Global Fixed Income Perspectives

4Q 2021

GLOBAL MARKET OUTLOOK

- Pandemic fears transferred from the delta to the omicron variant, which appears to be more contagious but potentially less severe. Moving from a pandemic to an endemic will be vital to reopening global economies. Low labor participation rates will continue to be the focus of politicians and business leaders as they assess the best way to move forward.
- 2021 ended with the U.S. Federal Reserve (Fed) set to embark on the next stage of its monetary policy as tapering is expected to end, purchases by March 2022 and at the same time, fiscal policy will not be as generous as previous years. Inflationary pressures will remain at the fore of policymaker discussions, especially in light of the U.S. mid-term elections that are on the horizon.
- As with most of the past year, valuations pose a challenge to investors as levels are close to historic lows from both a spread and yield perspective.

DM DEVELOPED MARKETS

With inflationary pressures increasing globally, central banks have pivoted toward a more hawkish stance. Volatility continues as uncertainty remains high. Political pressure may increase the risk that central banks tighten policy prior to economic forces naturally returning inflation to target levels.

IG INVESTMENT GRADE

Higher inflation, a Fed looking to reduce net purchases, and the dot plot implying a Fed Funds Target rate of 1% by the end of 2022 make for a tough backdrop for IG on a total return basis. The macro backdrop for spreads remains constructive while duration and curve flattening will have to be addressed.

HY HIGH YIELD

High yield spreads were briefly challenged in the end of November with the combination of hawkish Fed comments and reaction to the omicron variant. While spreads recovered nicely in December, caution is warranted given messaging from the Fed.

EM EMERGING MARKETS

Hard currency spreads start the year at the tighter end of historical levels with exception of EMBI HY. The stress ratio in China remains elevated given issues with the property sector. Local markets appear attractive following back-up in local rates and weaker currencies in 2021; need to see inflation pressures ease in EM.

SC STRUCTURED CREDIT

We remain constructive on the U.S. housing market and consumer finances in spite of interim volatility. Segments of structured credit remain supported by strong fundamentals, which should position them for outperformance over other credits next year.

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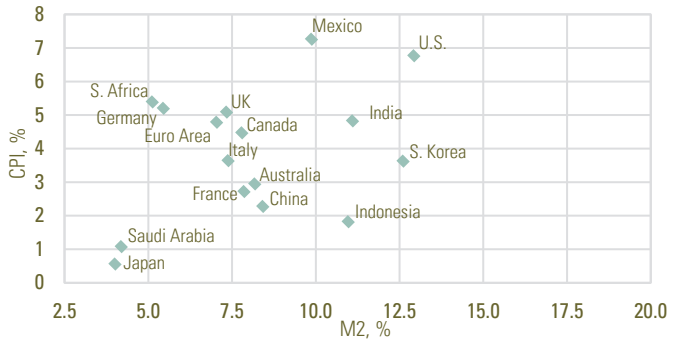
DM Developed Market Rates

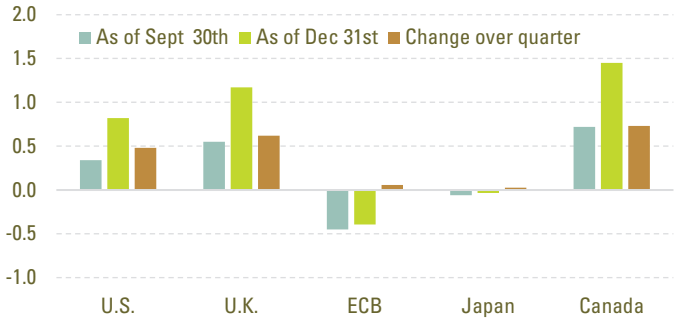
- There's a strong correlation between money growth and inflation pressures felt at the individual country level (Figure 1). With M2 growth largely slowing and fiscal stimulus decreasing, policymakers must be careful not to overtighten.
- Over the prior quarter, participants began anticipating large policy moves in 2022 across the U.S., U.K., and Canada given rising implied market policy rates (Figure 2), largely contradicting prior estimates of a more dovish outcome. Reducing bond purchases more quickly will also have a notable tightening effect.
- Over aggressive policy actions should lead to curve flattening and thus Brandywine Global's preference remains targeting sovereign bonds with longer maturity profiles.

Figure 1: Money Supply Growth vs. Inflation Rate
YoY Change, As of 12/31/2021



Source: Macrobond

Figure 2: Market Implied Policy Rate (End of 2022)
As of 12/31/2021



Source: Bloomberg (© 2022, Bloomberg Finance LP)

IG Investment Grade

- We are starting the year under a backdrop of higher inflation, which may or may not be transitory, a Fed looking to reduce net purchases, and the dot plot implying a Fed Funds Target rate of 1% by the end of 2022.
- U.S. IG index yields have backed up significantly since August — from 1.9% to nearly 2.5%. However, index spreads are little changed from around .90 bps in August to 94 bps now (albeit with a range of 84 to 105 bps).
- Below is a sensitivity analysis of the IG index of various scenarios of 10-year yield and IG OAS showing the potential set-up for the year ahead under different scenarios (Figure 3). We continue to like the fundamentals of the U.S. IG market and U.S. economy; we expect spreads to remain range bound but total returns to be dominated by duration moves, which we will continue to analyze and monitor.

