NEUBERGER BERMAN

Fixed Income Investment Outlook 2Q 2020

Opportunity in Credit

In the wake of the COVID-19 pandemic, the fixed income markets experienced unprecedented shocks, which drove down yields on many government bonds and sharply widened credit spreads. Amid compromised global growth and historic levels of monetary stimulus, we anticipate a potentially long period of zero (or negative) policy rates, with central banks increasingly buying higher-quality assets. With that in mind, we see a compelling opportunity in credit spreads, with an initial focus on quality securities in central bank-supported sectors broadening out to take on more risk as the pandemic runs its course.

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Investment Implications

In an environment of deep economic contraction, historic monetary policy easing and significant fiscal stimulus, we expect market volatility to remain elevated during the second quarter. As experienced in past episodes of heightened uncertainty, we believe these conditions will create substantial opportunities to deploy capital for long-term investment across select fixed income asset classes:

Investment Grade Credit: We believe the sector should perform well in light of ongoing support from key central bank facilities. We favor selective additions to medium- to high-quality credit risk over the near term. Subsector and security selection will be increasingly important to delivering alpha over the quarter.

High-Quality High Yield Credit: Our focus is on "up-in-quality" companies that have access to liquidity to help navigate elevated episodic volatility in the near term, with a heightened research emphasis on avoiding defaults and differentiating between credits. The return to the zero lower bound in the U.S. and low-to-negative rates globally underscores the forward-looking value of the asset class. While volatility is likely to persist, based on historical returns, recent spread-widening has likely created an attractive entry point for long-term investors.

U.S. Agency MBS: The risk/reward proposition of U.S. agency MBS relative to nominal Treasuries appears attractive given increased risk to the downside stemming from recently elevated global demand for "safe haven" sovereign assets. The Federal Reserve's asset purchase program should be supportive and help to provide a liquidity backstop in the second quarter.

Municipal Bonds: We expect the Fed's Municipal Liquidity Facility to continue to alleviate potential strains in the municipal market. Issuance is anticipated to increase in the near term given the economic impact from COVID-19, and the Fed's Facility should bolster confidence and aid liquidity.

European Peripheral Government Debt: We have a positive view on the government debt of most peripheral European countries with the notable exception of Italy. Continued QE and massive ECB bond-buying should provide support to sovereign yields despite growing public deficits. Italy has already criticized the Eurozone Stability Mechanism (and said it won't use it), so we expect yields on Italian sovereign bonds to move higher. Once the cost of Italian debt is repriced, it may provide tactical investment opportunities.

European Credit: We see a positive case for European investment grade and high yield credit, as these asset classes should benefit from compelling valuations and eventual recovery in risk sentiment. Our focus is on issuers with low business risk, and within more stable industries like the utility and telecom sectors. Strategies focused on corporate hybrids, financial securities and peripheral debt also offer attractive valuations after the first-quarter selloff.

Opportunity in Credit

The global fixed income markets experienced unprecedented shocks in the wake of the COVID-19 pandemic, as the virus spread globally, leading to severe, rolling containment measures across the world.

As discussed in our 1Q 2020 *Fixed Income Investment Outlook*, we had expected 2020 to be a year of stable growth with central banks largely on hold, with these positives partly offset by relatively tight credit spreads to start the year. Our positioning across fixed income strategies reflected this balance: We entered 2020 with moderate overweights to various spread markets, with "up-in-quality" biases within our spread exposures. Given the changes in economic conditions as a result of the shutdown of the global economy, we believe it's prudent to reassess our market views.

Where Do We Stand?

From an economic growth perspective, it's clear that the global economy is going to experience a deep recession. This recession will likely be of an intermediate duration, but shorter than that following the global financial crisis. Jobless claim data in the U.S. and Europe, in particular, suggest that labor markets will see significant rises in unemployment, likely exceeding the worst levels of 2008 – 09. What is unknown, in addition to the duration of this sharp recession, is how consumption, savings and investment patterns may change in the coming years.

