings season will be a real testing ground for how much wider high yields spreads could potentially go, but given the imbedded carry in the asset class, we feel high yields bonds are beginning to offer an attractive return profile at these levels.

EM — Emerging Markets

Pressure on emerging market fixed income continues. Emerging market valuations look quite attractive, especially following sharp drawdowns in local and hard currency markets. Global macro issues, including China, the Fed, and Russia-Ukraine, will remain critical to the asset class.

SC — Structured Credit

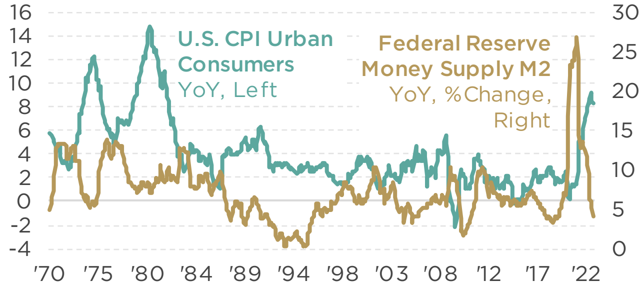
A risk rally early in the quarter turned risk-off after hawkish Fed comments at Jackson Hole. Price levels have reverted to their June lows and appear attractive, but we expect more market turmoil before reaching bottom. We remain defensive while we wait for better entry points.

DM Developed Market Rates

- While the debate continues about what portion of inflation was caused by demand versus supply factors, the significant role money supply growth played into inflation pressures is indisputable. M2 growth peaked in the U.S. in February 2021 at an astounding 27% on a YoY basis, but in August 2022, it dropped to 4.1% with contracting levels soon to follow. The lag effect of this contraction should become a major headwind to inflation in the coming quarters (FIGURE 1).
- On a more micro-level, given rising cost inputs and consumer demand, small businesses have consistently raised prices in order to maintain profit margins. Based on recent surveys, this dynamic is changing from early summer. Businesses are now expecting fewer price increases in the future, which could tame inflation pressures (FIGURE 2).
- We believe these micro and macro factors will dramatically weigh down inflation and put significant downward pressure on global bond yields. The critical questions are how long it will take for inflation to come back down to levels we previously expected, and how impatient central banks will be in destroying demand to get to the desired inflation levels.

1 U.S. CPI and Money Supply M2

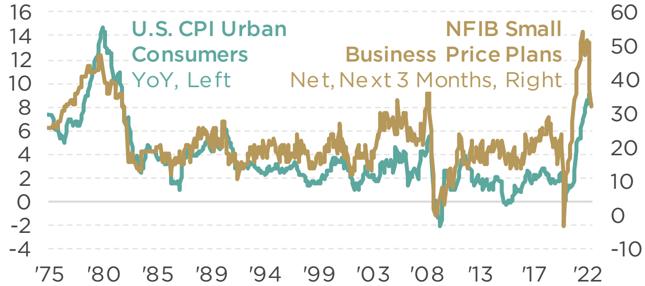
As of 9/30/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

2 U.S. CPI and NFIB Small Business Price Plans

As of 9/30/2022



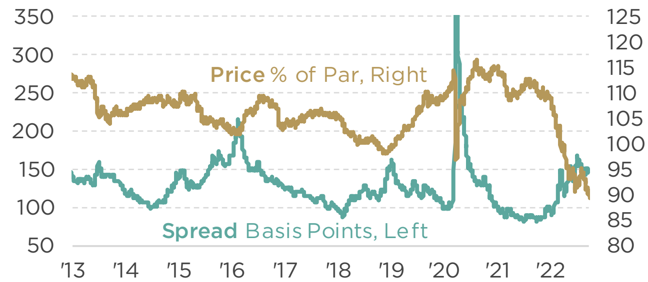
Source: Bloomberg (© 2022, Bloomberg Finance LP)

IG Investment Grade

- The dramatic rise in yields drove bond prices down significantly, but spread widening has been more muted in comparison (FIGURE 3). With many macro indicators pointing toward a slowdown/recession in the economy, bond spreads, although wider, do not corroborate the extent of the slowdown.
- Many factors are at play tamping spread widening this cycle: company fundamentals are on a more solid footing than previous cycles, leverage remains contained (interest in U.S. investment grade space remains over 8x covered, a cycle high), and maturities were pushed out during refinancing during record low interest rates in 2021/22.
- Cash balances are starting to dwindle in some corporates and some will need to refinance and roll over their debt. FIGURE 4 shows that for corporates, the cost of new financing versus existing debt climbed to over 200 bps, the highest since the turmoil of 2008/2009. This creates headwinds for companies that need access to cash for capex and potential M&A to combat strained supply chains, rising costs and the threat of economies worldwide edging closer to a recession.

