Fixed Income Asset Allocation Insights

Volatility May Persist, But Don't Discount Opportunities

December
2018

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

Credit spreads came under pressure in November from issues plaguing markets throughout the year — geopolitical worries about Italy and Brexit, expectations of slower growth and inflation, US-China trade tensions, and a hawkish Fed. However, credit spreads found a bottom late in the month, as did other risk assets, as investors saw hints of dovishness at the Federal Reserve and a possible ceasefire in the US-China trade dispute. As a result, our target allocation remains unchanged. While we see potential for additional volatility in coming months, valuations have reset wider and we continue to find attractively priced credits in investment grade, high yield, and emerging markets debt in the context of a benign default backdrop, strong corporate earnings, and a possible midcycle Fed pause.

US Macro View

Markus Schomer, CFA, Chief Economist

Central case

As stated last month, we continue to anticipate moderation in GDP growth and inflation, each in the 1% to 3% range, as well as moderation in consumption, housing activity, fiscal spending, and business investment. The labor market is near full employment and wage growth is gradually increasing. We anticipate two to three Fed rate hikes in each of next few years alongside a gradual balance sheet tapering, and an equilibrium real funds rate of 0%-0.50%.

Market movers

Trade. Expected talks between Presidents Trump and Xi could clarify whether tariffs on nearly half of China's exports to the US jump from 10% to 25%. A decision on EU car tariffs also may be drawing closer.

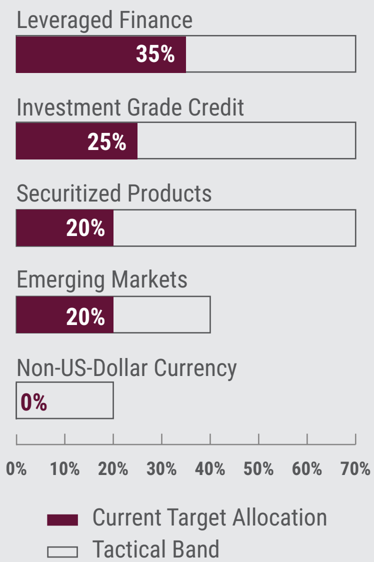
A Fed pause? At its December FOMC meeting, the Fed may signal that plans for five rate hikes after December are too hawkish. A cut in future rates of at least 25 basis points (bps) plus a reduction to 2% in the 2019 inflation forecast would support the guidance change.

The "R" word. Business investment stalled in Q3 and deteriorating manufacturing and service sector data suggest an approaching 2015-like recession. Slumping oil prices could dampen energy investment, while GM's factory closures signal a possible reversion to corporate margin defense instead of productivity- or capacity-enhancing investment spending.

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 27 November 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.

Leveraged Finance

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

Fundamentals

Earnings season was disappointing with only ~60% of issuers beating expectations. The materials, technology, consumer, and electrics sectors disappointed. The earnings growth peak thesis is the market's base case now; we are looking for high single-digit growth in 2019.

Valuations

Implied default rates across leveraged finance are ~3%, so while valuations imply a small uptick in corporate default rates, history says defaults are generally higher or lower than 3%. Stay tuned. The same confusion is evident in CLOs, as single Bs are widening while BBBs are tightening.

Technicals

CLO technicals remained positive while high yield and loans were negative, trending neutral/positive into year-end. Notable is that the quarter-to-date decline was contained to US and EU credit as emerging market (EM) credit and CLOs outperformed.

Leverage Finance Allocation Decision
We are maintaining our allocation of 35%. Spreads are now wide of what we consider to be fair-value range given strong corporate fundamentals and the benign default backdrop.

Investment Grade Credit

US Dollar Investment Grade Credit

Dana Burns, Portfolio Manager
US Dollar Investment Grade Fixed Income

Fundamentals

We remain constructive on credit fundamentals despite increasing leverage due to healthy balance sheets and cash flow generation. More economically sensitive names will remain volatile against the backdrop of mixed economic data. Trade and tariff concerns with China continue to weigh on sentiment.

Valuations

Heading into year-end we anticipate reduced demand for credit; there may be a more attractive entry point. Following recent spread widening, select credits look attractive.

Technicals

The technical backdrop for investment grade (IG) credit is soft, with rising broker-dealer inventories and tepid demand, both foreign and domestic, particularly on the long end.

