Global Fixed Income Perspectives

Brandywine GLOBAL

Global Market Outlook

- 2Q 2022 picked up where 1Q 2022 left off—fixed income assets repriced quite dramatically during the quarter to close the first half of the year with the worst performance in over 200 years.
- Headline inflation remained elevated while core appears to be peaking. University of Michigan inflation expectations, a measure closely monitored by the Fed, accelerated causing the Federal Reserve (Fed) to move aggressively with a 75 basis points (bp) rate hike at their June 15 meeting, exceeding market expectations. In addition, quantitative tightening started on June 15 and will accelerate in September.
- Similarly, the European Central Bank (ECB) is tacking to a more hawkish stance and looking to implement an "anti-fragmentation" program to protect the peripheral from spread widening.
- The late quarter sell-off in hard and soft commodities coupled with money supply growth decelerating will slow the rapid ascent in prices and may provide the Fed with room to maneuver in the later half of the year.

About this Publication

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

DM	Developed Market Rates	Global bond yields are now seemingly trading in line with growth fears and less with inflation pressures. While the market has not dismissed inflation worries, there are clear signs that show that the global economy is slowing at a rapid pace and tighter financial conditions are having an impact.
HY	High Yield	High yield bonds drastically repriced this quarter, particularly during June where the index posted its worst monthly loss since the outbreak of COVID. While this year has been a challenge for all fixed income asset classes, high yield is starting to look attractive given the carry now offered in most bonds.
IG	Investment Grade	Increased energy costs caused European IG credit spreads to underperform U.S. spreads, and the spread basis is at multi-year highs. The S&P upgrade/ downgrade ratio is also at multi year highs, demonstrating the strength and resilience of IG corporate balance sheets.
EM	Emerging Markets	The EM sell-off continued this quarter. In Europe, increases in energy prices due to the Russia-Ukraine war are leading to a surge in headline inflation. China has been in a man-made recession all year due to its zero-COVID tolerance. Valuations are getting more attractive, but signs of stabilization are needed.
SC	Structured Credit	Structured credit experienced mixed performance in the second quarter, though most segments are outperforming comparable corporates year to date. We continue to see solid credit fundamentals, which should lead to positive long-term performance despite near-term market volatility.

DM Developed Market Rates

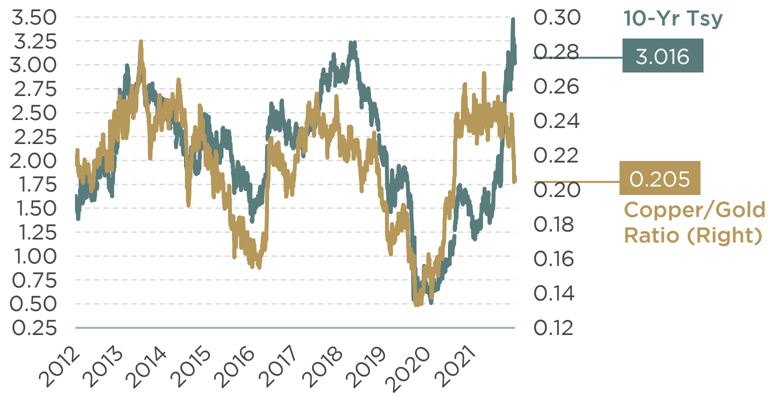
- While not always the best timing tool, the copper/gold ratio continues to provide insight on where global bonds are headed. Using the 10-year Treasury as a proxy, yields should move lower following the swift reversal of the ratio toward the end of the quarter (**FIGURE 1**).
- Many dismissed this metric in 2021 as copper prices hit decade highs while global yields remained stubbornly low. However, the more telling signal may have been that central banks were behind the curve.
- A further drop in commodity prices should provide central banks some relief from hiking pressures especially in those economies where headline inflation is highly derived from energy prices.

HY High Yield

- High yield corporate balance sheets are still very healthy relative to history with leverage at very low levels and interest coverage at record highs (**FIGURES 2 AND 3**).
- New issues have slowed considerably to about $150 billion of high yield issuance year to date, well behind the $700 billion of new high yield bonds printed in the previous two calendar years. Flows out of the asset class have also been meaningful with over $30 billion of year-to-date outflows recorded between ETFs and active managers.
- While we're not ready to call the top in spreads yet with a still very hawkish Fed and persistently high inflationary reports, we do note that when the yield-to-worst rises above 8.5% for the index, forward looking returns tend to look attractive (**FIGURE 4**).
- High yield bonds are among the only fixed income classes offering positive real returns, and we think capital will start to be attracted back to the asset class after the violent repricing of bonds year to date.

