JUN
22
2021

Mid-Year Outlook: Lots in the Air

The rest of 2021 could bring more of the same as investors juggle shifting data and decide which macro trends may be transitory or more lasting. Our experts offer mid-year outlooks across markets.

Macroeconomic Outlook: What’s Not Transitory in the Macro Outlook?

Francis A. Scotland »

Money is made or lost as markets transition from what investors believe will happen in the future to what actually occurs. At the moment, all macro signs point to a synchronous reopening boom with investors positioned for a utopic future. Current surveys and asset price profiles imply expectations for strong and long-lasting economic growth, a transitory spike in inflation, and a smooth tapering of the Federal Reserve’s (Fed’s) balance sheet at some point in the future. All of these indicators assume an end to the pandemic’s influence. The stakes riding on this sanguine view are high; equity prices are very stretched, and TIPS yields are very low.

Unfortunately, there is no historical recovery road map for navigating a world full of pandemic-related distortions bouncing back from disaster with monstrous stimulus measures set to be dialed back in various stages. Add to this unique circumstance the green drive to a net-zero carbon world, the possibility of the biggest tax hikes in the U.S. in over 50 years, and the Biden administration’s decision to shed any veil of pretense by officially declaring China an adversary and not just a competitor. There are a lot of balls in the air.

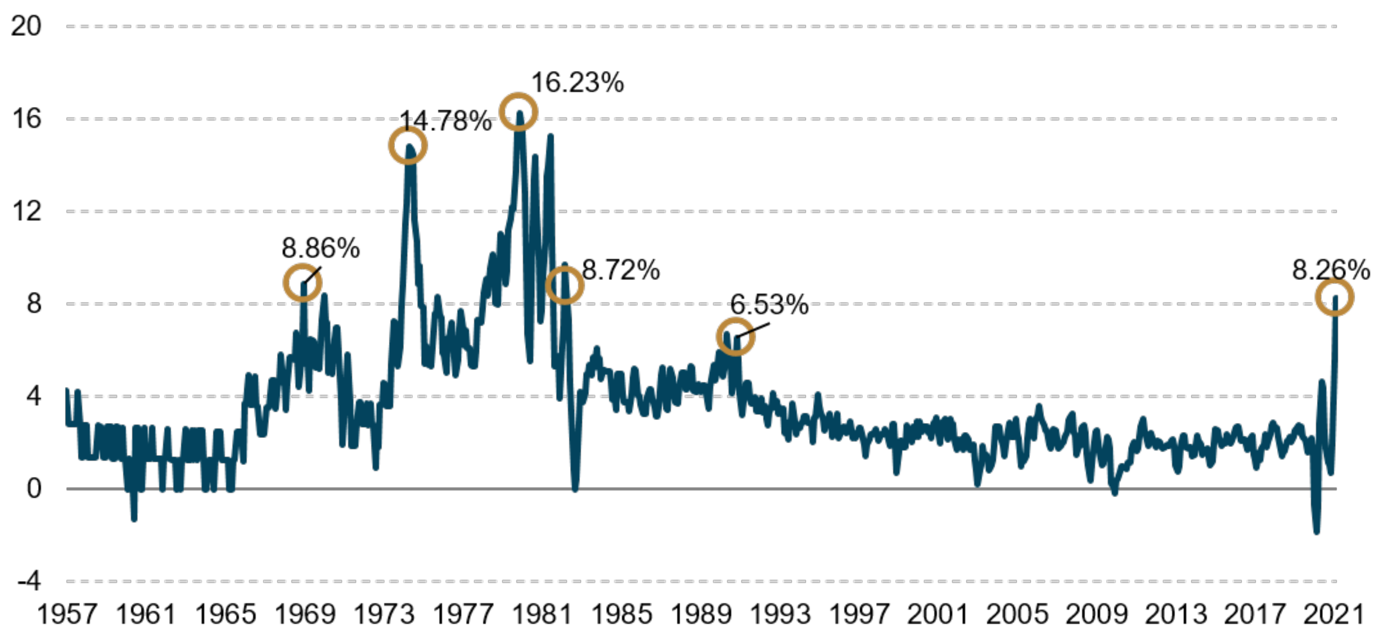
For the moment, the focal point of investment uncertainty is on the nature of the current spike in inflation (see Chart 1). The Fed argues it is transitory, a momentary consequence of supply-side disruptions colliding with reopening demand, and it will pass as “normalcy” is restored. Most investors are positioned for this outcome. But a growing number of high-profile types do not buy this narrative. Thinking inflation could become more entrenched, they find cold comfort in the Fed’s reassurance that the central bank has the tools to head off any longer-lasting inflation uptrends. Historically, the central bank has never been able to accomplish this task without a recession.

In our view, it is too soon to answer the inflation question. A longer-lasting inflationary outlook seems unlikely without a meaningful break in the U.S. dollar; so far, the currency seems to be holding a bid. In addition, the second half of the year should resolve any job market distortions caused by the temporary, excessive unemployment benefits, which will help clarify the labor supply picture. By the end of the year, the U.S. unemployment rate should be significantly lower.

However, the inflation outlook is only the tip of the iceberg in terms of what may be transitory or not. The biggest economic issue may be how transitory or permanent the savings and cash balances accumulated during the crisis prove to be. The build-up of savings during the pandemic amounts to trillions, and savings rates remain significantly higher than before the pandemic almost everywhere in the world. These developments compete as a plausible explanation for prevailing low real bond yields with the more popular accusation of central bank repression, especially considering the resilience of the dollar. Deposits held in the U.S. commercial banking system have risen to over $3.5 trillion above the pre-pandemic trend (see Chart 2). What happens to these cash balances is crucial to the outlook. They represent potentially explosive inflationary fuel equal to 16% of gross domestic product (GDP) and would clearly push inflation much higher for much longer if they flood into the real economy. Contrarily, the economic expansion may lurch over a fiscal cliff if households and businesses hang on to these cash balances longer than expected, especially with high energy and commodity prices already working to stunt growth and China coming off the boil. Add in the prospect for record-setting tax increases in the U.S., and there is not much in the outlook that can be taken for granted as lasting.

