Global Fixed Income Perspectives

Brandywine GLOBAL

Global Market Outlook

- Monetary policy across the globe was the focus of markets during the first quarter—mainly the pace and speed of the "normalization" of policy. The U.S. Federal Reserve (Fed) accelerated its timeline for ending quantitative easing and the pace and magnitude of interest rate hikes. It is still to be determined what the pace of balance sheet runoff will be at this time.
- Similarly, the market was caught off guard by the shift toward tighter monetary conditions in the Eurozone, which will need to be calibrated due to the impact of the Russian invasion into Ukraine.
- Russia's military incursion into Ukraine upended markets at the end of February in addition to creating a humanitarian crisis. The response by Europe, NATO, and other nations sanctioning Russia resulted in a dislocation in asset prices and has significantly disrupted supply chains, which will cause global growth to be much slower for the balance of the year.

About this Publication

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

DM | **Developed Markets**

With global inflation at multi-decade highs, investors are struggling as to whether bond yields will breakout through long-term support channels. Given central banks continually sounding more hawkish, yields are poised to rise until they break the back of inflation.

HY | **High Yield**

High yield bonds posted their worst quarterly returns since the outbreak of COVID-19 in Q1 2020. While previous drawdowns were largely driven by spread widening, this quarter saw significant pressure from underlying Treasury moves. Risks appear elevated, however yields look increasingly attractive.

IG | **Investment Grade**

Q1 2022 was dominated by spread widening and curve inversion. While borrowing costs for IG corporates have increased, the intermediate tenured curve has risen more than the long-dated curve. There are signs of relative outperformance of IG going forward.

EM | **Emerging Markets**

EM suffered negative returns during the quarter due to a back-up in treasuries and geopolitical events. Challenges ahead: Fed tightening, energy and food inflation pressures leading to risk with social unrest, and supply-chain improvement delays and lock-downs in China.

SC | **Structured Credit**

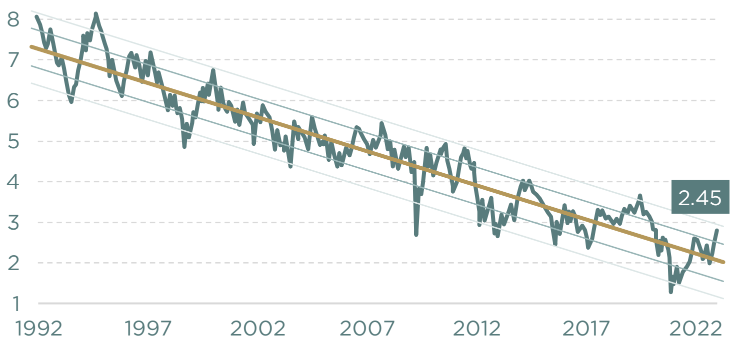
Structured credit severely underperformed corporate credit in the March rally. However, we believe that solid fundamentals should enable structured credits to stage a comeback in the second quarter.

DM Developed Market Rates

- U.S. and German 30-year bond yields are at the cusp of breaking through a 30-year downward trend (**FIGURES 1 AND 2**). Central bank rhetoric continues to emphasize eradicating inflation as its top concern in the face of upward yields.
- Global bond benchmarks began the year with near-record high duration (WGBI at 8.71 yrs.), causing significant total return losses as interest rates rose throughout the quarter.
- Given the market backdrop of elevated duration and volatility, the team continues to advocate underweighting developed duration. However, as growth concerns become more evident, this posture could quickly change should the market correct itself quickly.

1 U.S. 30-Year Bond Yield

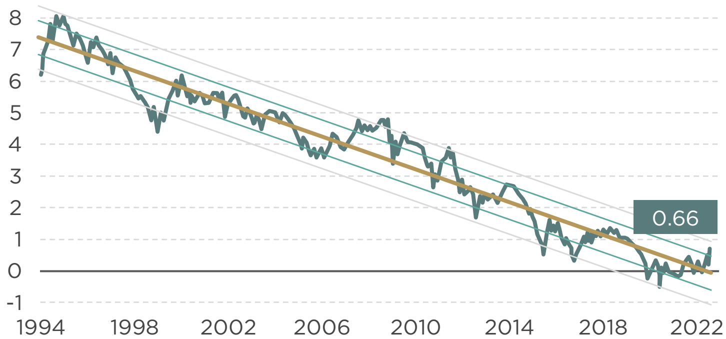
%, As of 3/31/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

2 German 30-Year Bond Yield

%, As of 3/31/2022



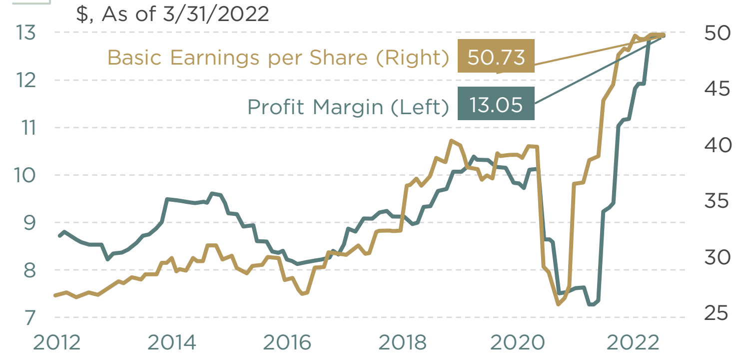
Source: Bloomberg (© 2022, Bloomberg Finance LP)

