Global Fixed Income Perspectives

3Q 2021

GLOBAL MARKET OUTLOOK

- Monetary and fiscal policy are at the forefront of markets given that accommodative policy is set to be tightened over the next 12 – 18 months as central banks reverse their quantitative easing programs and fiscal stimulus will not be as large. Policymakers will continue to debate whether the inflationary pressures are transitory and what impact they may have on the economy.
- The battle against the delta variant appears to be turning as case counts and hospitalizations appear to be retreating. Reopening of global economies should alleviate some of the supply chain issues that have come to the fore. However, these supply chain issues will pose havoc over the next six months as the northern hemisphere enters winter with energy inventory levels at historic lows.
- Valuations pose a challenge to investors as levels are close to historic lows from both a spread and yield perspective.

DM DEVELOPED MARKETS

In the face of decade high inflation, bond investors have largely dismissed the risk and accepted the transitory argument. Supply chain issues seem to be peaking but are far from normalizing. Can central banks continue their dovish stance in the face of a prolonged heightened price environment?

IG INVESTMENT GRADE

Energy, commodities, consumer staples and healthcare appear better positioned to pass inflationary costs through to customers in an environment where producer price index (PPI) inflation measures are significantly outpacing consumer price index (CPI) inflation and squeezing operating margins.

HY HIGH YIELD

High yield spreads showed marginal widening over the quarter as issuance was elevated and central banks pivoted to more hawkish rhetoric globally. Predicted default rates remain low and we continue to favor the yield pick up to other areas of fixed income assets.

EM EMERGING MARKETS

Slower growth for China is implied by policy crackdowns across various sectors and by the campaign to de-lever the economy. Inflation pressures in EM are leading to more rate hikes, and additional banks have started hiking cycles.

SC STRUCTURED CREDIT

We continue to view this space as cheaper than comparable credits and see value down the capital stack in CRT; BBB; CMBS and CMBX; CLO; and subprime ABS. A strong housing market and healthy consumer finances provide fundamental support to these investments.

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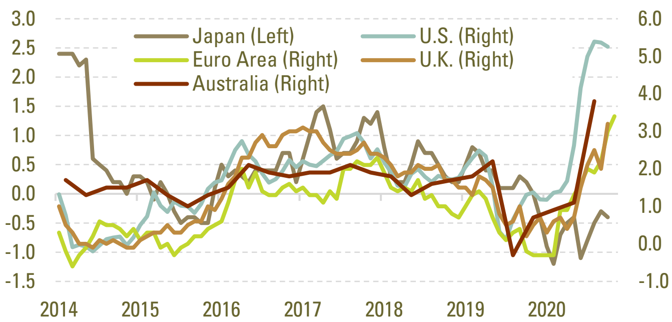
DM Developed Market Rates

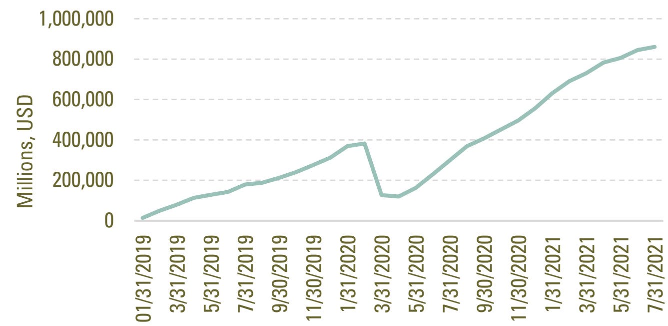
- Inflation numbers continue to dominate the headlines across the globe. Within the developed world, YoY figures are the highest the market has seen in a decade with the exception of Japan. (Figure 1)
- It's not just central banks buying bonds, flows into long-term bond funds in the U.S. have been growing at a steady rate since 2018 even in the midst of increasing inflation prints. (Figure 2)
- Even if supply shocks are diminished, elevated demand stemming from heighten savings should lead to prolonged inflation pressures.
- The combination of less accommodation from central banks and continued inflation should broadly lead to higher sovereign rates.

Figure 1: Global Inflation
As of 9/30/2021



Source: Bloomberg (© 2021, Bloomberg Finance LP)

