

Fixed Income Asset Allocation Insights

Tight Valuations Call for Buying on Weakness

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Robert Vanden Assem, CFA, Head of Investment Grade Fixed Income and Chairman of Fixed Income Asset Allocation Team

The first quarter was mixed for fixed income assets, with higher-yielding and less duration-sensitive assets, such as high yield bonds and emerging market debt, outperforming to start the year as US Treasury rates moved higher. However, all risk assets ended the quarter on a strong note, with most fixed assets generating strong total returns in March. While spreads remain stretched and are expected to trade on the tight end of valuation ranges, issuer fundamentals are strong and yields are high overall, resulting in a strong technical bid that continues to limit the potential for any extreme spread widening.

The path of central bank policy remains a strong driver of market sentiment thus far in 2024. Market expectations for the number of Federal Reserve rate cuts have come down from six as the year began to just two to three now, with expectations for the first rate cut pushed back to June or July. In the US, inflation surprised higher for the second consecutive month in February. While expectations are for the path of inflation to continue its downward trajectory, inflation has proven stickier than many anticipated. Nevertheless, the Fed has indicated that it believes cuts will likely be appropriate at some point this year, despite sticky inflation and stronger than expected growth, including a resilient consumer. These conditions have created a more hawkish Fed narrative as it awaits more data indicating inflation is on a sustainable path toward its 2% target. We believed the market was overly optimistic about the number of rate cuts coming into the year, but these recent adjustments have brought the market more in line with our expectations given the economic backdrop.

Meanwhile, economic conditions in Europe look weaker. Eurozone GDP was flat in the fourth quarter and expanded by just 0.1% compared to the prior year, though with dispersion among the constituent countries. The outlook improved most clearly in Spain, Portugal, and Italy, while Germany and France continue to lag and have been a more significant driver of negative sentiment. European Purchasing Managers' Index (PMI) readings remain low but have stabilized for a second consecutive month, with an improvement in services from 48.4 in January to 50.2 in February and manufacturing roughly static at 46.5 in February versus 46.6 in January. Inflation in Europe has also proven less sticky than in the US and continues to grind lower. We believe these market dynamics make the European Central Bank's decision to cut interest rates simpler than the Fed's, and as a result we expect the ECB to begin cutting interest rates earlier. This is also reflected in market expectations, which are currently pricing in three to four ECB rate cuts by the end of the year, with the first cut expected in June.

Against this backdrop, we expect fixed income assets to generate decent total returns during the year, driven primarily by carry. Credit spreads remain tight, but we believe the stable economic outlook and high all-in yields will result in stronger technicals with investors, supporting credit assets and insulating them from the worst downside scenarios. We had previously viewed emerging market (EM) debt as cheap, as spread tightening lagged developed market (DM) asset classes; however, this has since largely played out, and we now believe EM valuation premiums are fair value. Investment grade (IG) spreads now screen cheaper relative to high yield, but the yield pickup at lower rating tiers remains appealing. In addition, given the significant yield advantage for floating-rate credit over fixed rate, we expect floating rate to outperform this year. Across asset classes, we expect the demand for yield to keep valuations on the tighter side, so we continue to act as buyers into short-term periods of weakness.

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.

Our Asset Class Outlooks

Investment Grade Credit

Fundamentals remain solid, with strong profit margins, stable leverage, and reduced shareholder-friendly activity. In credit, we expect spreads to be well supported but largely range-bound, and total returns are likely to be driven primarily by rates moving lower. Any volatility experienced in the credit market in the coming months presents a potential buying opportunity. Within non-US-dollar credit, we remain cautiously positive in the medium term and still prefer the euro over the sterling credit markets.

Securitized Products

Over the long term, we are bullish. Mortgage-backed securities (MBS) have shown some signs of positive dispersion following the regional bank fears and rising rates that were a drag on performance during February. Declining interest rate volatility has also helped. Meanwhile, within commercial mortgage-backed securities (CMBS), the focus on commercial real estate portfolios is still a worry.

Leveraged Finance

The resilient macro outlook continues to support our expectation for a modest increase (but not a major spike) in defaults. The fundamental strength in credit metrics appears to have peaked but started at a strong level. We remain of the view that we're entering a multi-year process of repricing capital structures higher into a decent macro economy. We expect range-bound spreads, solid fundamentals, and US Treasury volatility, but downside scenarios appear tolerable. We continue to be underweight CCC rated credit and are ready to add risk in episodes of weakness.