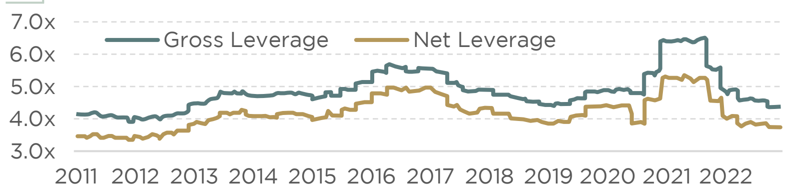
1 Copper/Gold Ratio vs. 10-Year Treasury

As of 6/30/2022



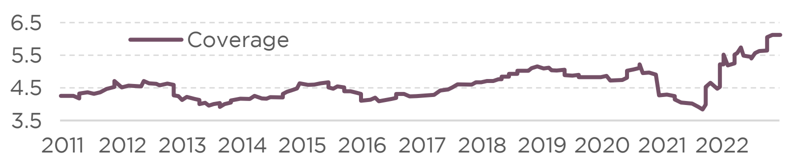
Source: Bloomberg (© 2022, Bloomberg Finance LP)

2 Gross and Net Leverage for U.S. High Yield Index



Source: Bank of America Merrill Lynch

3 Interest Coverage for U.S. High Yield Index



Source: Bank of America Merrill Lynch

4 ICE BOFA U.S. High Yield Index

Date YTW Breached Above 8.5%	Avg Dollar Price	FWD 1Y	FWD 2Y Annualized	FWD 3Y Annualized	FWD 5Y Annualized
7/24/2007	96.10	(0.89)	(0.40)	8.07	8.88
8/11/2011	97.01	13.83	11.22	10.28	7.37
12/11/2015	88.93	16.83	12.25	7.94	8.24
3/16/2020	87.06	21.65	9.68	--	--

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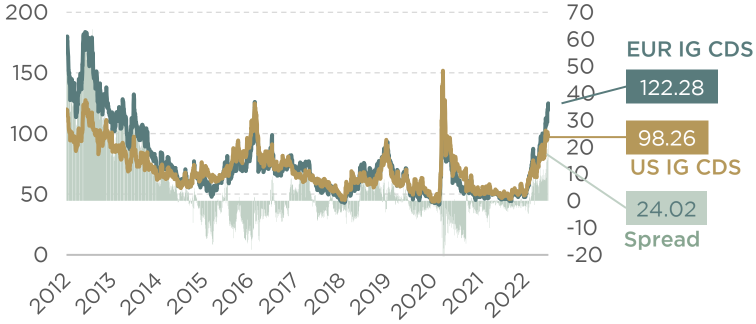
IG Investment Grade

- While both European and U.S. IG credit default swap (CDS) spreads have widened significantly this year, European spreads have appreciably underperformed, resulting in the largest spread basis since the aftermath of the eurozone debt crisis in Q3 2013 (**FIGURE 5**).
- Typically, the weighting of banks (especially periphery banks) in the EUR IG index has caused it to underperform against the U.S. IG index, as was the case in 2010-2013. However, current underperformance is driven by industrial names, such as BASF, Fortum, and Volkswagen, dealing with higher energy costs and the threat of reduced European gas supply as the war in Ukraine drags on.
- The S&P IG credit rating upgrade/downgrade ratio is at multi-year highs, led by the financials, energy, real estate, and health care sectors, all of which have benefitted from the recent inflationary environment (**FIGURE 6**).
- IG corporate balance sheets therefore appear to be in good health and able to weather reduced margins and profitability over the short to medium term. This highlights how important duration will be to the performance of IG over the next 12 months.

5 Europe vs. U.S. IG CDS and Spread

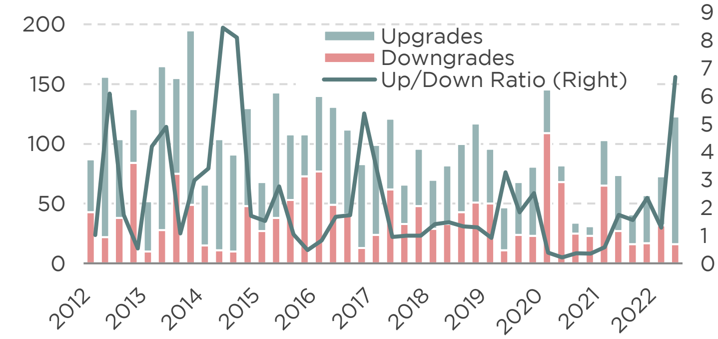
bps, As of 7/6/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

6 S&P IG Upgrade/Downgrade Ratio

As of 6/30/2022



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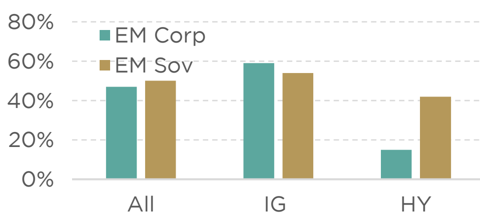
EM Emerging Markets Debt