Figure 3: IG FY 2022 Total Return Sensitivity Analysis
As of 12/31/2021. * Start of year was 95bps on IG OAS and 1.5% on 10yr yield

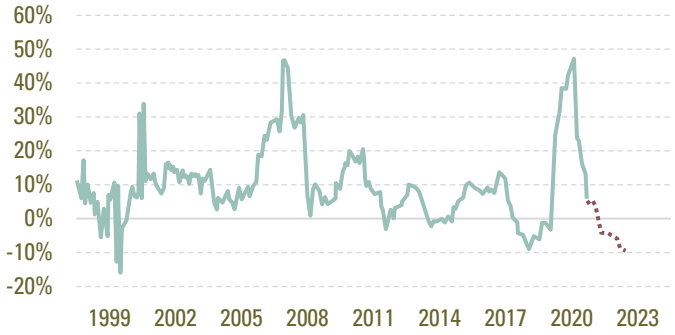
IG OAS \ 10-Year UST	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%	2.75%	3.00%	3.25%	3.50%
75 bps	8.4%	6.3%	4.2%	2.1%	0.0%	-2.1%	-4.2%	-6.3%	-8.4%	-10.5%	-12.5%
80 bps	7.9%	5.8%	3.7%	1.7%	-0.4%	-2.5%	-4.6%	-6.7%	-8.8%	-10.9%	-13.0%
85 bps	7.5%	5.4%	3.3%	1.2%	-0.9%	-2.9%	-5.0%	-7.1%	-9.2%	-11.3%	-13.4%
90 bps	7.1%	5.0%	2.9%	0.8%	-1.3%	-3.4%	-5.4%	-7.5%	-9.6%	-11.7%	-13.8%
95 bps	6.7%	4.6%	2.5%*	0.4%	-1.7%	-3.8%	-5.9%	-8.0%	-10.0%	-12.1%	-14.2%
100 bps	6.3%	4.2%	2.1%	0.0%	-2.1%	-4.2%	-6.3%	-8.4%	-10.5%	-12.5%	-14.6%
105 bps	5.8%	3.7%	1.7%	-0.4%	-2.5%	-4.6%	-6.7%	-8.8%	-10.9%	-13.0%	-15.0%
110 bps	5.4%	3.3%	1.2%	-0.9%	-2.9%	-5.0%	-7.1%	-9.2%	-11.3%	-13.4%	-15.5%
115 bps	5.0%	2.9%	0.8%	-1.3%	-3.4%	-5.4%	-7.5%	-9.6%	-11.7%	-13.8%	-15.9%
120 bps	4.6%	2.5%	0.4%	-1.7%	-3.8%	-5.9%	-8.0%	-10.0%	-12.1%	-14.2%	-16.3%

Source: ICE Data Indices, LLC, Bloomberg

HY High Yield

- Late in November and with subsequent updated language in December, the Fed turned to an overly hawkish stance both in terms of interest rate hikes and balance sheet tapering. Markets are now pricing in at least three rate hikes in calendar year 2022 with speculation that the balance sheet might actually be shrinking by the end of the year (Figure 4).
- Fiscally, the Senate has blocked progress on additional infrastructure stimulus and doesn't show a clear path forward for significant progress.
- Historically, high yield tends to underperform following times of balance sheet contraction (Figure 5).

Figure 4: Global central bank assets y/y should fall from 9% growth in Q321 to c0% from Q2-Q4'22



Source: Haver, Bloomberg Indices, UBS estimates

Figure 5: U.S. IG and HY excess return performance 6mo forward, contingent on balance sheet growth y/y: Risks rise with negative growth

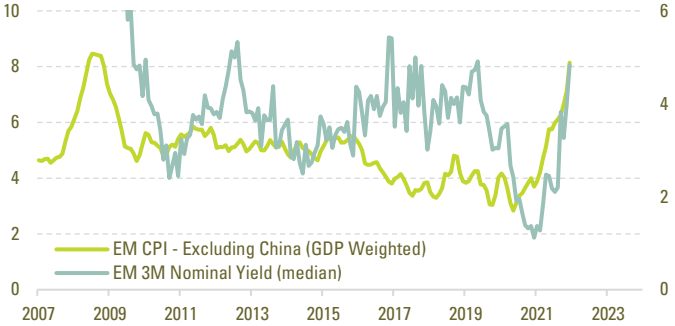
	6 months forward					
	USD IG Excess Return			USD HY Excess Return		
Balance Sheet Growth Y/Y%	Average	Median	% Positive	Average	Median	% Positive
<0	0.49%	0.98%	80%	-1.25%	0.60%	60%
0-10	0.41%	0.55%	63%	1.24%	2.10%	64%
10-20	0.19%	0.15%	53%	1.44%	1.84%	66%
>20	1.29%	0.95%	63%	3.47%	2.84%	59%