1 Core U.S. Inflation Rising at Fastest Rate Since 1982

Annualized 3-month Core CPI Change, As of 5/31/2021

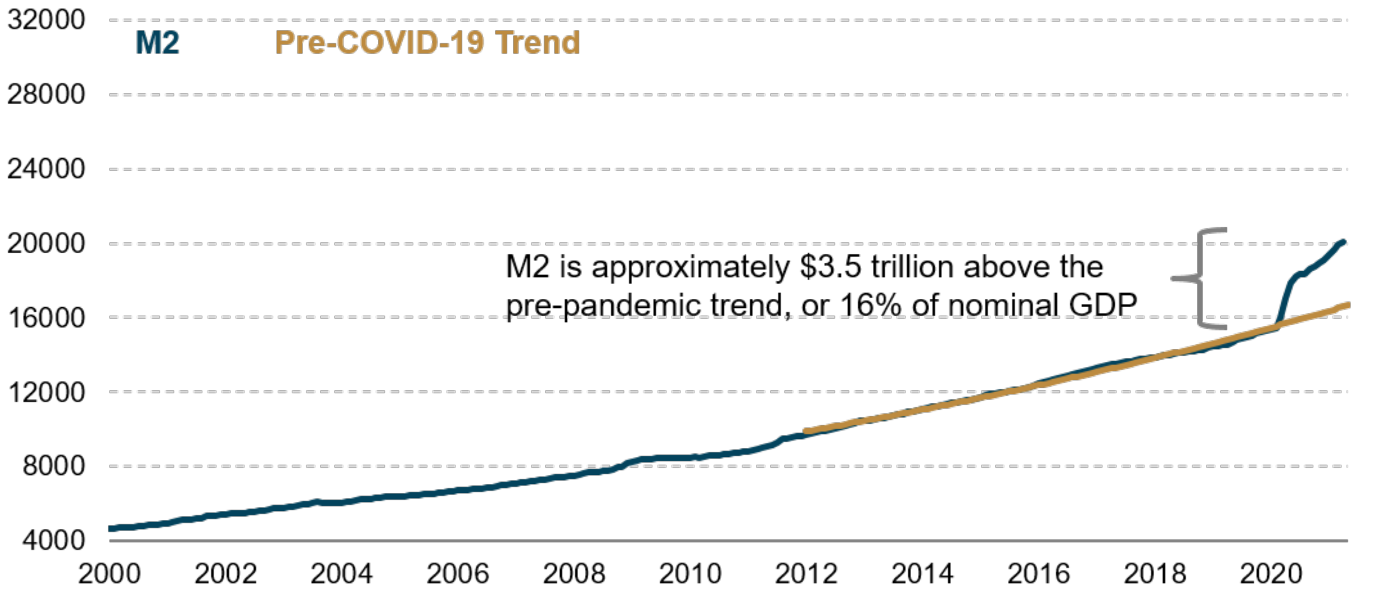


Source: Macrobond

2

U.S. M2 Money Supply Growth

$, As of 5/31/2021



Source: Macrobond

Global Fixed Income: More Noise than Signal

Jack P. McIntyre, CFA »

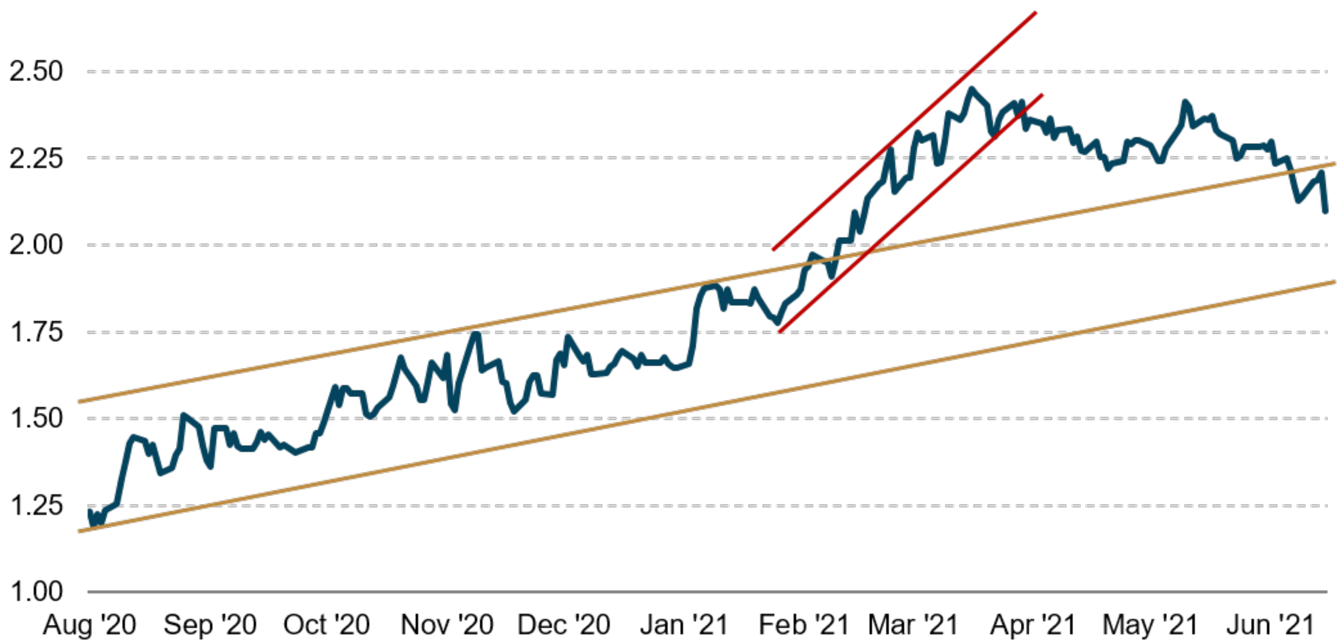
For developed market sovereign bonds, we expect the second half of 2021 will be like the environment we witnessed during the second quarter of this year—a directionless trading bias, lacking in conviction and keeping most developed market bond yields range bound. Bond markets will continue to struggle with the idea that the economic data reflects more noise than signal. I do not expect the market to break out until we move past supply bottlenecks and the supply/demand relationship falls back into alignment. If we think of economic activity in terms of organic drivers and inorganic drivers, we are knee deep in the latter. However, it is the former that will turn the recovery into an expansion. We are woefully underinvested in inventories in many parts of the economy, which is at the root of the supply/demand imbalance. This misalignment could start to improve later this year as the economic recovery continues apace, we hit peak demand, the supply curve shifts out, and production continues to ramp up. As inventories get restocked and an inventory cushion is built, production may increase at a more sustainable pace deep into 2022-23. This outlook is bearish for bonds.

The Fed is in the same boat as bond investors regarding how to interpret the economic data. Until there is greater clarity, the central bankers likely will go slow on transitioning to tapering, despite the "hawkish" tilt of the June Federal Open Market Committee (FOMC) meeting. Global vaccinations are moving in the right direction and gaining momentum, which will reduce the uncertainty around COVID-19. In turn, overall market uncertainty also will continue to subside. We likely have hit peak fiscal stimulus as well. All are ingredients for Treasury yields to be range bound or slowly drift higher, which has been the pattern since last August (seeChart 3). One exception was the February/March period when what started as a gradual move higher in rates reached a selling climax. What was the catalyst? It was simply that the proposed $1.9 trillion U.S. fiscal stimulus package came in at $1.9 trillion without any compromise. Markets clearly expected less, triggering a Treasury market tantrum

that spilled over to virtually any fixed income market. Perhaps that sharp spike in yields that caught investors by surprise was essentially the bond markets' taper tantrum? After all, it has been the last piece of information to really jolt the bond market. If we are correct about Treasury yields reverting to the pattern of a more gradual rise, emerging markets will still benefit from capital flows as the "return-on-capital" bias still dominates financial markets.