- Emerging markets were not immune to the market sell-off; the three main indices we track are now down mid-teens to low-20% year to date. Central banks in Central Europe have responded aggressively to the surge in headline inflation with rate increases, but that has yet to stem FX weakness.
- Chinese authorities are getting more focused on rekindling economic growth, the latest stabilization initiative out of the usual infrastructure spending playbook that will this time be financed by bringing forward $200 billion of next year's bond allocations from local government budgets. It is hard to see how potent these measures could be in the face of the country's persistent zero-COVID policy.
- Given the challenges in the global economy, primary issuance in hard-currency markets are running well below 2021 levels (**FIGURE 7**), and high yield issuance is about 15% of the levels we saw at this point last year. Yields are getting more attractive based on historical rankings (**FIGURE 8**), but we need to see some signs of stabilization.

7 Primary Market Activity Well Below 2021 Levels

2022 Primary Issuance % of 2021



Source: Bank of America

8 Yield % Tile Ranking

Units, as of 6/30/2022

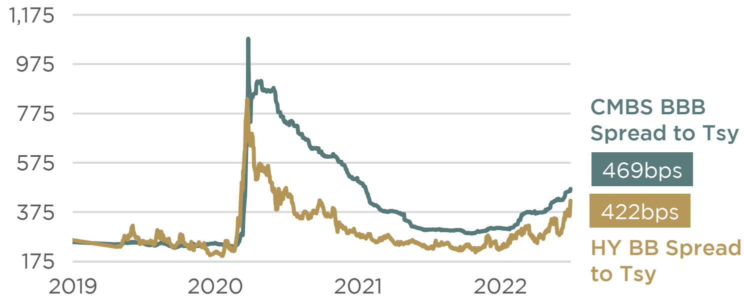
	Yield	% Ranking
EMBI	8.6%	95%
EMBI IG	5.1%	63%
EMBI HY	12.9%	99%
CEMBI	7.1%	88%
CEMBI IG	5.3%	69%
CEMBI HY	10.0%	82%

Source: J.P. Morgan & Chase

SC Structured Credit

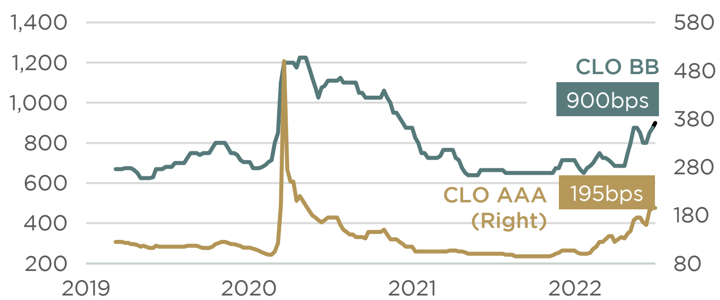
- Credit-risk transfer (CRT) securities struggled in the recent market rout, but the collateral has performed well with benign delinquency rates and resilient prepayment speeds. We see further upside in CRT due to their high carry, floating coupon, and strong collateral fundamentals. Although mortgage rates have risen sharply and home sales have slowed, most homeowners locked in at historically low rates, and we expect home prices to remain supported.
- Commercial mortgage-backed securities (CMBS) were roiled by economic uncertainty, but credit fundamentals of certain seasoned vintage fixed-rate conduits have remained firm. BBB tranches of these deals offer potential price appreciation and strong recovery with shorter duration and spread pick-up over comparable corporates. We also see value in Single-Asset, Single-Borrower (SASB) CMBS loans for their higher-quality collateral and floating-rate nature (**FIGURE 9**).
- In asset-backed securities (ABS), we remain constructive on subprime auto and consumer loan ABS, though we prefer to move up in credit quality. Delinquencies are normalizing from historical lows, but faster structural de-levering should support the bonds.
- Collateral loan obligations (CLOs) widened further over the quarter, but collateral performance is holding up and we still see floating-rate mezzanine tranches as attractive. (**FIGURE 10**).

9 Relative Value Comparison BBB CMBS vs. BB HY Spread to Worst over Treasury in Basis Points (bps), As of 6/30/2022



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

10 Relative Value Comparison CLO BB vs. CLO AAA Spread to Swap, Basis Points (bps), As of 6/30/2022



Source: ICE Data Indices, LLC., BofA Merill Lynch 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. 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Brandywine Global Investment Management, LLC

1735 Market Street
Suite 1800
Philadelphia, PA 19103

BRANDYWINEGLOBAL.COM

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