Our expectation is that global growth will remain weak, even by post-financial crisis standards. It is easier to shut down economies than it is to start them back up, given the interconnectedness of supply chains. It is also easier to lay off workers than it is to re-hire them; and it seems likely that some key drivers of developed-market economies, such as retail trade and travel, are going to be structurally impacted both on the demand and supply sides. There's good reason to believe that, after the worst of the global slowdown is experienced, the recovery to pre-crisis GDP growth levels will be slow and with ups and downs.

If the growth outlook is dimmer than it was a quarter ago, the outlook for credit markets is more nuanced, given the dramatic central bank initiatives announced in March. Compared to the global financial crisis, the central bank and fiscal initiatives globally have been front-end loaded—policies that took months or years to enact in 2008 or 2009 have been enacted in a series of weeks. This has important implications for capital markets, and potentially the severity of the recession as well.

We note that the first quarter of 2020 saw a sharp widening of credit spreads. At their worst levels, investment grade and high yield index spreads in the U.S. tripled, widening by over 220 basis points (bps) and over 650 bps, respectively. Similar moves occurred in European and emerging market credit indices. Based on our analysis of monthly return data over the past 20 years, these spread movements represented a four to six standard deviation event, with most markets widening 50 – 100% of 2008 spread levels over the course of one month.

The spread movement, in our opinion, began as a rational repricing of credit risk to reflect a weaker growth environment. The selloff then morphed into a major deleveraging event affecting virtually all global bond markets, and was only arrested by the intervention of all major central banks, and in particular by the U.S. Federal Reserve.

As we look forward, we believe spread markets across the world, but particularly those in developed market investment-grade credit, represent substantial value. The "end game" of this extraordinary period is likely to be a protracted period of zero (or negative) policy rates, with central banks increasingly buying higher-quality assets such as sovereign debt, agency mortgages and investment grade credit. We fully expect that private market investors' need for yield, coupled with this expanded government support for quality companies, will drive spreads in many markets to substantially tighter levels over the intermediate term.

The first quarter also saw a decline in government bond yields. Unlike the credit markets, which experienced a global, synchronized widening

of risky assets, the drop in government yields was more nuanced. Japanese and German yields ended the quarter largely unchanged, for example. U.S. 10-year yields, on the other hand, declined by approximately 100 bps as the Federal Reserve cut interest rates back to zero. While this was a significant reduction in U.S. Treasury yields, the widening of credit spreads was, for most markets, multiples of this decline. This resulted in negative total returns for virtually all fixed income sectors, including areas such as agency mortgages and municipal bonds, which generally would be expected to more closely follow the performance of Treasuries.

Looking ahead at government bond yields, we expect range-bound markets. While the supply of government bonds will likely increase because of expanded fiscal deficits, central bank support should keep interest rates stable. First-quarter fixed income returns were dominated by credit and risk-free allocations, and we expect that dynamic to continue.

Overall, our view is that that the historic widening in credit spreads has created an opportunity unlike any seen in a decade. However, we believe it should be accessed in deliberate fashion in light of ongoing volatility, starting with the best-quality issuers, largely in markets supported by central banks, and then potentially widened out as the path toward economic recovery becomes clearer. The economic environment is not going to be a tailwind for credit, so it is critical to recognize that quality and a focus on markets that are being actively supported by the central banks will likely be key to investment returns.

Timely Interventions

As we noted above, early in the crisis, swift actions by the Fed and other central banks helped stabilize the markets amid a flight to quality. The Fed cut rates to zero, loosened the terms on international dollar swap lines, and committed to unlimited quantitative easing in Treasuries and mortgages. As the quarter progressed, the Fed also provided liquidity to money market mutual funds and introduced a commercial paper facility to address strains on companies' short-term operational financing. Later in the quarter, the Fed introduced new facilities to support investment grade credit and small business lending, and then extended these facilities to include "fallen angels." Finally, in April, it broadened support to midsize companies and municipalities.

