

# Global Fixed Income Perspectives

## Global Market Outlook

- 1Q 23 began with a continuation of the Federal Reserve's (Fed's) and other central banks' battle against inflation but was quickly interrupted as a banking crisis emerged with Silicon Valley Bank and Signature Bank failing, and the market taking aim at the century old European bank, Credit Suisse. Central banks, regulators, and policymakers have responded quickly and aggressively to this crisis and will continue to provide necessary support. As banks respond by tightening lending standards and corporations by constraining spending, we anticipate that the resulting impact on economic activity will assist the Fed with curtailing inflation.
- China's reopening, geopolitical risks, and U.S. "debt ceiling" negotiations are all on our radar as we enter 2Q 23. One should expect a more targeted (policy objectives) and focused (services vs. goods) reopening from China that is more in line with the country's five-year plan. While debt ceiling negotiations will not begin in earnest until the summer, the market will begin to assess the risk and price in the probable outcome.
- Given the backdrop, we anticipate corporate earnings to be revised lower and continuation of the volatility seen in the markets over the last year.

## About this Publication

The Global Fixed Income Perspectives discusses performance and opportunities for global fixed income markets by segment.

### DM Developed Market Rates

We anticipate that the lagged effects in monetary policy will become more impactful as the year continues, including in economies with primarily fixed-rate mortgage structures. We, therefore, continue to be constructive on duration positioning across multiple developed markets.

### IG Investment Grade

With money market funds approaching yields not too dissimilar to IG short duration paper, underwriting becomes far more important. Financials, real estate, utilities, and leisure are all potential areas of investment as they have experienced recent spread widening.

### HY High Yield

We are expressing a cautious view for the high yield market in the coming quarters, focusing on higher quality names and bonds that are senior in the capital structure. After showing signs of weakness during the first quarter, we expect high yield credit to underperform going forward.

### SC Structured Credit

Attractive spreads and low net issuance are offset by market volatility, high interest rates, and economic stress. We foresee further market volatility and possible credit events. We remain defensive and watch for selective opportunities to add risk.

### EM Emerging Markets

Local markets outperformed hard-currency markets during the first quarter and should continue given attractive nominal yields in some markets. Inflation is likely peaking broadly, which should allow EM central banks to start cutting rates later this year. DM monetary policy and Chinese growth will be key to EM market performance.



## DM Developed Market Rates

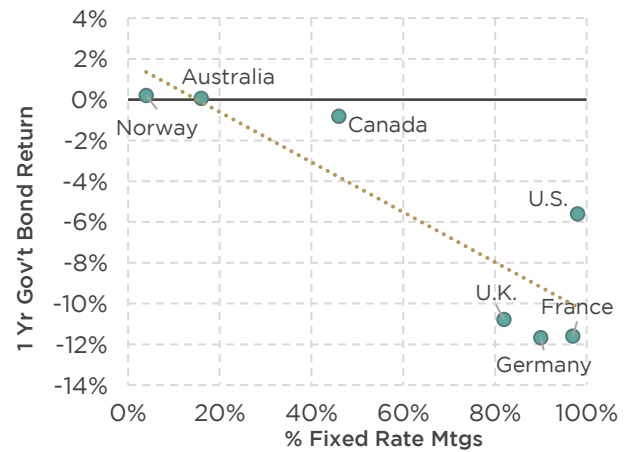
- The economic impact of increasing policy rates in developed countries always consists of some undetermined time lag. But how do differences in time lags effect the country’s bond yields? In many cases, dispersion amongst bond returns can be partly explained by the underlying mortgage structure of the economy.
- In comparing a country’s bond return (represented by the 7-to-10-year maturity) versus the country’s mortgage rate structure, a very clear relationship unfolds: The greater the percentage of fixed-rate mortgages that exist within a country, the lower the bond returns have been over the previous 12 months (see **FIGURE 1**).
- The theory behind this relationship is straightforward. Countries with a greater percentage of adjustable-rate mortgages are much more susceptible to tighter monetary policy than those countries that have primarily fixed rates. Central banks, therefore, must exert greater caution to avoid derailing a country’s housing market.
- We anticipate that the lag in monetary policy effects will become more impactful as the year continues, including in economies that are primarily fixed-rate mortgages. We, therefore, continue to be constructive on duration positioning across multiple developed markets.

## IG Investment Grade

- Bank deposits have flowed into money market funds and U.S. Treasuries since the start of the year, spurred on by trouble at small U.S. regional banks but also due to the increase in yields available for these relatively safe assets (see **FIGURE 2**).
- While in the past investment-grade credit may have been priced at a spread to Treasuries, they now compete against money market yields, which currently have higher yields (albeit significant differences), for investors’ attention.
- Although lower yields may potentially signal less value in some very short duration investment-grade credit, some pockets may interest investors with strong underwriting skills and a view on the macro environment and duration.
- Financials and real estate spreads have widened significantly due to stresses in the U.S. regional banks. This still leaves opportunities in the larger global banks, which have experienced spread widening in sympathy. Leisure and utilities also offer some potential opportunities (see **FIGURE 3**).

