Fixed Income Asset Allocation Insights

PineBridge® INVESTMENTS

Selectively Risk-On, Eyeing a Soft Landing

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Fixed income assets generated strong total returns during the third quarter. More duration-sensitive assets generated higher total returns given the rally in Treasuries. Market conditions remained broadly favorable during the quarter despite valuations remaining rich overall. Positive sentiment picked up in September as the Federal Reserve cut rates by 50 basis points, a larger cut than many expected coming into the quarter.

The labor market came into sharper focus over the course of the quarter as economic releases showed a softening labor market and moderating inflation. The August payroll report came up short of forecasts, with nonfarm payrolls increasing by 142,000 compared to the median forecast of 165,000, and bringing the three-month average to the lowest level since mid-2020. Meanwhile, inflation has eased sufficiently to justify the outsized Fed rate cut in September. The initiation of the first rate cut alongside the ongoing prospect of additional cuts into year-end has been very supportive for credit markets.

Looking forward to the end of the year and into early 2025, we maintain our view that credit markets remain favorable despite tight valuations. Yield and carry should be the dominant drivers of returns over the next 12 months. We continue to have a slight bias toward risk but remain selective across industries and issuers, as opposed to broad risk-on positioning. Despite the more positive bias, many risks remain in the market, including ongoing budget issues in the US, labor difficulties at US ports, the US election, and heightened geopolitical tensions with the escalation of the conflict in the Middle East and no end in sight to the Russia and Ukraine war. Ultimately, despite these risk factors, a soft landing is still our base case outcome, and indications are that the economy is heading that way.

Our Asset Class Outlooks

Investment Grade Credit

The next few months are likely to be volatile due to dynamics around economic data, the upcoming US elections, and uncertainty surrounding the timing of Fed rate cuts. Nevertheless, the team expects any short-term weakness to likely represent a buying opportunity in both credit and rates. Despite the potential for short-term fluctuations in credit markets, fundamentals are relatively solid. And notwithstanding some margin weakness, these conditions are likely to underpin credit markets over the short to intermediate term.

Securitized Products

We remain bullish on mortgage-backed securities (MBS) relative to investment grade credit. MBS spreads have tightened but are still 1.2 standard deviations away from investment grade (IG) spreads. In addition, despite four consecutive months of outperformance, money managers have not reduced their overweights. Within commercial mortgage-back securities (CMBS), recent spread performance has come from anticipation that lower rates will support property refinancings; however, this will do little to fix occupancy issues.

About This Report

Fixed Income Asset Allocation Insights is a quarterly publication that brings together the cross-sector fixed income views of PineBridge Investments. Our global team of investment professionals convenes in a live forum to evaluate, debate, and establish top-down guidance for the fixed income universe. Using our independent analysis and research, organized by our fundamentals, valuations, and technicals framework, we take the pulse of each segment of the global fixed income market.

Leveraged Finance

Given the resilient macro backdrop, we continue to expect a modest increase (but no major spike) in defaults. The fundamental strength in credit metrics appears to have peaked but started at a strong level. Spreads continue to be at the tighter end of the range but at attractive all-in yields. Liability management exercises (LMEs) remain a market focus, accounting for most defaults to date and, importantly, signaling them to the market six months or more in advance, crowding investors to BB/B assets. Bond and loan scenarios are converging, leaving them about equally attractive going forward. Loans have better carry for the time being, but bond risk skew looks similar, with prices approaching par.

Emerging Markets

The emerging market (EM) fundamental picture remains resilient, and the technical picture remains solid into year-end. EM corporate spreads widened against EM sovereigns and US IG/high yield (HY), retracing the recent tightening. The widening in spreads shows retracement of recent moves, and the pickup in the A rated bucket looks attractive. Within EM sovereigns, local currency returns still look the most attractive. The proximity of Fed cuts and supportive data are conducive for future inflows. Investors are increasingly interested in frontier countries' local debt, which is viewed as less correlated to the global macro picture. In hard currency we maintain our preference for IG.

Non-US-Dollar Currency

We favor a modestly stronger US dollar. Financial markets have been quick to price in 250 bps of Fed rate cuts by the end of 2025, which we believe overstates the downside risks to the US economy. At the same time, markets have been less convinced about the European Central Bank's easing pattern, despite evidence suggesting the German economy is struggling to recover from sluggish growth levels over the past 12 months.