Other central banks, some of which were already engaging in quantitative easing programs, also acted. The Bank of England introduced similar measures for the U.K., and the Bank of Japan opened a new, zero-percent lending facility. The European Central Bank came out with a new €750 billion public and private securities purchasing program and pledged to buy high-quality commercial paper.

Crucially, the fiscal response also came swiftly, with extensive support for small businesses and individuals. In the U.S., the $2 trillion U.S. stimulus "CARES Act" included small business loans, tax deferrals, stabilization funds and direct payments to individuals. The U.K. Treasury effectively promised to pay 80% of the wages of any worker furloughed due to the crisis; Germany set out plans to remove constitutional debt limits for a support program worth almost 10% of GDP; and the European Union is seeking to develop a credit facility to help maintain employment. Around the world, countries have been attempting similar fiscal measures.

Economic Fallout and Potential Recovery

In the midst of coronavirus-related slowdowns, whole segments of the global economy have become idle or close to it. With the sharp drop in U.S. private business activity, we anticipate that employment losses in the U.S. will be severe, particularly in the retail and leisure/hospitality sectors, which account for about 21% of the country's economy. They could suffer layoffs in the range of 50 – 75%, while the transportation sector could see job losses of 25 – 50%. All told, the unemployment rate could rise to 25+ million unemployed workers within a very short period (see table below).

PROJECTED JOB LOSSES

	% Range
Government	0 – 0%
Goods	5 – 10%
Trade, Transport & Utilities	35 – 57%
Wholesale Trade	10 – 20%
Retail Trade	**50 – 75%**
Transportation	25 – 50%
Utilities	0 – 0%
Information	10 – 20%
Financial Activities	5 – 10%
Professional & Business	5 – 10%
Education & Health Care	0 – 0%
Leisure & Hospitality	**50 – 75%**
Other	5 – 10%
Total Services	19 – 30%
Total	**14 – 23%**
In MMs of Jobs	21 – 34

Source: Neuberger Berman estimates based on Establishment Survey data as of February 2020 (three months, non-seasonally adjusted). Data could be better or worse depending on the duration of lockdowns and the success of loan and support programs.

Fiscal stimulus will help offset these impacts. The CARES Act has two crucial pillars: (1) small business loans and large corporate programs designed to limit potential unemployment, and (2) an expansion of unemployment benefits to protect incomes. The legislation expands payments by $600 a week, lengthens their duration from 24 to 39 weeks, and extends benefits to gig workers and others who might otherwise not qualify. All told, the CARES Act offers support that we believe could last through May or June, after which more may be needed. At writing, Congress was close to passing additional funding for loans to small companies.

In Europe, although reporting lags the U.S., we expect unemployment to also rise above levels experienced in the global financial crisis. The German auto sector, for example, has been close to a standstill while the service economy is also hurting; in Italy and Spain, the labor market relies on temporary and self-employed workers, many of which are employed at small companies and in hard-hit sectors like tourism.

Existing unemployment schemes should help limit layoffs, and support relatively quick ramp-ups in some countries when production resumes. Recognizing the need of small businesses for swift support, policymakers are looking to establish a loan-based instrument called SURE ("Support to mitigate Unemployment Risks in an Emergency") to enhance financial assistance for workers and job protection. Of course, the longer the lockdown, the more difficult it will be to sustain such measures, while much depends on the degree of funding and burden-sharing across Europe.

Despite this extraordinary monetary and fiscal stimulus, we anticipate significant contractions in U.S. and European growth rates.

In the U.S., our expectation is for a contraction in U.S. GDP for the full year of around 6% and a personal consumption decline of about 6 – 7%. As we move forward, a key issue will be the degree of potential rebound in travel and other severely impacted sectors—whether 85 – 90% (a good outcome) or something less.