Non-US-Dollar Investment Grade Credit

Roberto Coronado, Portfolio Manager, Non-Dollar Credit

Fundamentals

We have seen no major changes in credit metrics in Europe, as leverage has not increased and M&A activity and shareholder-friendly policies remain under control. Banks continue to have a strong capital base and have been reporting, on average, stable results.

Valuations

Credit spreads at the index level have widened considerably over the last two months. We continue to prefer the banking sector due to improving fundamentals, the potential for deregulation, and attractive yields, but are mindful of political and global trade risks.

Technicals

The European market has seen outflows. That, combined with the approaching end of quantitative easing, is not helping the credit market's technical picture.

Investment Grade Credit Allocation Decision
Our allocation remains at 25%. Valuations are attractive after the recent selloff and we could see a snapback toward year-end and into January. Over the medium term, however, technical and political risks point to a volatile 2019.

Emerging Markets

Sovereigns

Anders Faergemann, Portfolio Manager
Emerging Markets Fixed Income

Fundamentals

Signs of stability in Brazil and Russia, at least from a bottom-up economic perspective, cannot hide the fact that the Chinese economy is hitting the brakes, led by a domestic-driven slowdown. Tariffs and the inability of China's policymakers to ease sufficiently to counter the downdraft continue to weigh on economic and market sentiment. Our overall growth outlook is fairly balanced.

Valuations

EM sovereign spreads widened by another 30 bps in November to just shy of +400 bps, doubling the spread-widening since late September and hitting the widest levels since June 2016. The chief drivers of the recent widening have been Venezuela, Costa Rica, and Lebanon.

Technicals

Sovereign issuance has come to almost a standstill and new issues are broadly under water despite a higher new-issue premium. High cash levels provide a good buffer against the weaker market sentiment and flows from the asset class have generally stabilized.

Corporates

Steven Cook, Portfolio Manager, Emerging Markets Fixed Income

Fundamentals

With most results reported, the fundamental picture has not changed materially. We are still slightly more positive overall.

Valuations

We are starting to see more value in high yield, particularly in the China B space. High yield currently is pricing a much higher default probability than our 12-month expectations. Overall, EM corporates look good-value to cheap. The risk-adjusted return model still has a bias to IG given the volatility.

Technicals

The technical picture remains very robust on the back of higher cash levels and a fairly light issuance calendar into year-end. The challenge remains volatility in foreign exchange and US Treasuries at key technical levels, which is keeping the market defensive.

Emerging Markets Allocation Decision

We maintain our allocation of 20% and remain constructive on the asset class as fundamentals continue to be stable and spreads have widened to 2016 levels.

Securitized Products

Andrew Budres, Portfolio Manager, Securitized Products

Fundamentals

Fundamentals are still solid. Interest rate volatility, although rising in October, is still nowhere near pre-financial-crisis levels or those before Fed ownership of mortgage-backed securities (MBS).

Valuations

The relationship between IG credit and MBS performance had to normalize. It did, with IG going wider, rather than MBS performing better.

Technicals

Lack of recent bank buying is a high hurdle to overcome. We have seen small positive signs, with REITs able to raise some capital.

Securitized Products Allocation Decision

We maintain our allocation of 20% and continue to focus on signs of banks adding MBS to balance sheets again.

Non-US Dollar Currency

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

Fundamentals

Rising global headwinds in the form of a China slowdown, withdrawal of global liquidity, and higher oil prices ought to further support the US dollar, but may be countered by long dollar market positioning.

Valuations

The DXY index is close to 2018 highs yet still far below post-Trump election levels. Current valuations may provide an attractive entry point for longer-term investors.

Technicals

Recent market data suggest investors continue to add to US dollar longs. Net positioning is now ~$30 billion on the long side, versus a net short position of ~$26 billion earlier in 2018. This shift has provided a notable tailwind to the dollar.

Non-US Dollar Currency Allocation Decision

We maintain our 0% non-dollar allocation. Growth and interest-rate differentials continue to favor the US dollar until we see progress in other developed economies.

Our Recession Case Scenario Probability Increased While Our Central Case Scenario Decreased During the Month

Fixed Income Scenario Probabilities – Next 12 Months (as of 27 November 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	**17%**	20%	5%	25%	20%	15%
Central Case	1-3%	1-3%	Maintains -5% to +5% band	**68%**	70%	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 September 2018, the firm managed US$90.9 billion across global asset classes for sophisticated investors around the world.

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