### 1 Government Bond Returns vs. Mortgage Type Structure

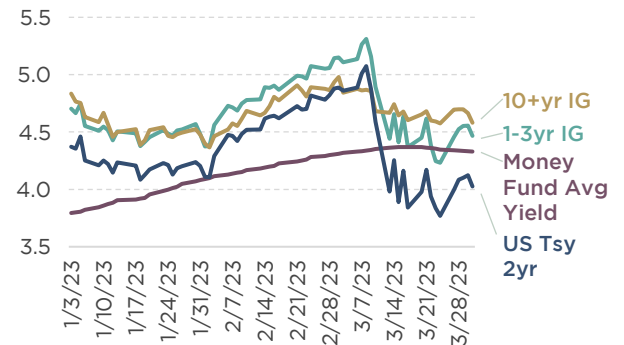
As of 3/31/2023



Source: OECD, BofA ML, Bloomberg (© 2023, Bloomberg Finance LP)

### 2 IG, Money Market and 2yr Treasury Yields

As of 3/31/2023, %



Source: Bloomberg (© 2023, Bloomberg Finance LP)

### 3 Select IG Sector Spread Monitor

As of 4/5/2023

Sector	Most Recent	Percent Rank (1yr)					Chg Mnth	Z-Score
		0%	25%	50%	75%	100%		
IG Index	143	[Bar chart showing rank]					19	0.8
Autos	111	[Bar chart showing rank]					16	0.3
Cap Goods	111	[Bar chart showing rank]					6	0.3
Energy	152	[Bar chart showing rank]					14	0.4
Financials	168	[Bar chart showing rank]					35	0.9
Leisure	180	[Bar chart showing rank]					23	0.4
Real Estate	194	[Bar chart showing rank]					42	1.0
Transport	144	[Bar chart showing rank]					15	0.7
Utilities	147	[Bar chart showing rank]					10	0.4

Source: ICE BofAML



## HY High Yield

- We don't think that the banking crisis during the first quarter has a large risk of contagion or threatens the broader U.S. financial system in the short term. However, we do think it helps accelerate a noticeable trend happening within the financial sector that could have larger macro implications.
- Banks have yet to adjust deposit savings rates following the aggressive Fed hiking regime of 2022, and depositors are incentivized to withdraw funds from banks into higher yielding money market funds (see **FIGURE 4**). Banks face the decision to either raise interest payments on deposits or endure deposit flight into the foreseeable future, and we think both options would challenge economic growth.
- When bank deposit bases are falling or bank net interest margins are dropping, banks normally respond by requiring higher lending standards for their loan books. This is clearly happening as a large number of banks are now tightening lending standards given the most recent Senior Loan Officer Opinion Survey (SLOOS) data (see **FIGURE 5**).
- As bank lending decelerates, we are concerned for the small/medium businesses that rely on this credit availability for day-to-day operations. We think the additional cost of bank lending may lead these corporations to think about rightsizing labor forces, a concerning development for the broader economy.

## SC Structured Credit

- Credit-risk transfer (CRT) securities continue to benefit from strong fundamentals and technicals as well as their floating coupons. However, a recession may heighten price volatility. We favor mezzanine over B notes.
- Commercial mortgage-backed securities (CMBS) spreads are attractive, but they signal high credit risk, mainly in retail and office properties, which may spread in a recession. We remain up in credit. (see **FIGURE 6**)
- Asset-backed securities (ABS) are likely to see increasing delinquencies and losses in spite of recent stabilization. We continue to monitor consumer credit indicators in this sector.
- Collateral loan obligations (CLOs) are seeing rising loan defaults and lower recoveries. Over-collateralization cushions remain healthy but face downward pressure. Further spread widening may offer better entry points.

### 4 ICI Money Market Funds Assets

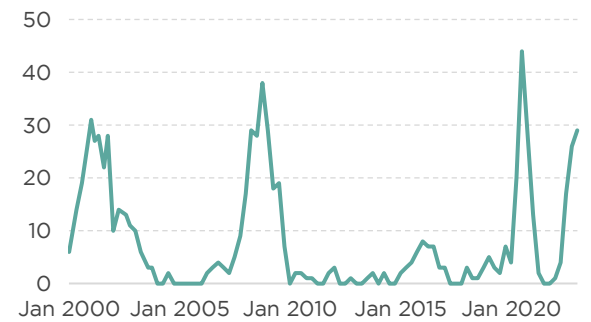
As of 3/29/2023, In Billions



Source: Bloomberg (© 2023, Bloomberg Finance LP)