HY High Yield

- Corporate earnings and profit margins are at record highs, reflecting healthy underlying business conditions in the broader economy (**FIGURE 3**). Corporate cash balances are also highly elevated after record high yield debt issuance in CY 2020 and 2021.
- The majority of high yield issuers took advantage of zero interest rate monetary policies to lock in low coupons and extend debt maturities. Most high yield corporate issuers have at least 2-3 years before their first debt payments come due.
- While near-term debt payments aren't an immediate concern, the combination of higher Treasury rates and marginally wider spreads have pushed the yield on the U.S. Corporate High Yield Index above the average coupon (**FIGURE 4**). If this persists, when debt does need to be refinanced, an increase in cost of capital will start to deteriorate the free cash flow profiles of debtors.
- The remarkably hawkish pivot from the Fed in November 2021 has shown no signs of relenting over the first quarter, raising the odds that the index yield will continue to push higher above the average coupon.

3 S&P 500 Index

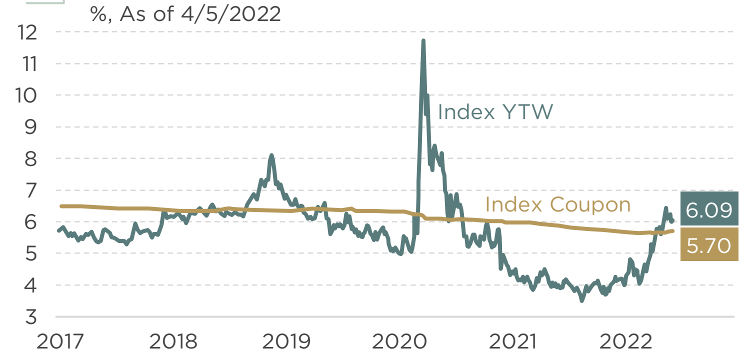
$, As of 3/31/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

4 Bloomberg U.S. Corporate HY Bond Index

%, As of 4/5/2022



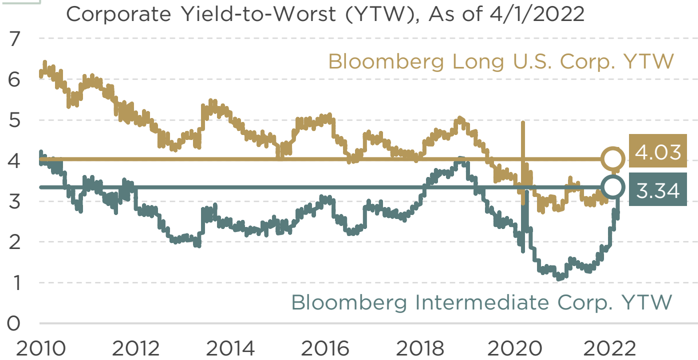
Source: Bloomberg (© 2022, Bloomberg Finance LP)

IG Investment Grade

- Q1 2022 was dominated by spread widening and curve inversion. The second half of March, however, saw some of the spread widening reverse, especially in AAA and BBB long-dated industrials, contributing to an excess return of 0.65% for the month (still an excess return of -1.77% for the quarter).
- **FIGURE 5** shows that borrowing costs for corporates are markedly higher across the curve since 2021. While intermediate yield is at the top of the last decade range, longer dated yields are nearer the lower end. With the rate curve flattening, so has the corporate spread curve: long-dated spread is 1.6x that of intermediates vs. a ratio above 2x in October.
- **FIGURE 6** shows the ratio of high-yield vs. investment-grade yields has compressed to 1.7x.

5 Intermediate vs. Long Term Corporate Yields

Corporate Yield-to-Worst (YTW), As of 4/1/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

6 Ratio of High Yield vs. Inv. Grade Yields

YTW*, As of 4/1/2022

*Bloomberg US Corporate HY YTW / Bloomberg US Agg Corporate YTW
Source: Bloomberg (© 2022, Bloomberg Finance LP)

EM Emerging Markets Debt

Hard currency EM was down close to 10% during the quarter. Local EM started the quarter outperforming most segments of the global bond market but reversed with Russia invading Ukraine, leading to a sell-off broadly in local EM. Going forward several challenges lie ahead:

- The Fed is moving forward with QT and rate hikes with the economy likely already slowing; this tightening of financial conditions could impact global risk markets, including EM. (**FIGURE 7**)
- Sanctions on Russia are impacting many facets of global commodity markets, including higher energy and food prices; this will affect consumer spending power and likely lead to some social unrest in some EM countries.
- China is facing another series of lockdowns, likely delaying improvement in global supply chains. We are seeing some signs of policy easing in China, which is starting to take some pressure off distressed property market, a positive development, but Fed tightening and inflation could overwhelm this. (**FIGURE 8**)