Source: MSCI ESG Research, Factset, and Brandywine

EM Emerging Markets Debt

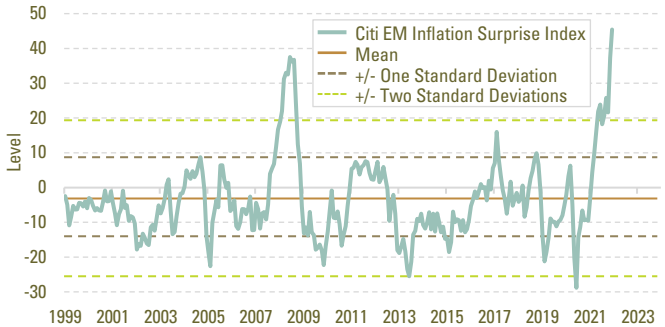
- Hard currency EM outperformed local markets significantly in 2021 with local markets down almost 10% versus flat to moderate losses in hard currency. The catalyst weighing on local markets was accelerating inflation, putting pressure on central banks to normalize policy rates and bringing three-month rates back toward 5% (Figure 6).
- Local markets appear to offer value within EM, but we think inflation surprises need to reverse allow central banks to slow the pace or stop hiking (Figure 7).
- A few risks we are monitoring include the pace of Fed tightening and the degree of reflationary policy in China as this will determine the return opportunity in EM. There are also several idiosyncratic risks, including election cycles, particularly in Latam where we've seen a move toward the left.
- We continue to find value in select hard currency corporates and EMBI issuers.

Figure 6: Central Banks Hiking due to Accelerating Inflation
As of 12/31/2021



Source: Brandywine Global, Bloomberg Finance LP

Figure 7: Citi EM Inflation Surprise Index
As of 12/31/2021

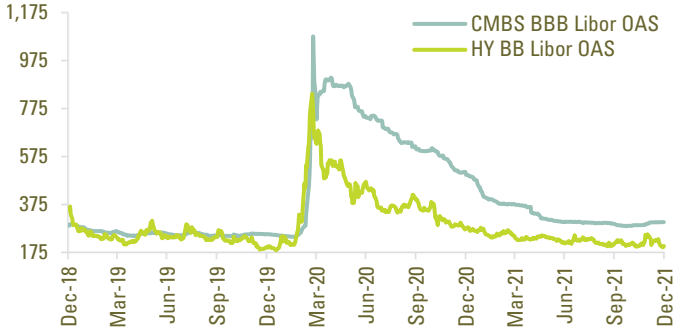


Source: Brandywine Global, Bloomberg Finance LP

SC Structured Credit

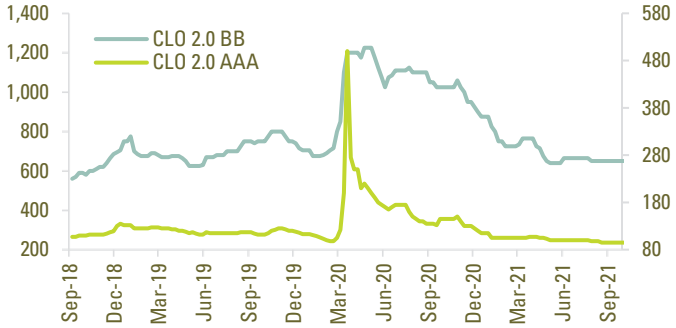
- Credit-risk transfer (CRT) mezzanine bonds offer a high carry profile and generous spread pick-up opportunity. They offer a scalable leveraged exposure to the housing boom and, as floating-rate instruments, should see increased investor demand in a rising rate cycle.
- We like BBB tranches of seasoned vintages of fixed-rate conduit commercial mortgage-backed securities (CMBS) and indexed credit default swaps (CMBX). They exhibit embedded price appreciation and amortization, spread pick-up from HY CDX, recovery potential, and shorter duration. We are also constructive on Single-Asset, Single-Borrower (SASB) CMBS loans for their higher-quality collateral and floating-rate nature (Figure 8).
- In asset-backed securities (ABS), we prefer higher-yielding securities rated B to BBB of subprime auto, equipment, private student loan, aircraft, container, railcar, and franchise ABS. The fundamentals should support positive returns.
- Backed by benign credit fundamentals, CLO mezzanine and equity tranches offer some of the most attractive opportunities in floating-rate bonds, and they may serve as a good hedge against rate hikes. (Figure 9).

Figure 8: Relative Value Comparison BBB CMBS vs. BB HY
Option-Adjusted Spread over LIBOR in Basis Points (bps), As of 12/31/2021



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

Figure 9: Relative Value Comparison CLO BB vs. CLO AAA
Spread to Swap, Basis Points (bps), As of 12/31/2021



Source: BofA Merrill Lynch Global Research