PINEBRIDGE INVESTMENTS

2018
**FIXED INCOME OUTLOOK**

# Beta Returns Are Facing Policy Disruptions


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- In 2018, we expect fixed income markets to shift from conditions that provided persistent tailwinds toward a multiyear period of mild but steady headwinds.
- Investors will need to obtain more from fixed income portfolios through alpha sources, whether via asset allocation or security selection, while managing the risks ahead.
- In this environment, we favor components of emerging markets debt, tranches of collateralized loan obligations (CLOs), and more dynamic opportunistic credit.

In recent years, fixed income performance has been aided by global central bank monetary policy accommodation. As a result, passive strategies that relied on beta returns performed reasonably well. Now, central banks are collectively preparing to shift from adding liquidity to markets to withdrawing it. While global central bank balance sheets will continue to collectively expand, 2018 represents a transition year between expansion and contraction. This is setting the stage for shifting and more volatile interest rates, and a normalization of inflation from persistently below target levels to meeting them in the US and stabilizing in other parts of the world.

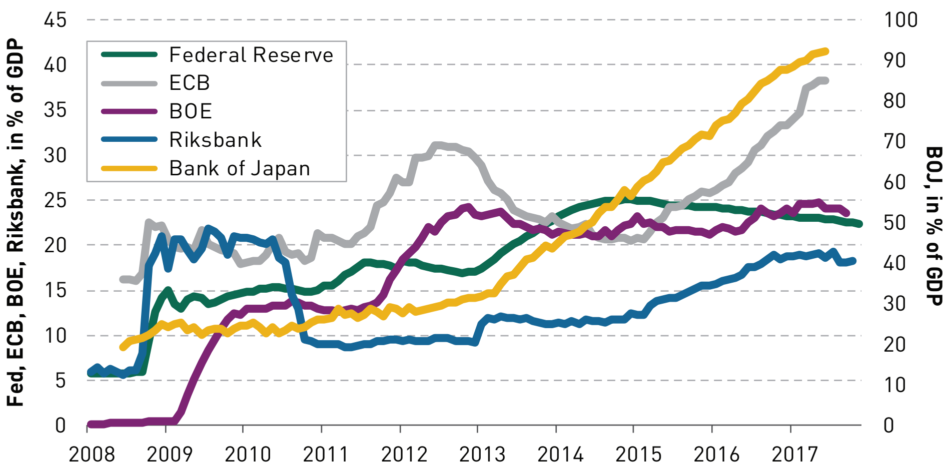
As central banks begin to synchronize monetary policy normalization, investors should expect increasing periods of short-term interest rate volatility. The normalization path is also likely to result in differing yield curve outcomes. For the US, we expect the curve to flatten as policy rates increase, while the longer end of the curve will remain relatively anchored by other global rates. In Europe, we anticipate that the curve will steepen as the back-end demand from central banks falls away. However, the European Central Bank (ECB) is less likely to raise short-term rates meaningfully above zero for an extended period of time.

All this means that, over the next three to five years, the conditions are in place for core fixed income portfolios to produce persistently low returns that will be insufficient to meet investor needs. Investors in fixed income will need to look beyond beta to meet their return requirements. It is becoming imperative to obtain more from fixed income portfolios through alpha sources, whether via asset allocation or security selection, while managing the risks ahead.

In this environment, we see the best opportunities in higher quality credit risk in more nontraditional areas of fixed income – the areas where portfolios tend to be underinvested. These include components of emerging markets debt, tranches of collateralized loan obligations (CLOs), and more dynamic opportunistic credit. Within the higher quality fixed income that will continue to be a meaningful component of most investor portfolios, we favor investment grade credit for both the relative safety and incremental yield pickup.

Developments in policy will drive investors toward select, incremental return opportunities in fixed income.

Global Central Bank Balance Sheet Growth




Source: Thomson Reuters Datastream, Bloomberg, PineBridge Investments calculations as of 23 October 2017.

## Synchronized growth leads to synchronized policy normalization

The often cited term "synchronized growth" is indeed an accurate depiction of the state of the global economy. For the first time since the financial crisis, almost every region of the world is experiencing positive growth. This condition is allowing for monetary policies to shift toward a path of synchronized normalization that will facilitate each individual central bank's ability to follow through on its exit of extraordinary measures.

Given the interconnectivity of capital markets and impact of disparate central bank policies on exchange rates, the coordinated process will remain cautious and gradual. Like cyclists who are working together in a peloton, the central banks and economies will be better able to manage the headwinds of removing the excess liquidity in a more harmonious fashion going forward.