Segment Snapshots

Using our independent analysis and research, organized by our fundamentals, valuations, and technicals framework, we take the pulse of each segment of the global fixed income market.

Investment Grade Credit

US Dollar Investment Grade Credit

Dana Burns, Portfolio Manager, US Dollar Investment Grade Fixed Income

Fundamentals

Fundamentals remain firm. The results for second-quarter earnings have been mixed, but good overall. Balance sheet strength remains good in general.

Valuations

Credit spreads are off their tights of the year after a brief selloff, and recent supply has kept spreads wider thus far in September. Nevertheless, appetite for US IG remains supportive given attractive all-in yields.

Technicals

Demand for US IG remains strong despite record issuance in 2024 and an active summer. Issuers have come to market aggressively recently as rates have come down. At the same time, investors are piling into the market in anticipation of Fed rate cuts and lower yields.

Non-US-Dollar Investment Grade Credit

Roberto Coronado, Portfolio Manager, Non-US-Dollar Investment Grade Credit

Fundamentals

Neutral. Companies in general continue to post decent results while balance sheets remain healthy and M&A activity remains low. Management teams, however, are providing cautious outlooks, citing limited visibility into future sales/margins as the economic outlook remains uncertain.

Valuations

Neutral. We see credit spreads close to fair value and expect the index to trade within a range in the coming weeks and months. We see a low probability of a large index move in either direction. For that reason, sector and security selection will be key to outperform.

Technicals

Positive. Flows into euro corporates have been strong so far this year while supply has been slightly higher than expectations. Investors continue to be better buyers of credit and new issues have been performing.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

The yield curve continues to steepen, which provides a tailwind to MBS valuations. Interest rate volatility (measured by the MOVE index) rose back above 100 but did not drag spreads with it. That is an encouraging sign.

Valuations

We are finally seeing a dispersion between MBS and IG credit. The historical spread between the two is starting to normalize, and if this continues, it will cause MBS spreads to go lower.

Technicals

Bond funds that were overweight MBS have not yet reduced their allocations. This is encouraging given how well MBS has been performing; it can be viewed as a signal that there is room for performance to improve further.

Leveraged Finance

John Yovanovic, CFA, Co-Head of Leveraged Finance

Fundamentals

The resilient economy has pushed default rates and upgrade/downgrade ratios in the right direction, but LMEs threaten. Last-12-month par-weighted default rates declined further to 1.73%/0.98% (with and without distressed exchanges); August saw no defaults and three distressed exchanges. In loans, including LMEs and distressed exchanges, the trailing default figure rose to 4.17% from 4.02% the prior month. Fundamentals remain firm and better than long-term averages.

Valuations

US HY option-adjusted spread (OAS) stands at 312 (BB 193, B 298, CCC 685), 33 bps tighter month-over-month. The CCC to BB/B spread ratio has tightened materially over the past two months, from a high of 3.8x to 2.9x, with the rally in a number of "left for dead" CCC credits. Option-adjusted duration (OAD) is at an all-time low of 2.92. Despite the discounted spread at its tightest level since April 2022, the yield to maturity (YTM) of the loan market remains above 9%.

Technicals

HY new issuance totaled $18.1 billion in August, flattish versus June/July but below the ~$30 billion monthly pace we saw in January through May. Year-to-date (YTD) issuance totals $203.1 billion. Non-refinancing activity continued to be higher than in the first half at 34.3% of supply in August but still stands at 21.8% YTD. Amend-and-extend activity slowed in August, but the pace remains ahead of last year's record level. CLO new issue supply increased month-over-month, with $14.6 billion pricing during the month, following $13.7 billion in July. New issuance volume is now 73% higher than year-to-date 2023 and is the fastest pace on record.

Emerging Markets

Sovereigns

Sam McDonald, Sovereign Analyst, Emerging Markets Fixed Income

Fundamentals

EM growth trends are structurally strong, supported by increasing fiscal discipline and reform momentum. The external picture is allowing for more robust current account surpluses, combined with increasing remittance and FDI/FPI flows – enhancing levels of foreign exchange reserves. Political and geopolitical risks remain high.