3 U.S. 30-Year Treasury Bond Yield

%, As of 6/17/2021



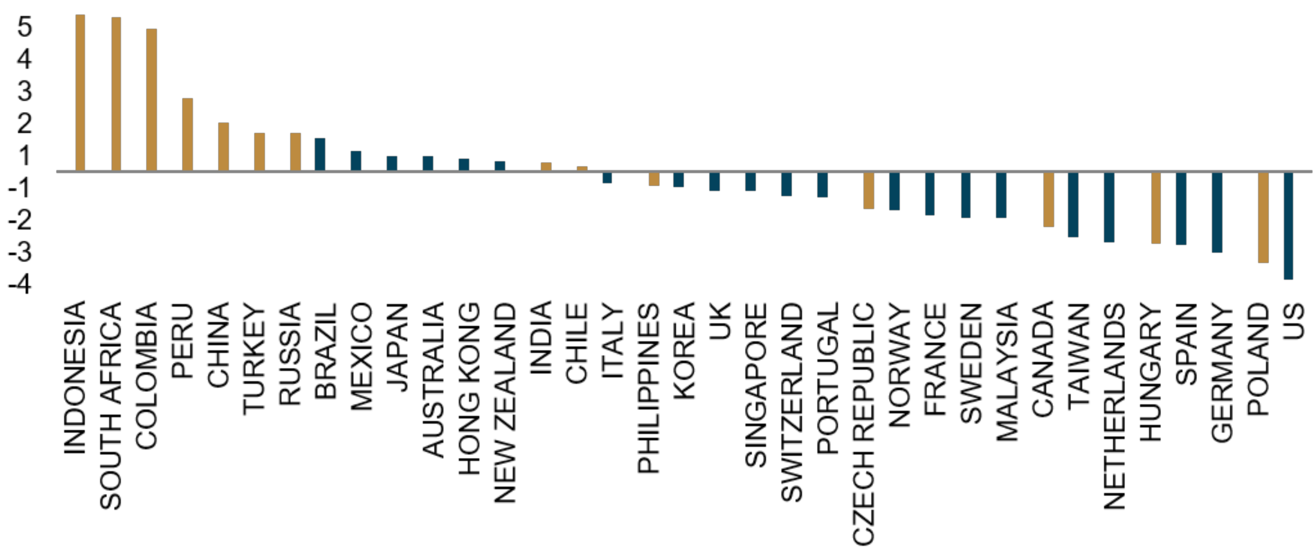
Source: Bloomberg (© 2021, Bloomberg Finance LP), Brandywine Global, Macrobond

In the debate of where value in global bonds may exist, developed market bonds continue to fall short. On a real yield basis, not enough inflation expectations are being priced into nominal yields. Where then can bond investors find attractive total return opportunities? We believe the answer is found in those bond markets that trade at attractive yield premiums—emerging markets (see Chart 4). Emerging market bonds generally have priced in more inflation expectations and still trade at solid risk-adjusted spreads relative to developed market bonds. We believe the global macro backdrop reflects the necessary conditions that must be in place for emerging market bonds to outperform. These top-down influences—including easy monetary conditions in the U.S. and China, accelerating global growth, receding uncertainty around the pandemic, and improving vaccination rates, among other conditions—rather than bottom-up, idiosyncratic factors, are supportive of emerging markets (see Chart 5). Diminished global uncertainty married with extremely easy financial conditions equates to capital flowing away from risk-advese bonds, i.e., developed markets, toward higher-yielding bonds. We expect emerging market bonds to be the biggest beneficiaries as they have some of the highest sources of risk-adjusted yield premium. However, one factor to watch is China's growth trajectory, which could slow as the country removes stimulus. China needs to be watched closely given the potential message embedded in its credit impulse measures. Meanwhile, U.S. growth continues to exceed other countries, although demand in Europe is picking up. Some emerging market central banks have already tightened policy rates and should be willing to tighten further if inflation concerns persist, which bond market vigilantes want to see. We still find compelling value in the local currency sovereign bonds of Mexico, Indonesia, South Africa, Brazil, and Colombia.

4

Real 10-Year Bond Yields – EM Bonds Still Offer Value

%, Real 10-Year Bond Yield Ranking Based on 12-Month % Change in Headline CPI, As of 5/31/2021

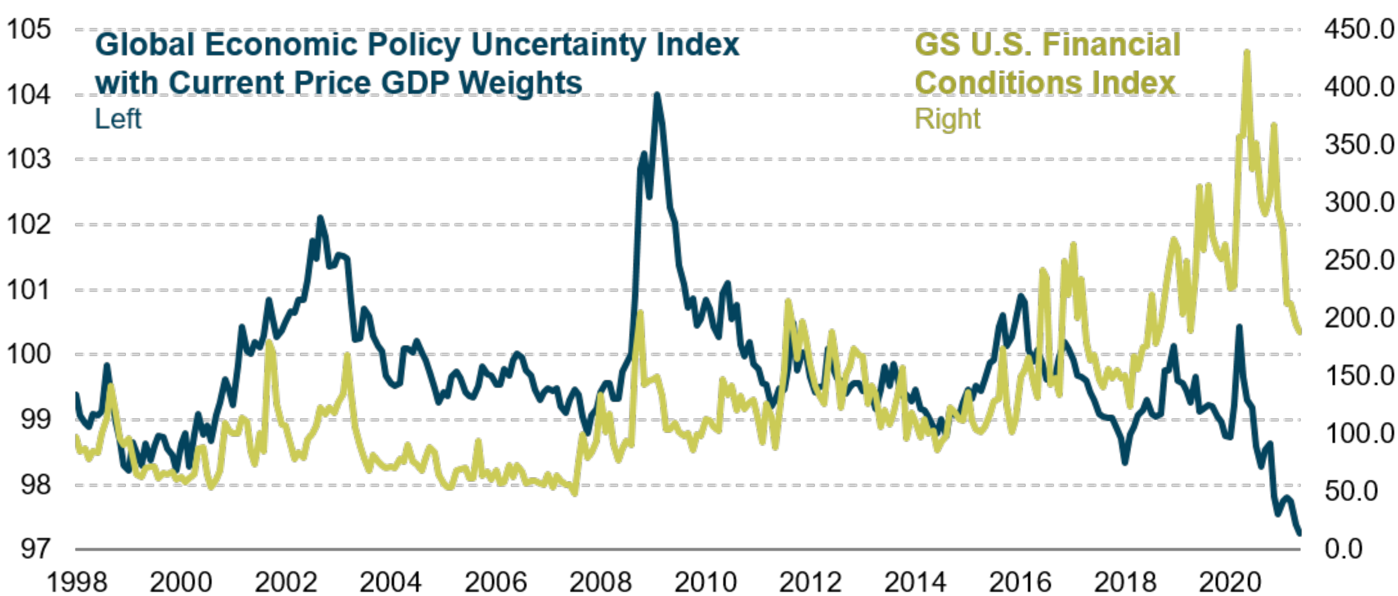


Source: Macrobond, Brandywine Global

5

Globally, Uncertainty Continues to Diminish

Index, As of 6/16/2021



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

Global Currencies: Range-bound Dollar

Anujeet Sareen, CFA »