Figure 2: U.S. Bond Mutual Fund Flows
As of 7/31/2021

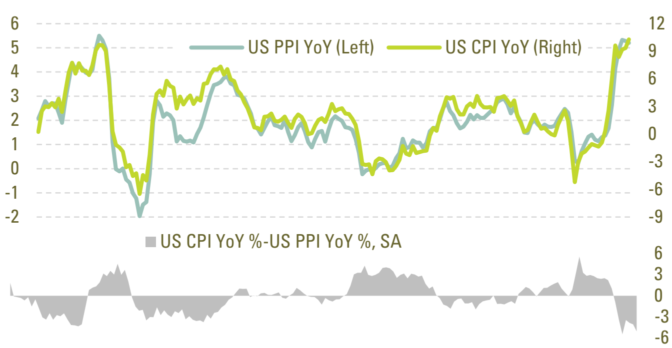


Source: Investment Company Institute

IG Investment Grade

- Is inflation transitory in nature or not? If one assumes that a higher rate of inflation is to persist, which sectors pose to benefit from this environment? Advantageous attributes include: pricing power (e.g., can pass-through cost increases), commodity based (e.g., essential raw material providers), inelastic demand, and real assets or infrastructure.
- Figure 3 uses the spread in CPI minus PPI inflation as a proxy for market-wide forward-looking changes in operating margins. Figure 4 looks at the correlation to forward operating margins within individual sectors.
- Through these observations, energy, commodities/materials, utilities, tech/semiconductor, consumer staples, and healthcare sectors are most likely to have operating margins rise in "inflationary" periods where CPI-PPI is falling (e.g., wholesale outpacing retail inflation).

Figure 3: U.S. Consumer and Producer Price Inflation Spread
%, as of 8/31/2021



Source: Brandywine Global, Macrobond, BLS

Figure 4: Sector operating margin correlation to CPI-PPI basis
As of 09/30/21

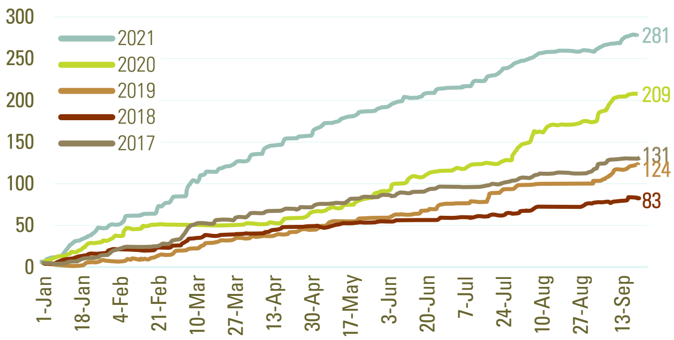
Top and Bottom sectors by correlation	CPI-PPI to Op Margin
Capital Goods	0.59
Transportation	0.58
Tech Hardware & Equip.	0.55
Auto & Components	0.52
Professional Services	0.52
Health Care	-0.41
Semiconductors	-0.41
Real Estate	-0.44
Energy	-0.48
Materials	-0.50

Source: Brandywine Global (© 2021, Bloomberg Finance LP)

HY High Yield

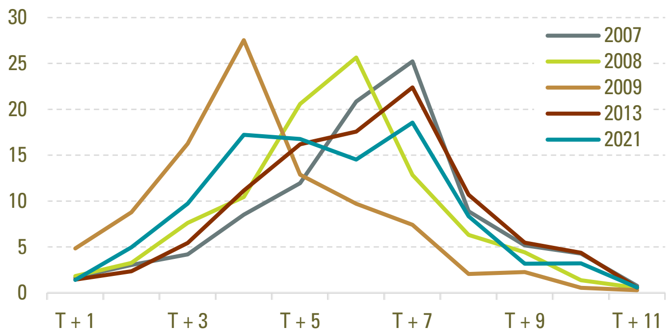
- High yield issuance is on pace to break the calendar year record in 2021. While the market has done well to digest the additional volume of new deals, spreads tend to widen when monthly issuance breaks over $40b. (Figure 5)
- The pace of new issuance has led to an extension of the typical maturity of outstanding high yield debt. “Major debt walls” that once concerned investors in the high yield market have been pushed out for a few years. (Figure 6)
- The lack of near-term maturities coupled with a healthy economic backdrop has resulted in estimated default rates returning to pre-COVID-19 levels. While there may be short-term volatility into the end of the year as the Federal Reserve unveils more detail into it’s quantitative tapering, we see no clear catalyst that would result in the default rates materially resetting higher.

Figure 5: U.S. HY Refinancing Related Issuance Cumulative Issuance ($bn)