3 U.S. Investment Grade Spreads and Price

ICE BofA U.S. Corporate Index, As of 9/30/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

4 U.S. Investment Grade Refinancing Costs

YTW – Coupon, As of 9/30/2022

Source: Bloomberg (© 2022, Bloomberg Finance LP)

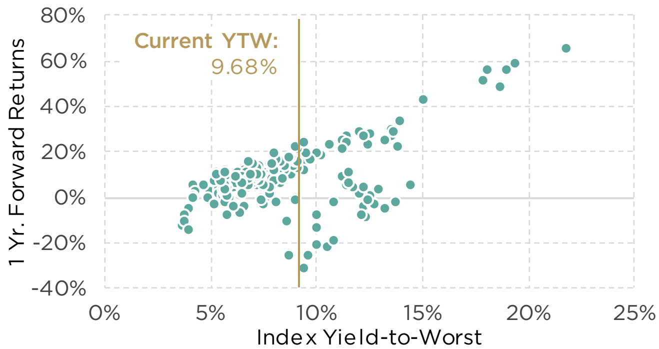
HY High Yield

- Spreads tightened marginally over the quarter as second quarter earnings releases highlighted a resilient corporate earnings backdrop, but there is concern that nominal corporate earnings may not remain at these historically elevated levels (FIGURE 5). Analyst estimates and corporate guidance have started to marginally deteriorate, and consumers continue to drawdown excess savings accumulated during the response to COVID. In addition, global PMIs turned considerably lower during the third quarter.
- Although the year-to-date drawdown in high yield bonds has been remarkable, the majority of losses have come from underlying rate increases. Spreads have widened in tandem but not to historically elevated levels. The majority of sector level spreads are currently around their 50th percentile rankings.
- We think the imbedded carry in high yield is now starting to look like an attractive opportunity. Since 2000, when absolute yields were at current levels, the average 1-year forward return is 14.8%, and the forward 1-year returns have been positive for 71% of the observed periods (FIGURE 6).
- While we're still not ready to call a top in spreads, we think this segment of the fixed income market may have potential longer-term value opportunities.

5 S&P 500 Earnings Per Share
As of 10/5/2022

Source: Bloomberg (© 2022, Bloomberg Finance LP)

6 U.S. Corporate HY Index
1 Yr. Forward Return, As of 9/30/2022

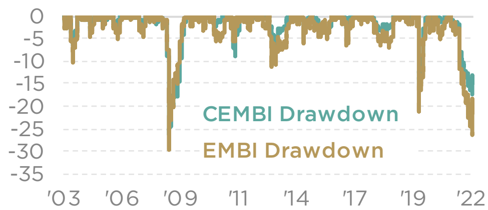


Source: Bloomberg (© 2022, Bloomberg Finance LP)

EM Emerging Markets Debt

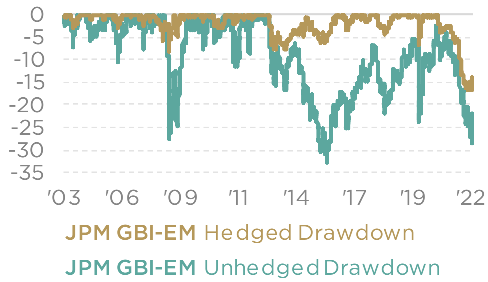
- Pressure on emerging market fixed income continued in the quarter as U.S. treasury yields and the U.S. dollar advanced higher. On a forward-looking basis, emerging market valuations look quite attractive, especially following sharp drawdowns in local and hard currency markets (FIGURE 7 and FIGURE 8).
- In local markets, nominal yields are approaching 10% or higher across several markets. Inflation remains elevated, however, there are signs of reduced inflation momentum in select markets.
- In the Emerging Markets Bond Index (EMBI) market, we expect more distressed sovereigns to approach the IMF. However, in both the Corporate Emerging Markets Bond Index (CEMBI) and EMBI IG markets, we believe there will be an opportunity in long-end once we see U.S. treasuries peaking out. In the CEMBI BB and B segment, running yield is quite attractive, providing some cushion to weather further bouts of volatility.
- Global macro issues, including China, the Fed, and Russia-Ukraine, remain critical to the asset class.

7 CEMBI & EMBI Drawdown
As of 9/30/2022



Source: J.P. Morgan

8 JP Morgan GBI-EM Drawdown
As of 9/30/2022



Source: J.P. Morgan

SC Structured Credit

- Credit-risk transfer (CRT) securities benefit from favorable market technicals due to mezzanine tenders and curtailed class B issuance. Their floating coupons are attractive amid rising interest rates.
- Commercial mortgage-backed securities (CMBS) have fared well, and quality seasoned BBB notes are attracting high yield investors. Cap rates have been stable, but we expect a reckoning, especially in the office sector. However, the maturity wall next year is moderate and the market remains orderly (FIGURE 9).
- Asset-backed securities (ABS) have been the best-performing credit sector. Their short durations have kept them relatively stable amidst the market volatility. Delinquencies are rising, but structures continue to de-lever briskly.
- Collateral loan obligations (CLOs) have underperformed leveraged loans and high yield bonds. BB and B yields are reaching double-digits. We are cautious about liquidity in the sector, but valuations are starting to look attractive (FIGURE 10).

9 BBB- CMBS vs BB HY Corporate Credit

As of 9/30/2022, Option-Adjusted Spread over USD LIBOR in Basis Points (bps)

Source: ICE Data Indices, LLC., BofA Global Research

10 CLO 2.0 BB vs CLO 2.0 AAA

As of 9/30/2022, Spread to Swaps/Discount Margin in Basis Points (bps)

Source: BofA Global Research

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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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