The forces that propelled the U.S. dollar in 2020 have started to moderate in 2021, causing the greenback to trade more in a sideways range since the beginning of this year. Investors should expect the dollar to remain range bound for the balance of this year as these bearish and bullish forces vie for dominance.

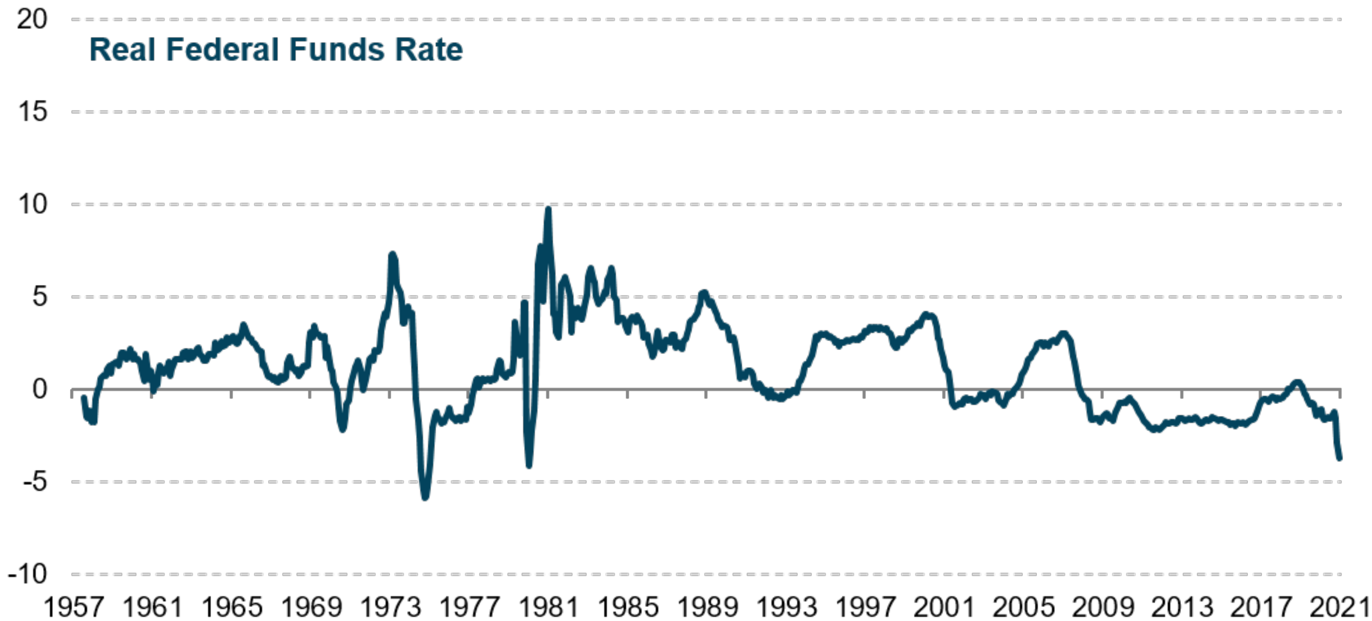
Bearish forces

The factors pressuring the U.S. dollar lower remain formidable. One, the state of U.S. monetary policy continues to offer a strong disincentive to hold dollars. Short-term real interest rates are currently the most negative since the early 1980s (see Chart 6). Two, the Fed's Flexible Average Inflation Targeting (FAIT) regime biases the central bank to normalize policy more slowly than other major central banks that have not adopted a similar change to their monetary framework. Hence, the Fed is more likely to lag any increase in real interest rates compared to other countries. Three, the current account deficit has deteriorated materially from -2% GDP in late 2019 to nearly -4% GDP in early 2021 (see Chart 7). The balance-of-payments identity requires the current account to equal the capital account. In the case of the U.S., the large current account deficit requires a commensurately large capital account surplus to balance international flows. However, as we just noted, U.S. short-term interest rates do not currently offer an attractive return for global capital flows. The U.S. is not only offering highly negative short-term real interest rates, but it is offering them at a time when the country's borrowing needs from the world are the largest in over 10 years. This combination is not good for the currency. Finally, four, the global economy is likely to sustain elevated growth rates through the second half of this year as the rollout of COVID-19 vaccines allows more economies to stage powerful recoveries, similar to what we have already seen in the U.S.. In such an environment, the world has a diminished need to hoard the primary reserve currency of the world, the U.S. dollar.