Source: Credit Suisse

Figure 6: HY and Leveraged Loan Maturity Profile

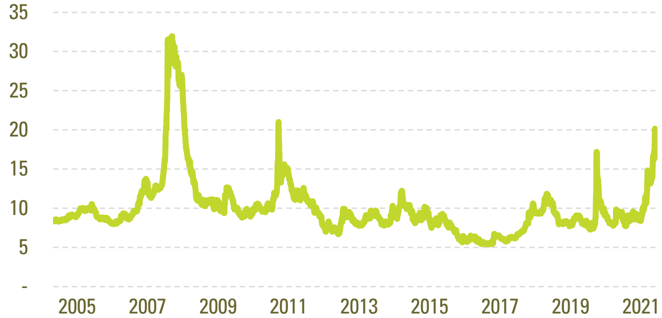


Source: BAML

EM Emerging Markets Debt

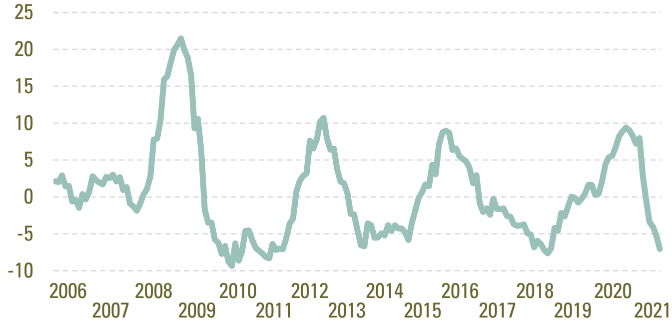
- Hard currency corporates returned a small gain for the quarter led by investment grade, while sovereign credit was negative. Hard currency valuations continue to trade toward the tighter end of historical ranges.
- China high yield credit widened further (Figure 7) following crackdowns across various sectors. President Xi’s pursuit of “common prosperity” in China has been a campaign against private enterprises, including crackdowns on internet platforms, fintech, tutoring, data privacy, crypto trading, and property speculation. These policies and the campaign to de-lever the economy imply slower growth ahead for China (Figure 8).
- Local market rates and currencies broadly sold off during the quarter. With inflation pressures picking up around the world, we saw further acceleration of rate hikes in addition to new cycles being started.

Figure 7: China High Yield Credit Yields Over 20%
As of 10/7/2021



Source: USE ICE BAML Index Disclosure

Figure 8: China Credit Impulse Weighing on Growth
As of 9/14/2021

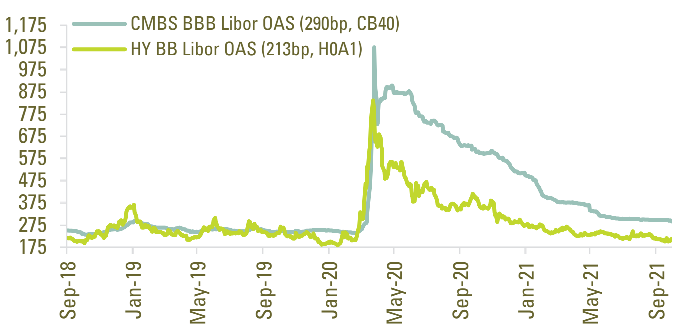


Source: Bloomberg (© 2021, Bloomberg Finance LP)

SC Structured Credit

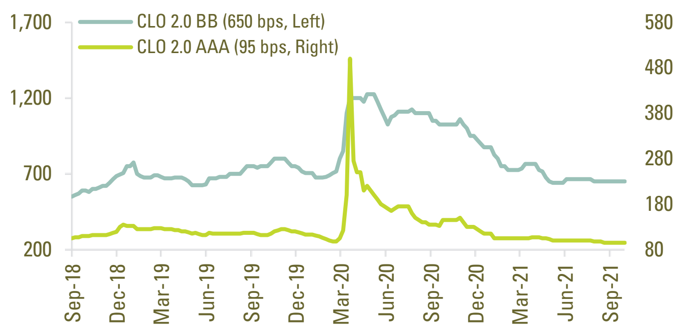
- Credit-risk transfer (CRT) notes continue to benefit from a strong U.S. housing market and improving collateral performance. Delinquencies continue to decline, and prepayment speeds remain high, providing solid fundamental support. Notes down in the capital stack should benefit from structural de-levering, credit rating upgrades, and call/tender upside. Fannie Mae's return to the new issue market should be a favorable technical. Floating rate coupon also protects from higher interest rates.
- We see commercial mortgage-backed securities (CMBS) as offering good relative value compared to high yield corporate credit, with uncertainties in the sector well priced in. Opportunities can be found in some seasoned CMBS conduits rated from single-A to BBB-. Seasoned CMBX indices also offer attractive value (Figure 9).
- Consumer credit asset-backed securities (ABS) also appear attractive, including BB-rated subprime auto ABS and marketplace lending ABS. These are supported by healthy household credit, high used car prices, fast de-levering, rating upgrade upside, and short duration.
- We maintain our view that CLO BB tranches offer attractive value due to improving leverage loan fundamentals, floating rate coupons, and spread pickup relative to other credit sectors. (Figure 10).

Figure 9: Relative Value Comparison BBB CMBS vs. BB HY
Basis Points (bps), As of 9/30/2021



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

Figure 10: Relative Value Comparison CLO BB vs. CLO AAA
Basis Points (bps), As of 9/30/2021



Source: BofA Merrill Lynch Global Research