Valuations

At 378, the EMBI is 22 bps tighter month-over-month and 40 bps tighter YTD. The selloff in spreads last month has now been entirely offset, leaving year-to-date returns higher than they were before the volatility. Valuations remain tight on balance.

Technicals

Record issuance YTD (at $145 billion) paints a constructive picture for the remaining months of 2024, with the majority of issuance completed in the first half. Cash flows are distributed more evenly throughout the year. Our net issuance number has increased, with more credits being able to re-enter the Eurobond market this year, in addition to new names coming to the dollar market (e.g., Montenegro and Benin). September is a heavier month for cash flow and issuance. We should expect those remaining names with issuance needs to come before the US election. EM hard currency funds have seen outflows after the increase in volatility, though this has now slowed.

Corporates

Kim Keong, Trader, Emerging Markets Fixed Income

Fundamentals

The results are underway with roughly 80% of CEEMEA and Latin America coverage reporting second-quarter earnings and over 70% of our coverage in Asia reporting their first-half earnings. The themes have been similar to the previous quarter, with results broadly neutral with a skew to positive. The sectors that have seen positive beats have been from the consumer, technology/media/telecom, oil and gas, metals and mining, and pulp and paper sectors. In terms of regional differences, we have seen stronger beats in LatAm, small beats in Asia, and mixed performance in CEEMEA (with misses mainly from Turkey). Our current Credit Trend scores are unchanged, with 15% positive and 11% negative.

Valuations

Over the last month, CEMBI BD spread to worst widened 6 bps, with HY (+9 bps] underperforming IG (+6 bps). In terms of regions, LatAm was a laggard in both IG and HY. In terms of country, within the IG+ index, Israel, Malaysia, Nigeria, the Philippines, and Singapore outperformed; the laggards were Macau, Peru, Chile, Mexico, and Qatar. In the HY+ index, the main outperformers were China, Argentina, Nigeria, South Africa, and Peru; the underperformers were Ukraine, Ghana, Hong Kong, Macau, and Indonesia. Over the same period, EM corporates lagged against EM sovereigns by 21 bps (IG +2 bps; HY +57bps) and against US IG (by +7 bps) and US HY (by +6 bps). We particularly find the pickup in the A bucket attractive.

Technicals

EM corporate primary activity remained muted in August at $13 billion, and with the scheduled and unscheduled cash flow, net financing remained negative at -$5 billion. In September, we have seen $32 billion of issuance so far, the highest two-week volume since January 2022. Despite the pace of issuance, given the scheduled cashflow of $37 billion, we will likely see a small positive in net financing for the month. Recently, JPM revised its gross issuance forecast higher by $40 billion to $340 billion, with the vast majority from an increase in the Middle East and Africa as well as in China. This would also reduce the net negative financing for the year to -$113 billion. However, this still remains large and positive for technicals, as we are expecting roughly

$100 billion of net scheduled cash flows into year-end despite the uptick in issuance forecasts. We continue to see greater participation from the crossover community in the primary markets, which has also been a supporting factor.

Non-US-Dollar Currency

Anders Faergemann, Senior Portfolio Manager, Emerging Markets Fixed Income

Fundamentals

Two-year US/Germany interest rate differentials have narrowed significantly in recent months (moving from 200 bps in April to 135 bps in September), undermining support for the US dollar. Rising concerns about a faster softening in the US labor market put the Fed on alert to increase its pace of monetary policy normalization beyond that of other central banks, and by kicking off the cycle with a 50-bp cut, it cemented this market view.

Valuations

While financial markets have been quick to price in an additional 200 bps of cuts by the Fed by the end of 2025, we believe this overstates the downside risks to the US economy. Our base case remains one of "stabilization" or a soft landing, yet the rate of change in the US economy has removed an anchor for US dollar strength. Consequently, we have adjusted our 12-month EUR/USD forecast higher, from 1.0500 to 1.1000.

Technicals

Contrary to the sluggish eurozone data, markets have taken the ECB's gradual approach to monetary easing at face value, causing the perceived policy convergence between the Fed and the ECB to bolster the euro. While we don't see any immediate catalyst for the euro to strengthen further, only short-term technical flows and broader positioning favor some type of reversal at this time.

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pinebridge.com

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