6

U.S. Real Policy Rate

%, Using Core CPI, As of 5/1/2021

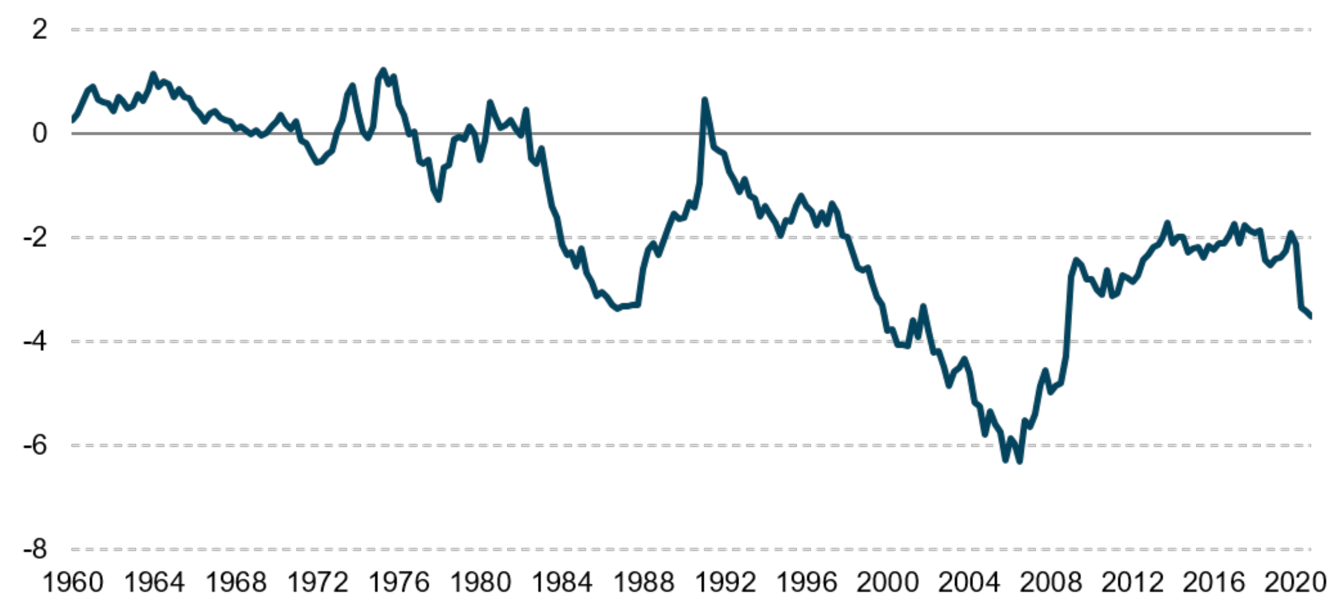


Source: Haver Analytics

7

U.S. Current Account Balance as Percent of GDP

%, Seasonally Adjusted, As of 10/1/2020

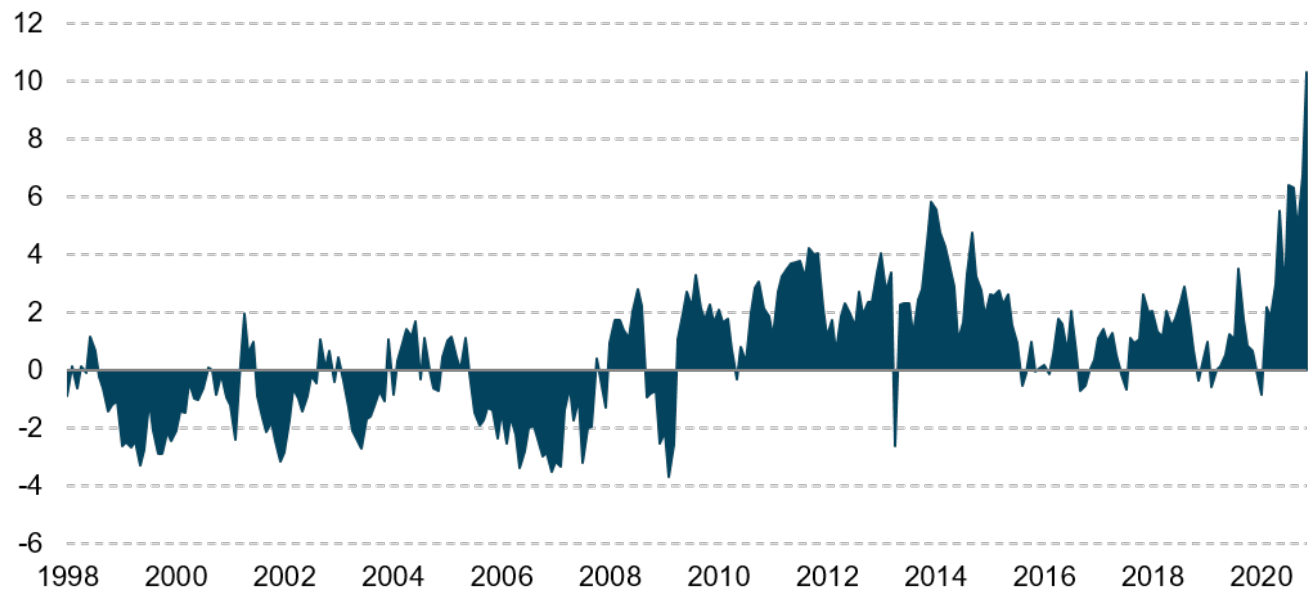


Source: Haver Analytics

Bullish forces

On the other hand, there are three factors that are becoming progressively more bullish for the U.S. dollar. One, the U.S. economic recovery continues to power ahead of recoveries in most major countries around the world. This outperformance is partly due to the accelerated availability of COVID vaccines in the U.S., partly due to the extraordinary fiscal support for the economy, and partly due to U.S. growth leadership in the technology sector (see Chart 8). Two, perhaps more importantly, the Fed's reaction to strong U.S. economic and inflation developments is shifting. Even given the FAIT framework mentioned earlier, the Fed finds itself needing to consider a reduction in stimulus ahead of other major countries. While the level of Fed policy remains dollar negative, the change in Fed policy to a more hawkish stance is dollar bullish. Finally, three, Chinese authorities have steadily reduced monetary and fiscal stimulus since late 2020, and the signs of this policy shift are now manifesting in slower domestic economic data, notably in the property sector. A weaker Chinese economy tends to have a larger negative impact on countries other than the U.S., particularly on commodity price performance. Consequently, the relative growth profile favors the U.S., supporting dollar strength.

8 **Composite PMI: U.S. vs. World**
Index, As of 5/1/2021



Source: Haver Analytics

Longer-term forces?

The dollar's longer-term prospects depend on two different forces. One, the U.S. has started following polices consistent with what some call Modern Monetary Theory, namely the deliberate deployment of large fiscal deficits financed with excessively easy monetary policy to support growth. A sustained commitment to this path is likely to generate wider external deficits, higher inflation, and a weaker dollar. On the other hand, the U.S.'s ability to sustain its technology leadership remains critical to continued economic outperformance, attracting the capital flows needed to drive the dollar higher. Time will tell.

Range-bound dollar

The "push" and "pull" forces for the dollar have become more balanced cyclically compared to last year. Select emerging market currencies that lagged the global recovery are still likely generate attractive returns in the second half of this year while the U.S. dollar, more broadly, is likely to remain range bound for the balance of 2021.

