FIXED INCOME ASSET ALLOCATION INSIGHTS AUG: 2018

MAKING A CASE FOR SECURITIZED ASSETS

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Tighter spreads marked most credit-related asset classes in July amid progress on trade, solid second-quarter earnings, and subdued new-issue activity. Investment grade (IG) credit and emerging markets (EM) debt experienced strong total returns despite longer duration profiles amid a backdrop of higher Treasury rates. We have reduced our IG credit exposure to 20% from 25% and increased our securitized products allocation to 20% from 15%. IG credit has been challenged this year by concerns over the impact of trade policy on multinational issuers and supply/demand technicals. While these have improved recently, valuations appear fair given the risks. Since the market should be able to absorb the moderate net new issuance of agency mortgage-backed securities (MBS) despite Fed tapering, we still see the potential for securitized assets to provide positive excess returns over Treasuries.

ABOUT THIS REPORT

Fixed Income Asset Allocation Insights is a monthly 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.

US Macro View

Markus Schomer, CFA, Chief Economist

Central case

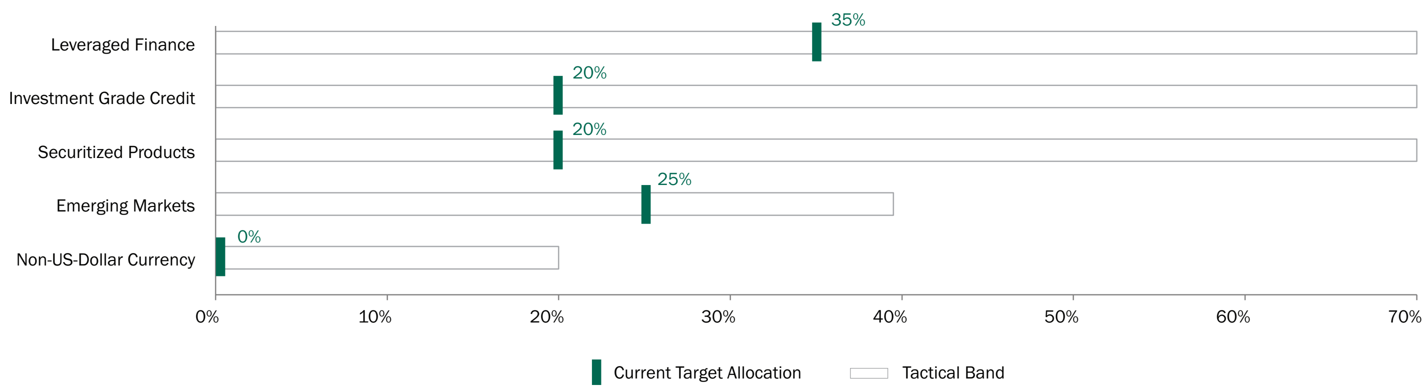
We expect moderate GDP growth and inflation, both at 1% to 3%, with GDP growth in a range around long-term potential rate and headline and core inflation trending around the Fed target. The main drivers are moderate consumption and housing demand, modestly positive fiscal spending, and rebounding business investment. We expect a labor market at or near full employment, with a gradual increase in wage growth. Finally, we see the Federal Reserve initiating two or three rate hikes in each of next few years, alongside gradual balance sheet tapering, with the equilibrium real funds rate 0%-0.50%.

Market movers

Stronger business, weaker consumer. Most recent surveys and factory order data indicate business activity not only unaffected by trade tensions, but actually showing signs of reaccelerating, while weakness in real disposable income growth suggests a deteriorating consumption backdrop.

Future Fed actions. With a notable departure in style from his predecessors Ben Bernanke and Janet Yellen, Fed Chairman Jerome Powell has been very bullish in press conferences and Congressional testimony, indicating the FOMC could add a fourth rate hike to its 2019 forward guidance.

Target Portfolio Allocations (as of 26 July 2018)



For illustrative purposes only. We are not soliciting or recommending any action based on this material. There can be no assurance that the above allocations will be in any account at the time this information is presented. This material must be read in conjunction with the Disclosure Statement.

Trade tensions' effect on growth. Despite reports of companies citing trade tensions in earnings warnings and bailouts for farmers, business surveys remain bullish and durable goods orders are picking up again. So far, the macro data show no damage.

Leveraged Finance

John Yovanovic, CFA, Portfolio Manager, High Yield Bonds
Julie Bothamley, Portfolio Manager, Leveraged Loans

Fundamentals

Sales and earnings estimates appear strong for the next two quarters. The buy side remains relatively disciplined on credit despite a notable lack of supply. Fundamentals for collateralized loan obligations (CLO) remain sound, but high levels of primary loan issuance have weighed on prices, sending them lower in June.

Valuations

We expect option-adjusted spreads (OAS) to remain stuck in a 310-370 trading range, implying a default rate of ~2%. Value looks fair to full here with the yield curve and derivative CLO/loan spread effects as headwinds and strong earnings as a tailwind. CLO spreads have begun to stabilize and are likely to tighten after the supply wave passes.

Technicals

Technicals are positive overall with volatile flows, a continued light primary calendar, and investors buying on dips. Trade war fears and commodity price movements continue to have outsize influence.

Allocation Decision

We are maintaining our allocation of 35%. Fundamentals remain robust and valuations are fair. We see potential for the asset class to trade through fair valuation due to a favorable technical environment.

Investment Grade Credit

US Dollar Investment Grade Credit

Dana Burns, Portfolio Manager
US Dollar Investment Grade Fixed Income

Fundamentals

Corporate fundamentals remain solid and initial second-quarter earnings have been strong. Concerns over trade wars remain, but we expect a positive resolution for US firms.

