Fixed Income Asset Allocation Insights

Finding Opportunities for Value Amid Tighter Valuations

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

Credit spreads generally traded tighter in September amid a backdrop of optimism related to China, less pressure in select emerging markets, higher oil and other commodity prices, and record highs in US equity markets. As a result, our allocations remain unchanged. Rate normalization in the US has been a major theme across fixed income markets during the past several years, but as the European Central Bank and the Bank of Japan each appear poised to begin tightening sometime in 2019/2020, the story will begin to change. It will become one of normalization outside the US and the consequent impact on non-dollar bonds. Despite tighter valuations, we continue to find attractively priced credits within US-dollar-denominated emerging markets debt, leveraged finance and investment grade credit.

US Macro View

Markus Schomer, CFA, Chief Economist

Central case

We continue to see moderate GDP growth of 1% to 3%, which brackets the long-term potential rate, and moderate 1% to 3% inflation bracketing the Fed target, all driven by moderate gains in consumption and housing, modestly positive fiscal spending, rebounding business investment and a gradual increase in wage growth as full employment is approached. Expect two to three gradual Fed rate hikes in each of next few years alongside gradual balance sheet tapering and an equilibrium real funds rate of 0%-0.50%.

Market movers

US elections. If Democrats win the House, don't expect dramatic changes for the economy; expect more gridlock. But if Congress wrestles back its constitutional authority over trade, the current confrontational policy may end.

A Fed pause? Last month, we highlighted the risk of a fourth rate hike being added to the Fed's 2019 guidance. Now it's possible the Fed may change or even abandon forward guidance and pause early next year after tightening only once or not at all. Any directional hint could be market moving.

Wage inflation. While still below previous cycle highs, wage gains have risen in recent months, as has the Personal Consumption Expenditure deflator. While consumer prices have moderated from a surge earlier this year, the biggest threat to a Fed pause and a lid on bond yields is wage-driven inflation.

Leveraged Finance

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

Fundamentals

For the next two quarters, sales and earnings estimates appear to remain strong. The buy side remains relatively disciplined on credit despite a notable lack of supply.

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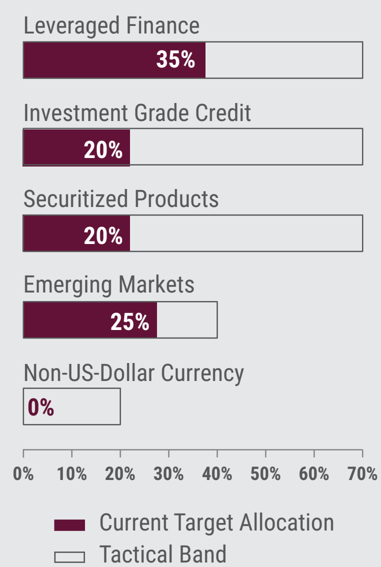
About This Report

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.

Target Portfolio Allocations
(as of 24 September 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.

Valuations

Still stuck in a 310-370 option-adjusted spread trading range, valuations currently stand at 320, implying a default rate of ~2%. Value looks fair to full with headwinds of the rate curve and the effects of the spread between loans and collateralized loan obligations (CLOs), versus tailwinds of strong earnings. The loan supply is normalizing. BBB-, BB-, and B-rated CLOs were cheap versus high yields and loans on a Z-score basis. Spreads are widening on anticipated heavy issuance.

Technicals

Positive overall. Flows are volatile and the light primary calendar continues. Trade war fears and commodity price movements continue their outsized influence day to day.

Leverage Finance Allocation Decision

We are maintaining our allocation of 35%. Spreads are trading toward the tighter end of what we consider to be fair value, but the fundamental backdrop remains robust.

Investment Grade Credit

US Dollar Investment Grade Credit

Dana Burns, Portfolio Manager
US Dollar Investment Grade Fixed Income

Fundamentals

Corporate fundamentals remain firm, yet concern over trade wars and tariffs remain. Ultimately we believe there will be a positive resolution for US firms but prolonged negotiations eventually will have a negative impact.

Valuations

Select credits remain attractive, but following the recent snap-back in credit spreads the value proposition isn't as compelling as it was at the end of August.

Technicals

The technical back drop for investment-grade credit spreads improved in September with the return of foreign buying amid lower dealer inventories.

Non-US-Dollar Investment Grade Credit

Roberto Coronado, Portfolio Manager, Non-Dollar Credit

Fundamentals

Neutral/Positive. We see no major changes in credit metrics in Europe; leverage has not increased, and M&A activity and shareholder friendly policies remain under control. Banks retain their strong capital base and generally continue to report better results.