Global Credit: Hedging Bets on the Recovery

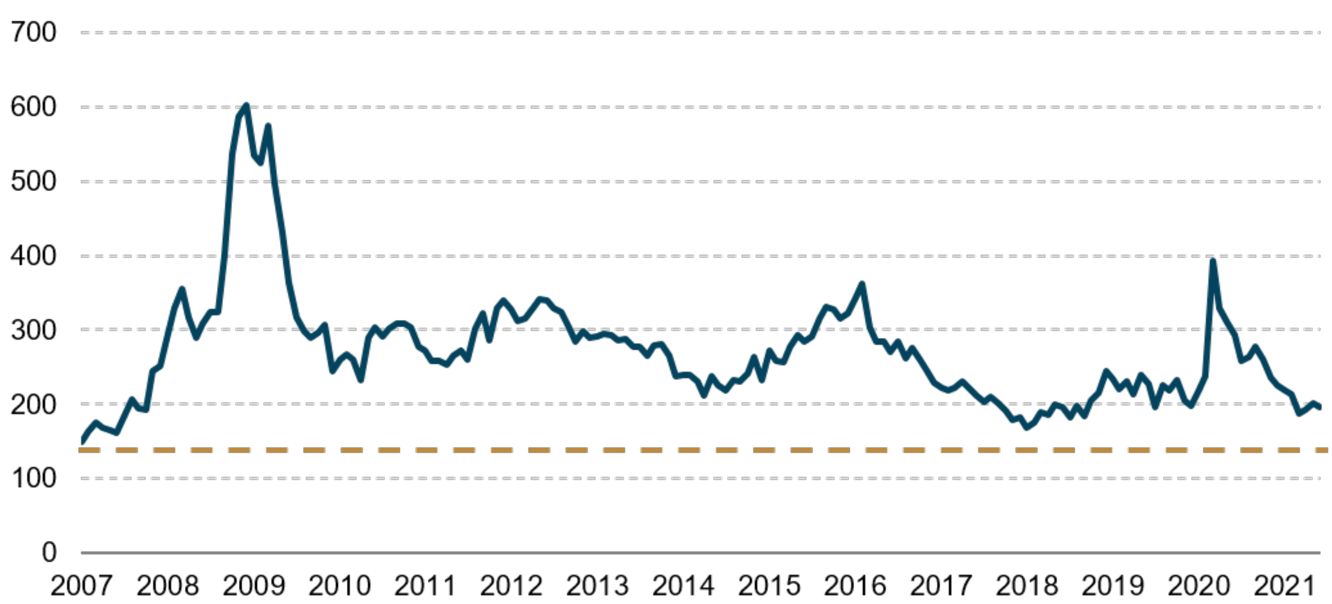
Brian L. Kloss, JD, CPA »

We expect the remainder of 2021 will be challenging, but in a different sense than 2020 given the high valuations at the start of this year. Returns will be harder to come by but should still be positive. We think corporate bond spreads are probably near their tightest but could become even tighter through the balance of 2021 as global growth recovers exponentially. Spreads will widen eventually, given the unprecedented governmental fiscal spending and the increased easing of pandemic restrictions. However, in the near term, investment grade bond spreads could see another 20 basis points of tightening, closing in on the tight pre-2008 levels (see Chart 9), and below-investment grade bond spreads could tighten by 50 to 100 basis points (see Chart 10). Where there are opportunities to pick up some incremental yield in corporate credit, we think this positioning will be well compensated over the next 12 months. Overall, we are constructive on corporate credit, especially the shorter end of the curve. Pro-cyclical sectors, such as commodities, basic materials, and healthcare technology, provide interesting opportunities.

9

Baa Spread

Basis Points (bps), As of 6/21/2021

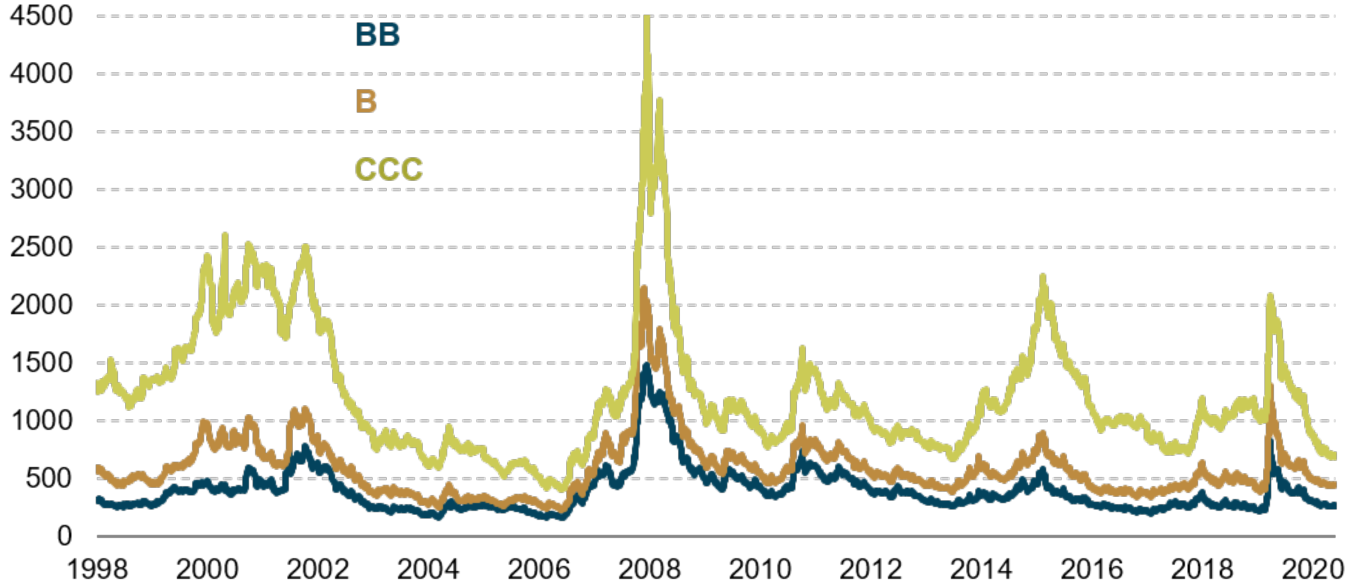


Source: Macrobond

10

Global Quality Option-Adjusted Spread (OAS)

Basis Points (bps), As of 5/31/2021



Source: ICE BofA

However, we believe active management will be key in these conditions, as the opportunities across corporate credit markets will be selective and uneven. Investors will need to use all the tools in their toolkits, including sector, duration, and quality rotation. While continuous monitoring of the macroeconomic environment will be important, so will strong underwriting criteria for individual securities given the nuances and small anomalies across the corporate bond spectrum.

Security selection will be particularly important within high yield, where we currently see a bifurcated market. For example, within the CCC component of the U.S. High Yield Index, more than half of the securities in this segment yield 6.5% or lower while roughly 14% of the constituents yield 9.5% or higher as of May 31, 2021.

With investors increasingly concerned about the potential for a spike in inflation, the first quarter offered a preview of what could happen. Treasury yields rose by approximately 75 basis points, jarring asset prices significantly during the quarter. If inflation returns for real—and assuming it is the result of stronger economic growth—longer-duration assets will be repriced across the quality spectrum. In this scenario, we would expect more equity-like assets, namely lower-quality assets with shorter maturities and pricing power, to outperform other fixed income segments. The rate curve should initially steepen before the market prices in a policy response from the central bankers.