Valuations

Select credits remain attractive but we are cautious, anticipating the possibility of higher volatility as we enter the fall.

Technicals

The technical backdrop for IG credit has improved recently due to dramatically reduced broker-dealer inventories and the return of foreign buying.

Non-US-Dollar Investment Grade Credit

Roberto Coronado, Portfolio Manager, Non-Dollar Credit

Fundamentals

Fundamentals are neutral. We see no major changes in credit metrics in Europe, as leverage has not increased while M&A activity and shareholder- friendly policies remain under control. Bank capital remains strong, and banks have been reporting stable results, on average.

Valuations

We are neutral on valuations. Credit spreads at the index level have widened considerably year to date. We continue to prefer the banking sector due to improving fundamentals, the potential for de-regulation, and attractive yields, but are mindful of political and global trade risks.

Technicals

We are also neutral on technicals. Central bank purchases continue to support the market in euros, but participants are preparing for the end of QE. Supply should increase after the summer, but inflows from foreign investors are possible.

Allocation Decision

We are reducing our allocation from 25% to 20%. Spreads have tightened to within what we consider a fair valuation range. We still find attractively priced credits on an issuer-by-issuer level.

Emerging Markets

Sovereigns

Anders Faergemann, Portfolio Manager
Emerging Markets Fixed Income

Fundamentals

EM fundamentals remain largely unchanged; growth remains strong and inflation low. The Chinese authorities are focused on growth, and the yuan depreciation will help. The rest of Asia is slowing a bit, though the level of growth remains solid. Central and Eastern Europe show stable growth; Russian and South African numbers are a little softer, while Turkey is overheating. The Latin American recovery is proceeding apace, and Brazil and Argentina will join in once recent short-term issues dissipate.

Valuations

Spreads are 30 basis points (bps) tighter on the month, and at 333 bps are around average for the post-crisis period. Some value still remains in EM sovereign credit overall, and there are interesting individual country stories.

Technicals

EM bond outflows picked up in June but inflows started to return in July. The near-term issuance pipeline is light, although coupons and amortizations will total only $3.5 billion in August before picking up to $7 billion in September.

Corporates

Steven Cook, Portfolio Manager, Emerging Markets Fixed Income

Fundamentals

Despite solid fundamentals, default rates are still expected to be 2.6% this year, up from 0.9% year-to-date (YTD). IG will account for 70% of maturities over the next two years.

Valuations

Spreads on the CEMBI BD Core Index, now stabilized at 317 bps (similar to fourth-quarter 2016 levels), hit 325 bps at the end of June, up 55 bps year-to-date and up 80 bps from February. In the second quarter, spreads on high yield, up 77 bps, were the drag compared with IG, up 22 bps. Higher beta Bs, up 130 bps to 574 bps, underperformed BBs (up 50 bps), in part due to Asia HY weakness. We view valuations as attractive given the stronger fundamentals compared with 2015-2016.

Technicals

Poor liquidity due to a drop off in supply marks technicals. July issuance of $3.6 billion compares with $46.1 billion in July 2017; net issuance of $17 billion year-to-date (versus $142 billion in 2017) is supportive. Last week saw the first weekly inflow in 10 weeks.

Allocation Decision

We maintain our allocation of 25%. Spreads on EM debt remain attractive within the context of a robust fundamental backdrop.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

Negative convexity is at an extremely low range historically because interest rates have risen enough to take most of the mortgage-backed securities universe out of the refinance zone.

Valuations

Spreads are at five-year wides, with interest rate volatility extremely low and convexity very low.

Technicals

The Fed is unwinding its purchase program, but paydowns are extremely low. Organic net supply is coming in at a much slower pace than last year.

Allocation Decision

We are increasing our allocation to 20% from 15%. Moderation of housing price growth along with higher mortgage rates could push prepayments down.

Non-US-Dollar Currency

Dmitri Savin, Senior Vice President, EM Fixed Income Portfolio Strategy/Risks

Fundamentals

While monetary policy divergence still favors the US dollar, short-term growth dynamics are less supportive, as expectations in both the US and eurozone have caught up.

Valuations

Market support remains at 1.1500 in the euro to the dollar (equivalent to roughly 95.00 on the US Dollar Index). A drop below could lead to an extension of the dollar correction.

Technicals

According to the latest IMM foreign exchange positioning data, the current $19.7 billion net long US dollar position has touched levels not seen since 24 January 2017, a period in which the dollar was still very much buoyed by the economic optimism accompanying the newly inaugurated President Trump.

Allocation Decision

We are maintaining our 0% non-dollar allocation. The greenback is expected to continue to benefit from attractive growth and interest rate differentials versus major currency pairs.

Our Scenario Probabilities Were Unchanged During the Month

Fixed Income Scenario Probabilities – Next 12 Months (as of 26 July 2018)

Increase | Decrease | Unchanged

Scenario	US GDP Growth	Inflation	USD Basket	Avg. Scenario Probability	Scenario Probabilities: USD Inv. Grade	Securitized Products	Leveraged Finance	EMD	Non-USD IG
Recession; Deflation	< 1%	< 1%	Breaks 5% band on the downside	**15%**	15%	10%	25%	10%	15%
Central Case	1-3%	1-3%	Maintains -5% to +5% band	**67%**	75%	65%	60%	65%	70%
High Growth; Inflation	> 3%	> 3%	Breaks 5% band on the upside	**18%**	10%	25%	15%	25%	15%

Source: PineBridge Investments. For illustrative purposes only. Any opinions, projections, forecasts, and forward-looking statements are based on certain assumptions (which may differ materially from actual events and conditions) and are valid only as of the date presented and are subject to change.