Valuations

Neutral. Credit spreads at the index level have widened considerably year to day and now are in line with the five-year average. We continue to prefer the banking sector due to improving fundamentals and attractive yields, but are mindful of political and global trade risks.

Technicals

Neutral/Negative. Central bank purchases continue to support the euro market but the end of QE is approaching. Supply has disappointed so far this month but we have seen just small outflows from the asset class.

Investment Grade Credit Allocation Decision

We maintain our allocation of 20% and continue to find attractively priced credits, particularly in financials.

Emerging Markets

Sovereigns

Anders Faergemann, Portfolio Manager
Emerging Markets Fixed Income

Fundamentals

Emerging markets (EM) growth has stabilized, while inflation is stable except for the few countries having experienced large devaluations. Chinese macro figures show a further slowdown, which the authorities are very committed to fight. Growth in the rest of Asia has stabilized. In EMEA and Latin America, growth figures are stable apart from Turkey and Argentina, which will be going through an adjustment period over the next months.

Valuations

Spreads are 30 basis points tighter on the month, and at +344 are only slightly attractive relative to post-crisis spreads. There is more value in HY, which has underperformed recently.

Technicals

Active funds have experienced small outflows while ETFs have had inflows. Coupons and amortizations, $7 billion in September, will total $24 billion by yearend. The new-issue pipeline is building, but countries are playing the waiting game for now.

Corporates

Steven Cook, Portfolio Manager, Emerging Markets Fixed Income

Fundamentals

We tweaked our longer term HY outlook to be slightly less positive, since we cannot ignore the weaker macro outlook for some EM countries, which we feel will feed through into corporates and which we believe should be reflected in our Trend. Nevertheless, we remain positive on a large number of HY names. In IG, we kept things unchanged as the outlook and metrics remain positive overall.

Valuations

The August HY rally came on the heels of the July selloff dominated by Turkey and Argentine credits. Today, EM HY and

IG corporates look cheap, but IG has the edge on a volatility-adjusted basis and is our preference.

Technicals

Supply forecasts are being revised downward as a function of market conditions and the fact that most companies do not need to refinance.

Emerging Markets Allocation Decision

We maintain our allocation of 25%. Despite recent outperformance, EM-DM spread differentials remain wide on a historical basis.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

Remain solid due to interest-rate volatility at almost the lows of the year and convexity, which while worse than at mid-year best levels is still about 50% better than a year ago.

Valuations

Recent weakness versus IG was a bit disconcerting, but it will take a month to determine if the cause was merely supply.

Technicals

The worst of summer supply buying in mortgages should be over. The Fed is on track to end paydown reinvestments, which was well forecasted.

Securitized Products Allocation Decision

We maintain our allocation of 20%. Absorbing the Fed run-off has not been a major obstacle for the market thus far as real money demand has kept spreads in check.

Non-US Dollar Currency

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

Fundamentals

Growth dynamics and expectations of continued monetary policy divergence between the Fed and other major central banks support the US dollar outlook.

Valuations

The DXY index is about 2.2% off of year-to-date highs and far below post-election levels. Current valuations could provide an attractive entry point for investors.

Technicals

Recent data suggests that US dollar longs have been trimmed for the third consecutive week. However, the recent reversal does not appear to be driving dollar weakness.

Non-US Dollar Currency Allocation Decision

We maintain our 0% non-dollar allocation, expecting the greenback to benefit from interest rate and growth differentials relative to other developed economies.

Our Central Case Probability Increased while Our High Growth Case Probability Decreased During the Month

Fixed Income Scenario Probabilities – Next 12 Months (as of 24 September 2018)

Increase | Decrease | Unchanged

					Scenario Probabilities				
Scenario	US GDP Growth	Inflation	USD Basket	Avg. Scenario Probability	USD Inv. Grade	Securitized Products	Leveraged Finance	EMD	Non-USD IG
Recession; Deflation	< 1%	< 1%	Breaks 5% band on the downside	**16%**	15%	5%	25%	20%	15%
Central Case	1-3%	1-3%	Maintains -5% to +5% band	**69%**	75%	75%	60%	65%	70%
High Growth; Inflation	> 3%	> 3%	Breaks 5% band on the upside	**15%**	10%	20%	15%	15%	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.

About PineBridge Investments

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 30 June 2018, the firm managed US$87.0 billion across global asset classes for sophisticated investors around the world.

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