While the spotlight has been primarily on the US Federal Reserve in recent years, in many ways, the pivotal change and influence lies with the ECB. It has been the anchor for government bond yields and its policy shift represents a more dramatic turn. Even with a new chairman leading the Fed, the US policy path will likely be a continuation of its recent course. The ECB and, at some point, the Bank of Japan (BOJ) will alter their policies in a more significant manner.

As we look ahead, we expect the focus to transition away from monetary policy and toward more fiscal policy. In the US, the anticipated tax code modifications and deregulation have not yet materialized, but efforts are renewed to implement growth-related policies that would also result in higher deficits and debt financing requirements.

US tax code modifications would have two different effects on fixed income. First, they would improve already strong economic growth, thereby helping interest rates to rise further. On the corporate front, the tax modifications, as proposed, would benefit investment-grade credit and could have a negative impact on highly leveraged issuers.

Similarly, European governments focused on austerity also appear to be shifting toward a more stimulative policy stance and willingness to tolerate budget deficits. This would benefit credit but have a negative impact on rates.

## Tailwinds in emerging markets

While the synchronized normalization process should result in headwinds to developed market fixed income, the conditions across many areas of emerging markets are quite different. In recent years, many emerging markets were combatting the nemeses of fixed income: high inflation, rising interest rates to defend currency levels, and declining growth. They are now shifting toward a more favorable environment of declining inflation and more stable growth combined with central banks that may be lowering or at least maintaining interest rates. Therefore, in emerging markets, fundamentals should be supportive of fixed income and act as future tailwinds.

However, while the fundamental outlook is more favorable, valuations have tightened as capital has been attracted to the yield premium in emerging market debt. So, while there are excess yield opportunities across emerging market debt, additional caution and bias toward higher quality components are warranted. As with other risk assets, security selection will become more critical in the year ahead.

## Corporate credit fundamentals remain attractive, but valuations leave no room for error

Earnings outlooks for corporate issuers are positive and should benefit from improved macroeconomic conditions. These are further supported by potential corporate tax cuts and additional favorable policy proposals. In leveraged finance, default rates are expected to remain below historical averages, and high yield in particular has had a full credit cycle and is currently in the improvement phase of declining default rates.

While commodities were an area of concern for investors in recent years, that concern is shifting toward retail as technological shifts are creating secular disruption. Markets are seeing a high volume of debt issued by tech and software related businesses. Tech industries are more prone to changes in competitive and product lifecycles, which could alter the investment outlook in those businesses. So these areas require more caution from a fixed income perspective, where the upside is limited but downside risks can be significant. Technological disruptions may represent an opportunity in equity markets, but they are primarily a risk in fixed income.

Improving macroeconomic conditions and earnings improvements are supportive of tight credit spreads but at current levels, it is difficult to see outcomes that result in returns above coupons. We also see increasing tail risk to the downside. Credit risk would seem to be a better risk to take than interest rate risk, but tail risks are becoming more likely to materialize in credit, so there is little room for error and security selection becomes paramount in these market conditions.

Loans represent a relatively attractive asset class with defensive characteristics against both rate increases and downside tail risks due to their seniority. But spreads are being compressed and convexity is negative (i.e., their prices fall along with interest rates) due to borrowers' ability to prepay, so the outlook is for coupon minus returns.

CLO tranches offer favorable risk-adjusted returns and an alternative way to take underlying loan exposure with excess yields. However, there is a trade-off due to their complexity. If investors are able to properly analyze the potential risks, including those related to credit, collateral deterioration, and liquidity, we believe CLOs are an attractive opportunity.

Finally, investors may find opportunities to enhance yield by taking on illiquidity premiums in asset classes such as direct lending to small and midsize enterprises.

## Headwinds on the horizon

Flare-ups in politics and policy threatened markets for much of 2017, but in the end, we saw near-"Goldilocks" conditions in fixed income. Spreads for higher risk assets continued to tighten as the fundamental global economic outlook improved and investors continued to search for yield. This drove demand for government bonds and also produced positive returns as inflation remained subdued and central banks maintained a largely accommodative posture.

But in 2018 and beyond, we expect fixed income markets to shift from conditions that provided persistent tailwinds toward a multiyear period of mild but steady headwinds. Excess central bank liquidity will persist in 2018, with global central bank balance sheets continuing to expand. Yet the year is likely to be an inflection point before a shift toward a gradual withdrawal of liquidity from global markets, leading to conditions that will result in lower fixed income returns.

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