Emerging Markets

Given more recent spread tightening for EM corporates, valuations appear closer to fair value. However, the solid supply-side technical picture and the robust fundamental picture are supportive of the asset class. For EM sovereigns, local currency returns still look the most attractive. Fed cuts should encourage portfolio inflows, unlocking some of the value. On the HC side, the risk reward balance favors corporate HY over sovereign HY.

Non-US-Dollar Currency

Foreign exchange market volatility has lessened, and trading ranges have narrowed as investors' thoughts on the future path of central bank policy have moved to the forefront. Regarding eurozone growth, an improved outlook is most clear in Spain, Portugal, and Italy, but Germany and France continue to lag and are a more significant driver of negative sentiment. This dynamic also leaves the growth differential in the dollar's favor.

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 despite an uptick in interest costs due to improved cash balances as management teams reduced capex and share buybacks.

Valuations

Credit spreads are at the tighter end of the range. Nevertheless, appetite for primary issuance and the long end remains supportive given attractive all-in yields. "Story names" are catching up with the larger, more liquid credits. Intermediate financials remain attractive.

Technicals

Demand for US IG remains strong despite record issuance in January and February. Lower supply and a lack of bonds available for sale continue to support the long end. While the current pace of issuance would lead to record annual issuance, market participants anticipate an eventual cooling in primary activity.

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 merger and acquisition activity remains low. Management teams, however, are providing cautious outlooks, citing limited visibility into future sales and margins amid an uncertain economic outlook.

Valuations

Neutral. We view credit spreads as 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 large index moves in either direction. For that reason, sector and security selection will be the key to outperformance, in our view.

Technicals

Positive. Flows into euro corporates have been strong so far this year, while supply has been roughly in line with expectations. Investors continue to be better buyers of credit, and new issues have been performing.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

Interest rate volatility is approaching two-year lows (based on the MOVE index) – a strong positive for mortgage-backed securities (MBS) valuations. Volatility was not forecasted to drop until the Fed had started cutting rates.

Valuations

MBS spreads have room to tighten. On a relative basis versus corporate IG spreads, MBS is 1.9 and 2.6 standard deviations wide on a five- and 10-year lookback basis, respectively.

Technicals

While a midsized US lender recently in the spotlight because of its struggles did not hold a meaningful amount of MBS on their books (holding more loans than securities), it brought attention back to regional bank reorganizations, with another bank expressing interest in revamping its securities portfolio.

Leveraged Finance

John Yovanovic, CFA, Co-Head of Leveraged Finance

Fundamentals

The macro picture remains resilient enough to support our stable default outlook. Last-12-month (LTM) par-weighted default rates have continued to fall and now stand at 2.5% with distressed exchanges and 1.7% without. The par-weighted upgrade/downgrade ratio was under 1.0 for the fifth consecutive month, at 0.8 in February, versus 1.2 for the LTM period. Fourth-quarter 2023 earnings season is largely complete, and results and the 2024 outlook were positive, with average revenue up 1% and EBITDA up 5% year-over-year, average leverage at 3.9x (BB 3.3x, B 4.5x, and CCC 6.4x), and coverage at 5.0x. (Fundamentals based on JP Morgan data as of 01 March 2024.)

Valuations

US HY option-adjusted spreads (OAS) were down to a two-year low of 301, 18 basis points tighter month-over-month. The CCC to BB-B spread ratio is off last month's highs but still elevated at 3.2x. Yield to worst is at 7.80% and has been relatively less volatile than spreads, given negative correlations between spreads and rates. The discounted spread to maturity for the LCD Leveraged Loan Index has compressed roughly 20 bps. The market has seen the greatest spread compression from the lower-quality components. (HY data based on Bloomberg as of 18 March 2024. Loan data as of 15 March 2024.)

Technicals

US HY new issuance remained elevated at \$27.7 billion in February, with the first-quarter total at \$59.3 billion, already the strongest quarter since the beginning of the current monetary policy regime. However, refinancings remained the dominant use of proceeds, at 95% of all volume. The \$12.5 billion year-to-date supply surplus is a meaningful improvement over the \$156.4 billion deficit in 2023. Loan technicals remain positive, with demand continuing to outpace supply. (Technicals based on JP Morgan data as of 01 March 2024.)

