

>> FIXED INCOME ASSET ALLOCATION INSIGHTS **MAR: 2016**

Portfolio Allocations

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

We reduced our investment grade credit target allocation by 5% in favor of securitized products as we seek higher quality and lower duration. Mortgages have held up reasonably well this year with refinancing activity relatively benign despite sharply lower Treasury rates. Nonetheless, we continue to favor investment grade credit over emerging market debt and non-US dollar currencies. We remain neutral on high yield.

Credit spreads have rebounded from February's wides as China's central bank assuaged concerns of a large yuan devaluation. Fears about European bank stability have subsided, and US economic data are moderately encouraging. However, we expect market volatility to continue as investors still face low commodity prices, rising high yield defaults, slowing global growth outside the US, and divergent policies among developed nations' central banks.

Macro View

Markus Schomer, CFA, Managing Director, Chief Economist

Central case

We see 2%-4% global GDP growth and a stronger US dollar based on developed market recovery and emerging market stabilization. A commodity price rebound and base effects will push inflation higher, albeit below central bank targets.

Market movers

Oil production freeze. While the agreement among Russia, Saudi Arabia, and other oil producers to freeze production is a step in the right direction to stabilize prices, in the short term it may not be enough to correct the oversupply. Longer term, oil prices should increase as supply tapers off and demand expands with global growth.

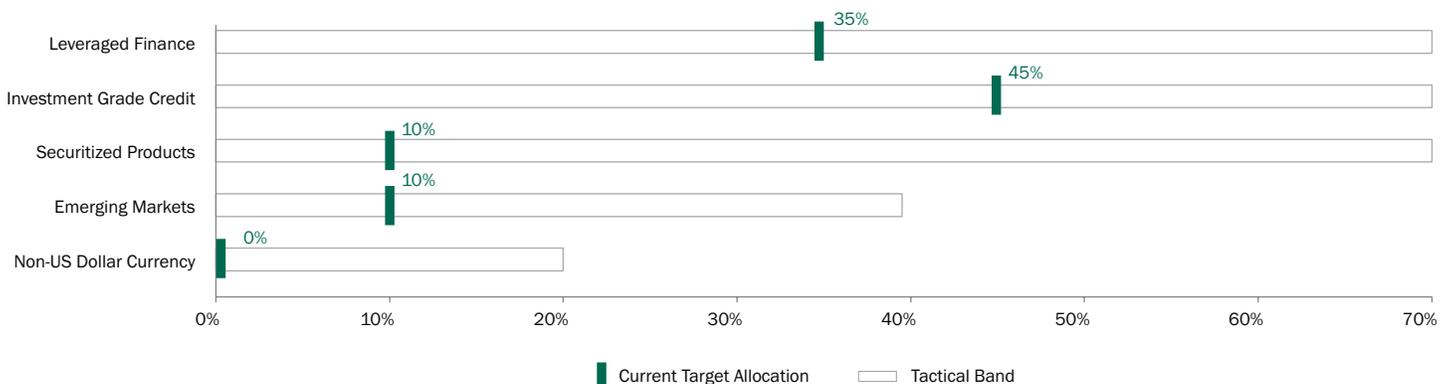
Negative interest rates. The Bank of Japan (BOJ) joined the ranks of several other central banks in the developed world by introducing negative interest rates – which still may not be enough to stimulate growth. Thus, the BOJ could go further into negative territory before we see an increase.

More stimulus in China. Several data points suggest a ramping up of Chinese policy stimulus: all-time highs in total social financing to offset capital outflows, easing of mortgage lending

ABOUT THIS REPORT

Fixed Income Asset Allocation Insights is a monthly publication which encapsulates the cross-sector fixed income views of PineBridge Investments. Our global team of investment professionals convene 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 assess the pulse of each segment of the global fixed income market.

Target Portfolio Allocations¹ (as of 22 February 2016)



¹There can be no assurance that the target or range will be achieved. For illustrative purposes only. This material must be read in conjunction with the disclosure statement.

standards to strengthen the property market, and rhetoric by central bank governor Zhou defending the yuan. Could we see an improvement, especially in the non-manufacturing sector, in the coming months?

Leveraged Finance

John Yovanovic, CFA, Managing Director, High Yield Bonds
Julie Bothamley, Managing Director, Leveraged Loans

Fundamentals

Halfway through earnings season, we see quarter-over-quarter sales off by 4.2%, as anticipated, but earnings in line with expectations. Fundamentals still show leverage deterioration, though liquidity measures remain high.

Valuations

The option-adjusted spread of 806 has retraced back to euro crisis levels, and we estimate the default rate will increase to around 4%-5% during 2016. This still results in an 8%-14% base case return estimate over the next 12 months, or an 8.6% probability-weighted return including the bear case. Given our estimate that the market is pricing in an 8.5% default rate, either we're going to have a recession or current levels are attractive.

Technicals

We see technicals as neutral, though we are not ready to upgrade our score as dealer inventories remain near lows and an estimated 70% of trades have agency-poor liquidity. Most accounts claim to have 4%-6% cash, but we continue to see outflows; the new-issue market is open for better quality issuers and sectors.

Allocation Decision

We maintain our 35% allocation. Valuations are inexpensive as spreads have widened to levels not seen since the depths of the European debt crisis in 2011. However, the market must contend with a large fallen-angel overhang and a season of mediocre earnings releases.

Investment Grade Credit

US Dollar Investment Grade Credit

Dana Burns, Managing Director,
US Dollar Investment Grade Fixed Income

Fundamentals

Ratings downgrades are on the rise. Energy sector fundamentals remain poor due to persistently low oil prices, and concern over banks (notably European) has increased due to negative rates and energy exposure. We believe the selloff in financials is overdone.