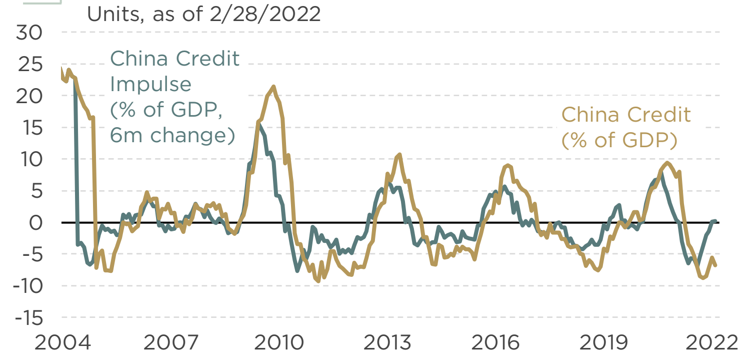
7 Rate Hiking Cycle Could Impact Global Activity

Units, As of 3/31/2022

Source: Brandywine Global EM Forward Real Yield Valuation model, Bloomberg (© 2022, Bloomberg Finance LP)

8 Signs that China Loosening Policy

Units, as of 2/28/2022



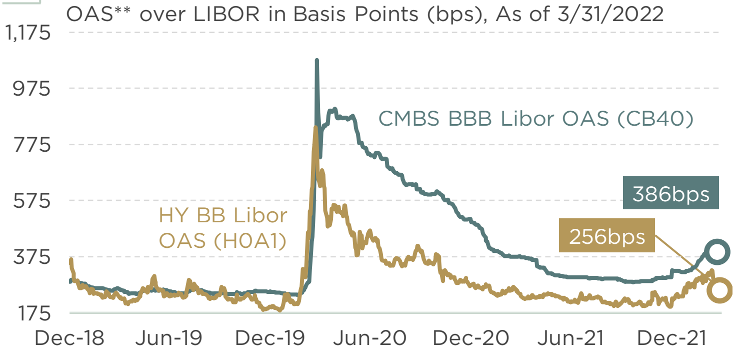
Source: Bloomberg (© 2022, Bloomberg Finance LP)

SC Structured Credit

- Credit-risk transfer (CRT) bonds underperformed in the first quarter due to a sharp increase in new issue supply amid the backdrop of increased macro volatility. Nevertheless, CRT mezzanine bonds are supported by continually improving collateral credit quality and strong home price valuations. They offer a high carry profile with opportunity for spread pick-up and, as floating-rate instruments, should see increased investor demand in a rising rate cycle.
- We like BBB tranches of seasoned vintages of fixed-rate conduit commercial mortgage-backed securities (CMBS). They exhibit embedded price appreciation and amortization, spread pick-up over comparable corporates, recovery potential, and shorter duration (**FIGURE 9**). We are also constructive on Single-Asset, Single-Borrower (SASB) CMBS loans for their higher-quality collateral and floating-rate nature.
- In asset-backed securities (ABS), we prefer higher-yielding securities rated B to BBB of subprime auto and consumer loan ABS. The fundamentals should support positive returns.
- Backed by benign credit fundamentals, CLO mezzanine tranches offer some attractive opportunities in floating-rate bonds, and they may serve as a good hedge against rate hikes. (**FIGURE 10**).

9 Relative Value Comp. BBB CMBS vs. BB HY

OAS** over LIBOR in Basis Points (bps), As of 3/31/2022

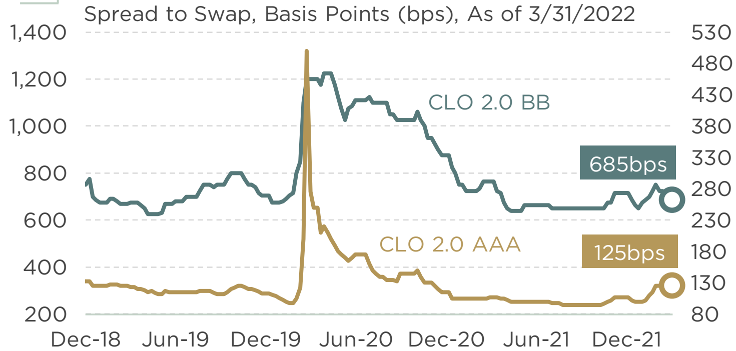


**Option-Adjusted Spread

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

10 Relative Value Comp. CLO BB vs. CLO AAA

Spread to Swap, Basis Points (bps), As of 3/31/2022



Source: BofA Merrill Lynch Global Research

Brandywine GLOBAL

Brandywine Global Investment Management, LLC

1735 Market Street
Suite 1800
Philadelphia, PA 19103

Around the Curve

BRANDYWINEGLOBAL.COM

AROUNDTHECURVE.COM