Emerging Markets

Sovereigns

Ilke Pienaar, Head of Sovereign Research, Emerging Markets Fixed Income

Fundamentals

The external backdrop continues to improve, with strong foreign direct investment flows backed by a promising pipeline of commitments. Near-shoring trends and structural changes (like Brazil becoming a significant net oil exporter) have also bolstered the overall picture. Leading indicators continue to point to EM growth accelerating this year while DM slows. Political risk and noise remain high, but we expect the majority of the voting rounds this year to have a positive outcome on countries' institutional quality.

Valuations

Compared to our fair value (FV) estimates, the market is somewhat expensive. At 357.2, the EMBI is back at early-November 2021 levels (but not yet at the lows seen during that year), held up solely by HY spreads. Notwithstanding some favorable revisions to our IG fair value estimates during the month, IG spreads continue to trade narrower than our FV calculations. (Spread data from Bloomberg as of 19 March 2024.)

Technicals

Record issuance of \$90.2 billion year-to-date paints a constructive picture for the rest of the year. We have raised our net issuance number somewhat with more credits able to re-enter the Eurobond market this year. Net financing will now be close to zero – not negative, as thought before – but still lower than last year. Amortizations payments will be about 70% larger than in 2023. Weekly hard currency inflows turned positive in the second week of March (for only the second time this year). Local currency weekly flows continue to post small positive numbers and are positive year to date, in contrast to the negative hard currency number. April will be another strong month for cash flows.

Corporates

Kim Keong, Trader, Emerging Markets Fixed Income

Fundamentals

We are now in the middle of the fourth-quarter 2023 reporting season, and approximately 50% of companies in our CEEMEA coverage and 60% of those in our Latin America coverage have reported. Results have been neutral thus far, in line with our expectations, and we've observed a similar number of upside surprises and misses in the results. We've seen positive surprises thus far in the oil and gas, real estate, and consumer sectors, with misses in industrials and financials.

Valuations

Over the last month, CEMBI BD spread to worst tightened by 24 bps, with HY (-37 bps) outperforming IG (-13 bps). Similar to last month, lower-rated credits have tightened, and in terms of regions, Asia and CEEMEA outperformed Lat Am. In IG, Kuwait, Peru, Kazakhstan, Qatar, and Nigeria outperformed, and in HY, outperformers included Ghana, the Philippines, Zambia, and Ukraine. In comparison to DM, over the last month, EM corporates tightened by 10 bps in IG and by 21 bps in HY. We often observe this when rates are on the move; as most of the EM corporate bonds trade in cash prices, they often outperform DM peers in terms of spread. (Valuations data from Bloomberg based on the CEMBI Broad Diversified Index as of 15 March 2024.)

Technicals

The primary activity in February was more active than last year, printing \$30.1 billion, but below the five-year average of \$35.3 billion. The net supply for the month, including scheduled and unscheduled cash flows, ended at \$3.6 billion. We've seen \$11.4 billion in primary issuance in March, and considering the five-year average supply for the month, at \$28.3 billion, as well as robust scheduled cash flows of \$34.5 billion, net financing for the month is likely to be negative. April is expected to be largest month for cash flow, with \$43 billion, so we expect the positive supply-side technical to continue. (Technicals data from JP Morgan EM Corporate Weekly Monitor as of 18 March 2024.)

Non-US-Dollar Currency

Dmitri Savin, Portfolio Manager, Portfolio and Risk Strategist, Emerging Markets Fixed Income

Fundamentals

We continue to expect measured, synchronized rate cuts by the Fed and the ECB. The ECB's paths to cutting rates remain clear, with inflation proving less sticky. On the Eurozone growth side, manufacturing PMIs have started to turn, indicating that we may be reaching a bottom in growth. The BOJ ended negative interest rate policy (NIRP) in March, making the policy rate positive for the first time in eight years and marking the first hike in some 17 years.

Valuations

We are keeping our 12-month EUR/USD forecast at 1.0500, in line with our "Stabilization" scenario. We have kept our 12-month USD/JPY forecast at 142.50 to reflect countervailing forces between current yield differential and scope for the Bank of Japan to exit yield curve control.

Technicals

According to JP Morgan as of 11 March, following near decade lows in yen futures positioning two weeks ago (-1.9 sigma), hawkish rhetoric from the BOJ led to some short covering, bringing overall positioning to -1.6 sigma. Meanwhile, over the medium term, US dollar positioning appears relatively flat overall based on both futures and options data.

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