While we see opportunities from the global economic recovery, we also are seeking to insulate portfolios from a potential uptick in inflation. Currently, our sector rotation is geared toward commodities and basic materials with the intent of capitalizing on those sectors poised to benefit from the post-pandemic economic reopening. On the inflation front, we also are focused on those entities that have pricing power as a potential hedge against rising prices. To help cushion portfolios from potential spikes in interest rates, we are tilted toward securities with shorter maturities or with expectations that the bonds will be called. However, given the speed of the recovery and resulting pressure on central banks to change policies, this positioning may be outdated by as early as mid-way through the third quarter; that is where flexible guidelines and active rotation will come into play. We will assess the global macroeconomic landscape continuously and reposition accordingly as conditions evolve.

Structured Credit: A Tale of Three Markets

Tracy Chen, CFA, CAIA »

Booming housing market:

The strong U.S. housing market has been the bulwark of the post-pandemic U.S. economic recovery. Double-digit housing price appreciation has been fueled by healthy household income growth, generous fiscal stimulus, historically low mortgage rates, a severe lack of housing supply, and strong housing demand. However, other developed countries like Australia, Canada, New Zealand, Sweden, and Norway are experiencing even stronger housing booms. It is not surprising as global central banks' quantitative easing flooded the market with massive liquidity.

We believe the housing market boom is well supported by the structural factor of imbalanced supply and demand. Millennials, having postponed home buying, are increasingly contributing to home ownership household formations. Demand is further propelled by the structural migration out of densely populated cities to suburban areas and more people working from home. The lack of housing supply is a result of decades of underbuilding due to resource—lumber, labor, and land—constraints (see Chart 11). We think year-over-year housing price appreciation in 2021 could stay between 10% to 12% and in the high single digits for 2022 as the supply/demand imbalance may not be resolved in the short to medium term. Helped by the generous stimulus, household savings and balance sheets remain favorably positioned. Forbearance programs are levelling off and prepayment speeds are accelerating, benefiting underlying collateral performance. We think the unwinding of the forbearance should be a smooth process.

The best way to gain exposure to the U.S. housing boom and healthy household sector, in our view, would be to invest in mortgage and consumer credit. We like the down-in-capital-stack trade in credit-risk transfer (CRT), which should benefit from fast delevering of the deal structures and call upside. We also like consumer credit asset-backed securities (ABS), including BB-rated subprime auto ABS and marketplace lending ABS.

11

Single-Family Housing Inventory

Months Supply, As of 4/30/2021

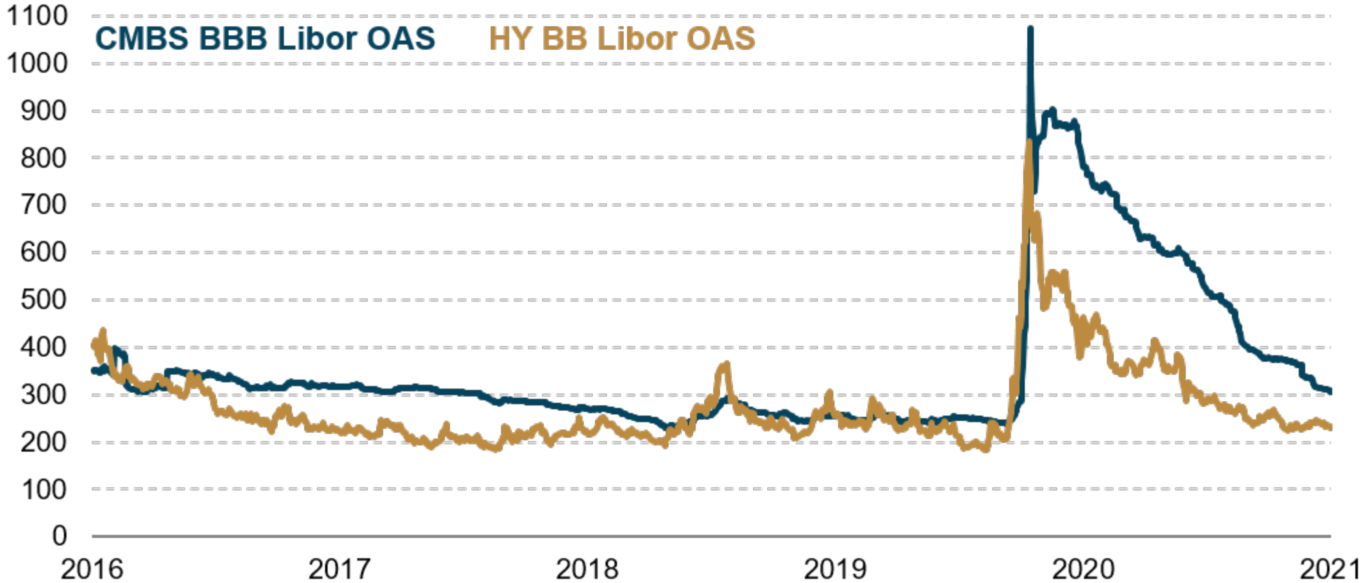
Source: Goldman Sachs

Recovering CRE market:

The commercial real estate (CRE) market, one of the hardest-hit sectors, is also rebounding. However, the recovery is uneven. Multi-family, industrial, and even hotel sectors are recovering faster, but other property types like retail and offices still face considerable uncertainty. Investors need to identify which underperformance is transitory and which is structural. There are several factors that are favorable for commercial mortgage-backed securities (CMBS), including the very easy financial conditions, attractive capitalization rates resulting from the overly pessimistic sentiment on the CRE market, abundant distressed buyers eager to provide liquidity, solid underwriting standards post-Global Financial Crisis, and a decade of embedded property price appreciation. We see good relative value in the CMBS market compared to high yield corporate credit, with risk premiums compensating for the uncertainties (see Chart 12). Bond selection is key. We are finding opportunities in some of the single-A and BBB- tranches of CMBS conduit deals, especially the seasoned vintages. Most of those seasoned deals have delevered due to amortization. We also see value and decent spread-tightening potential in seasoned CMBX indices.