### 5 Senior Loan Officer Survey - Banks Tightening

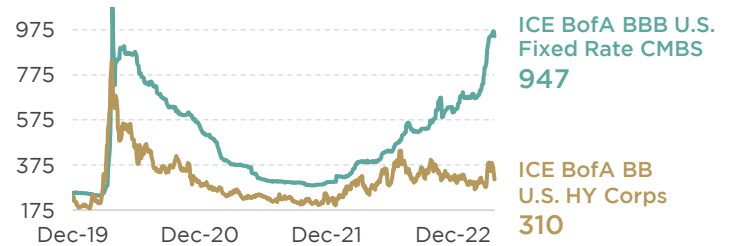
As of 1/31/2023, Number of Banks



Source: Bloomberg (© 2023, Bloomberg Finance LP)

### 6 BBB- CMBS vs BB HY Corporate Credit Option-Adjusted Spread

As of 3/31/2023, in Basis Points (bps)



Source: ICE Data Indices, LLC., BofA Global Research

### 7 CLO 2.0 BB vs. CLO 2.0 AAA Spread to Swap /Discount Margin

As of 3/31/2023, in Basis Points (bps)



Source: BofA Global Research



## EM Emerging Markets Debt

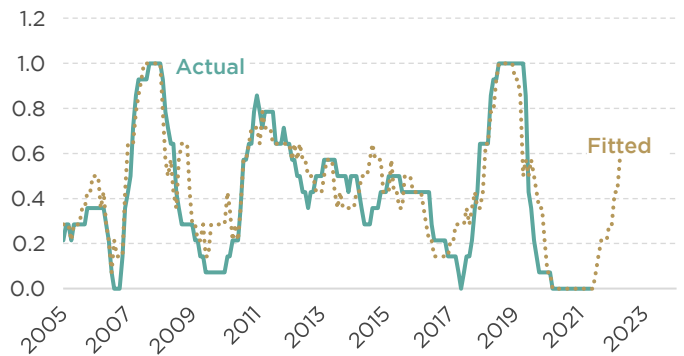
- Nominal EM yields (see **FIGURE 8**) remain quite attractive across a number of markets where we see inflation and political risk premium peaking, allowing local rates to rally from elevated levels. Based on our analysis, we see scope for a number of EM central banks to start their rate cutting cycles later this year (see **FIGURE 9**).
- The market is somewhat bifurcated between ratings buckets. CEMBI IG and EMBI IG spreads are generally tight; CEMBI IG spreads trading around the 45<sup>th</sup> percentile and EMBI IG spreads around the 22<sup>nd</sup> percentile. In CEMBI high yield, we are seeing pockets of stress picking and expect default rates to rise some from current levels. EMBI HY spreads are 900 bps with the CCC bucket trading at 3,900 bps; we expect further restructuring/defaults in the stressed sovereign market.
- We will continue to monitor the policy responses to inflation, tight labor markets and stress in the U.S. banking sector and the resulting impact to global growth and risk assets. We expect a tightening in lending conditions in the U.S., which should support disinflationary processes but weigh on growth. China reopened at the start of the year and expectations were high, but so far growth has been fairly modest. To what degree will Chinese growth recover as we move through 2023? That will be an important driver for some EM countries levered to the Chinese growth cycle.

### 8 EM Local Nominal Yield Remains Attractive\* As of 3/31/2023, %



Source: Bloomberg (© 2023, Bloomberg Finance LP), Brandywine Global  
\*BRL, COP, CZK, HUF, IDR, MXN, PLN, THB, ZAR

### 9 EM Rate Cutting Cycle to Start 2<sup>nd</sup> Half of 2023 As of 3/31/2023, Share of Countries Cutting Over the Next 12-Months, Ratio



Source: Bloomberg (© 2023, Bloomberg Finance LP), Brandywine Global

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The ICE BAML U.S. High Yield Index tracks the performance of USD-denominated below investment grade corporate debt publicly issued in the major U.S. markets. The ICE BAML European High Yield index tracks the performance of below-investment grade corporate bonds publicly issued in Europe. The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest-rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries. The ICE BAML U.S. Mortgage-Backed Securities Index tracks the performance of U.S. dollar-denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market. The ICE BAML U.S. Fixed Rate CMBS Index tracks the performance of U.S. dollar-denominated investment grade fixed rate commercial mortgage-backed securities publicly issued in the U.S. domestic market. The JP Morgan Corporate Emerging Market Bond Index (CEMBI) Broad is a global, liquid corporate emerging markets benchmark that tracks U.S. denominated corporate bonds issued by emerging markets entities. The JPM EM Bond Index Global Diversified is composed of U.S. dollar-denominated Brady bonds, eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities. The JPM Government Bond Index-Emerging Markets (GBI-EM) Broad Diversified is a comprehensive emerging market debt benchmark that tracks local currency bonds issued by emerging market governments. 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