Valuations

Select sectors and credit spreads remain attractive on a relative-value basis. If oil is nearing a bottom, we believe it would broadly benefit investment-grade spreads.

Technicals

Poor investor sentiment has curtailed issuance so far in 2016. We believe less issuance could favor spreads if sentiment turns positive. The outlook for oil remains the wild card.

Non-US Dollar Investment Grade Credit

Roberto Coronado, Senior Vice President, Non-Dollar Credit

Fundamentals

Europe is in the middle of reporting season, but so far we see no material change in the pattern of weak earnings yet strong balance sheets. European financials continue strengthening their capital base.

Valuations

Credit spreads in Europe have moved wider over the last four weeks, driven mainly by subordinate bank paper. We continue to see value in financials, since the current widening does not reflect fundamentals, and selectively in non-energy corporates.

Technicals

Expectations of further quantitative easing in Europe and low primary supply more than offset the small outflows seen over the last three weeks. In the near term, technicals remain supportive.

Allocation Decision

We reduced our allocation from 50% to 45%. We advocate maintaining an overweight to investment grade credit given stable fundamentals, current valuations, and the current phase of the credit cycle.

Emerging Markets

Sovereigns

Anders Faergemann, Managing Director,
Emerging Markets Fixed Income

Fundamentals

China's economy is expected to stabilize at very weak levels over the short term with fixed-asset investment on a downward trend and industrial production continuing to slide. The broader Asia growth surprise index turned sharply lower in January and we expect global trade numbers to be negatively affected by the overall weak growth outlook for emerging markets.

Valuations

EM sovereign spreads have made new five-year highs and now look vulnerable to further widening. However, current spreads discount a lot of negative news and the higher yields provide a good buffer for slightly wider spreads. In spite of the recent recovery in EM currencies, the US dollar remains in the driver's seat for 2016.

Technicals

Cash levels remain historically high among EM fund managers and with outflows muted, the technical picture remains fairly strong. February has already seen an increase in sovereign issuance, but there is still no urgency among major EM issuers to come to market.

Corporates

Steven Cook, Managing Director, Emerging Markets Fixed Income

Fundamentals

We believe fourth-quarter results will be key for how corporates navigated the 2015 global turmoil. Currency depreciation

supports some key export sectors and mitigates weakness in select domestic-focused businesses. Banks are vulnerable amid lower growth, and we expect weakening risk profiles. Defaults will likely rise, but more in terms of number of issuers (particularly smaller entities) rather than as a percentage of the high-yield debt supply. Default forecasts for 2016 have settled at 3.5%, slightly above the 2.5-3.0% long-term run rate.

Valuations

January retained 2015's year-end volatility as fears on China, oil, and commodities widened corporate spreads. February brought stability, but spreads remain their widest in years and close to our "Armageddon" scenario. On the fundamentals, prices are historically cheap, but the reduction in liquidity warrants an additional premium for EM corporates.

Technicals

Continued low issuance driven by lower growth, capital expenditures, and working capital translate into technicals remaining supportive. But current risk aversion will severely test institutional allocations.

Allocation Decision

We maintain our 10% allocation. Emerging market spreads are attractive historically but offer limited relative value when compared with spreads in other risk asset classes such as US high yield.

Securitized Products

Andrew Budres, Senior Vice President, Securitized Products

Fundamentals

Mortgage rates remain "sticky," with less movement than the 10-year Treasury. There was a brief window to take advantage of a 3/8-point drop.

Valuations

Although no catalyst looms to tighten mortgage-backed securities (MBS) spreads, the asset class has been able to cast aside risk-off moves and wide short-term interest rates swings.

Technicals

Negative interest rates invoke fears of dramatically lower mortgage rates, which could bring lots of MBS volume to market and possibly put pressure on spreads.

Allocation Decision

We have increased our MBS allocation from 5% to 10%. Interest rates dramatically dropped in mid-February but the window to take advantage and refinance lasted only about 72 hours. MBS spreads continue to perform relatively well when compared with other spread segments of fixed income.

Non-US Dollar Currency

*Anthony King, Managing Director,
Non-US Dollar High Grade Fixed Income*

Fundamentals

Divergence between the Fed and the BOJ/European Central Bank should continue to support US dollar strengthening. However, the marginal impact of additional easing by foreign central banks seems to be diminishing.

Valuations

Longer-term fair-valuation models imply that the US dollar is overvalued versus many major currencies. However, this historically has been the case ahead of Fed rate hiking cycles; the trigger for mean reversion in a currency is typically some change in macroeconomic performance.

Technicals

Moves in the International Monetary Market suggests that net US dollar notional positioning is down to its lowest level since mid-October 2015, when the dollar bottomed.

Allocation Decision

We maintain our 0% allocation. The dollar rally has stalled recently on technical factors including net long US dollar positioning at its lowest levels since last fall. However, we believe the dollar will continue to be supported by US economic growth and interest rate differentials between the US and other major currencies.

Our Average Scenario Probabilities Were Unchanged Month-Over-Month

Fixed Income Scenario Probabilities – Next 12 Months (as of 22 February 2016)

		Scenario Probabilities								
		US GDP Growth	Inflation	USD Basket	Avg. Scenario Probability	USD Inv. Grade	Securitized Products	Leveraged Finance	EMD	Non-USD IG
Scenario	Recession; Deflation	< 1%	< 1%	Breaks 5% band on the downside	29%	35%	25%	25%	40%	20%
	Central Case	1-3%	1-3%	Maintains -5-0% band	63%	60%	65%	70%	50%	70%
	High Growth; Inflation	> 3%	> 3%	Breaks 5-10% band on the upside	8%	5%	5%	5%	10%	10%

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