12 **CMBS BBBs Lag the Recovery in High Yield BBs**

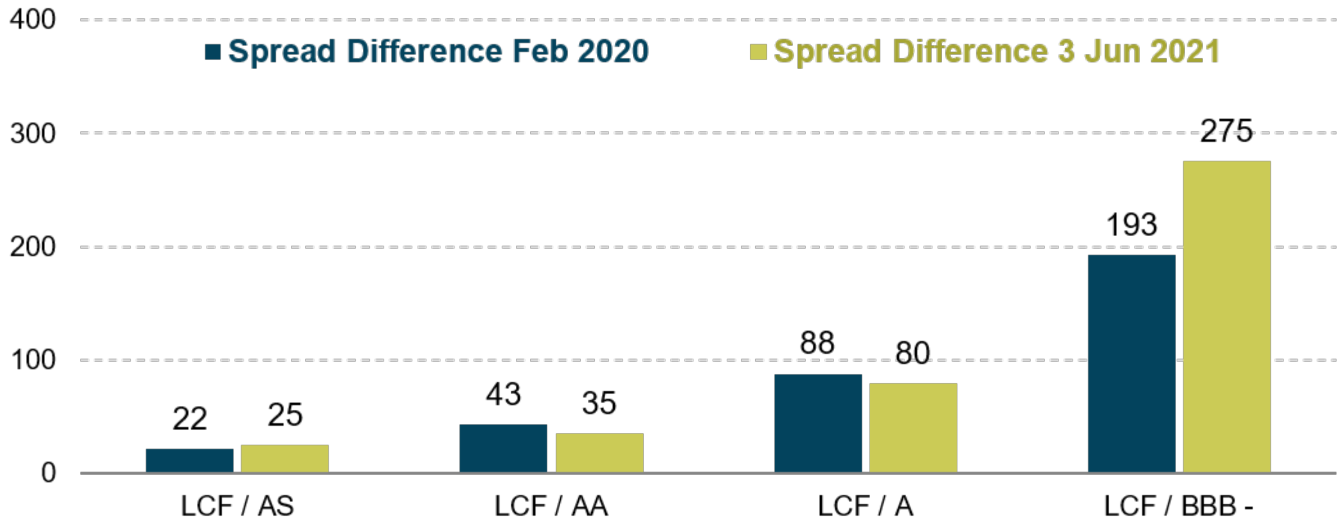
Basis Points (bps), As of 6/11/2021



Source: ICE BofA

The CMBS credit curve near the top of the capital stack is at or near the pre-COVID-19 levels while spreads between the last cash flow (LCF) AAA and BBB- remain comparatively wider (see Chart 13). We see large potential for credit curve flattening.

13 **Spread between Last Cash Flow (LCF) AAA vs. Other Tranches**
Basis Points (bps), As of 6/3/2021

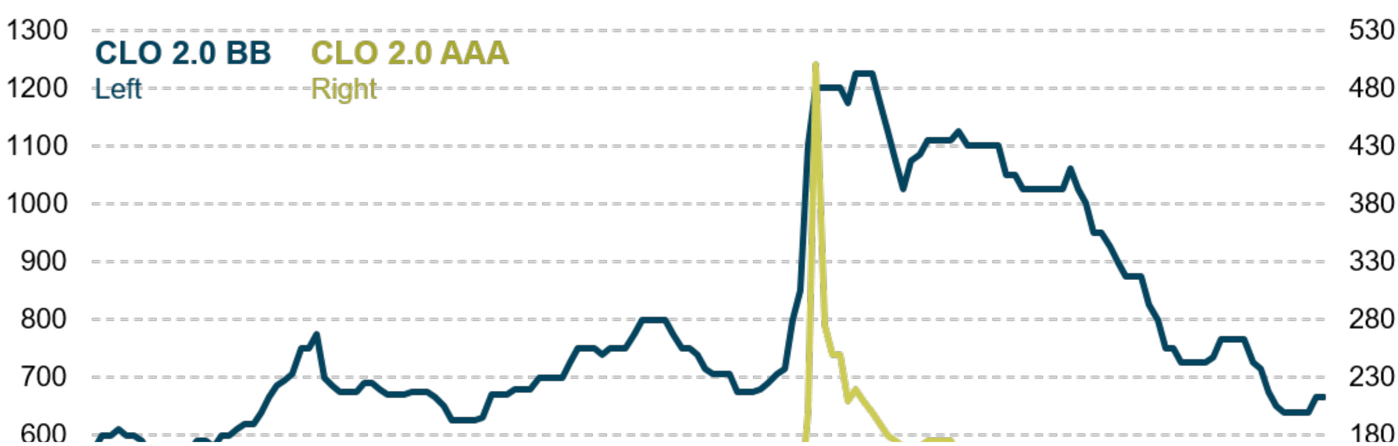


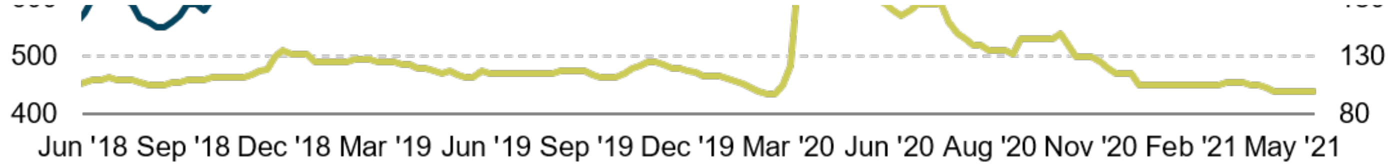
Source: BofA Global Research

Red-hot CLO market:

The arbitrage economics for collateralized loan obligations (CLO) look compelling. New issuance has boomed with increasing resets and refinancings, reaching historical highs. However, we believe the credit curve is too steep. Unlike other credit sectors, CLO spreads have yet to revert to pre-COVID-19 levels, and we believe CLO BB and equity tranches offer very attractive value. Outstanding CLOs total over US$800 billion, giving the market both depth and scale.

14 **CLO BB and CLO AAA Spread Still Wider than Pre-COVID Level**
Basis Points (bps), As of 6/11/2021





Source: BofA Global Research

Equities: Many Paths for Value Outperformance

Patrick S. Kaser, CFA »

The first half of 2021 delivered strong performance for the value indexes versus growth indexes, although it is barely noticeable on trailing 1-year returns. Furthermore, growth still crushes value over longer-term periods. Some observers are calling value's comeback over already, but they are generally anchoring their views to 5-year valuations. There is a fundamental flaw with this approach. The 5-year valuations dataset only looks at a period in which growth dominated and thus does not truly capture a more normal environment for relative valuations. The reality is that while value has done well very recently, growth has continued to deliver positive absolute performance, and expensive stocks have gotten more expensive. As the disparity between growth and value continues to widen, we think these extreme discounts leave plenty of room for sustained value outperformance. As my colleague Michael Fleisher explained in his recent blog, "Growth Stocks Signaling Value Cycles", even with the recent value rally, the discount of value stocks relative to growth stocks remains substantially below historical levels.

We believe the routes to value outperformance remain numerous. Continued economic growth, higher interest rates, a steeper yield curve, inflation risks, and expensive growth stocks with difficult year/year comparisons are all paths to relative outperformance for value stocks. Financials and health care screen as the most attractive opportunities.

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