Our expectation for Europe in 2020 is an overall contraction of 5 – 6%, while on a global basis the economy will likely contract by 2 – 3%, even as China and parts of Asia reactivate their economies.

Market Conditions and Positioning

While the economic environment will likely remain challenging, central bank policy actions have changed the market environment. Initial illiquidity across sectors including Treasuries has greatly improved due to the speed and extent of central bank intervention. Unlike during the financial crisis, the primary market in investment grade has remained open for business, with high volumes among both financial and nonfinancial issuance. Commercial paper, municipal and even high yield markets have benefited from actual or implied central bank support.

However, it's important to understand the premium that we believe should be placed on available cash and liquidity in assessing credit in the current environment. Prices on many bonds received a bump in the wake of announcements of support measures, but as the effects of the current downturn become better understood, fissures in capital structure and flaws in business model are likely to reveal themselves. Looking more globally, different segments of the emerging world may be affected more by the virus and related economic impacts, depending on the state of their health care systems and solidity of their financial position. In short, it is an environment where research will be especially crucial in credit and security selection.

In terms of positioning, we believe that portfolios should be especially cognizant of risk and maintaining liquidity both to manage volatility and maintain flexibility as conditions improve. We believe a few key themes will be with us for a while and will inform credit market positioning:

- Central bank policy rates will be at zero for the foreseeable future. Unlike the aftermath of 2008 – 2009, there's no doubt about where central bank rates are going: They aren't going anywhere. An extended period of zero rates will increase pressure on investors seeking yield and income.

- Central banks are going to be competing buyers for many credit sectors. We've seen this before in Europe, but it's coming to the U.S. next. The Fed will likely be a competing buyer in investment grade credit and take a certain amount of supply out of the private market.

- Companies will attempt to improve balance sheets, which will be good for bondholders. More liquidity, higher rewards for being investment grade rated, and more conservative leverage levels, are likely outcomes from this period.

- The markets will likely bifurcate between the "haves" (those that have the support of central banks) and the "have nots" (those that will have to navigate a weaker global growth environment without the central bank backstop).

Where does this leave us in terms of portfolio construction? We believe sectors such as agency mortgages, U.S. and European investment grade credit, and municipal bonds are attractive and will see substantially tighter spreads over time as the above themes support them. Other markets, like higher-quality non-investment grade investments, higher-quality emerging markets, and short-duration fixed income strategies should also be supported. But the general outline of navigating a weaker economic environment with heavy central bank involvement in markets will remain in place for an extended period of time.

In terms of what future credit market returns may look like, a review of historical market performance may provide some perspective (see table below). Drawing on available historical data for investment grade credit, high yield and emerging markets sovereign debt, we looked at one-year performance of these asset classes after significant spread-widening. For all these asset classes, we found that they generally provided significant gains over the subsequent year.

Looking Ahead

Markets are likely to remain turbulent for much of 2020 as investors assess the path out of the coronavirus pandemic, the extent of lasting economic consequences and the potential impacts that liquidity infusions may carry across asset classes. With the November election approaching, the change in climate is likely to influence not only the outcome, but the course of public policy, the level of taxation and the degree of government involvement in the private economy.

There's a lot we don't know about the future. It is often easy to overestimate structural changes in this kind of environment and underestimate the chances that the world simply returns to "normal." However, we do suspect that we are going to enter a period of change. Spending patterns, corporate balance sheet management, and working arrangements in homes and offices are but just a few examples of areas where we are likely to see change. The next few years are going to require more investment flexibility and tactical adjustments as we navigate a post-virus world.

However, for the near term, we believe investors should remain focused on two somewhat conflicting key ideas: that economic growth will remain relatively weak and create challenges for pockets of the credit markets, and that broad-based central bank support for credit markets will be a powerful force. The combination of these two ideas leaves us focused on high-quality fixed income investments, which in our view have substantial upside even after the recent retracement in markets. A world of zero yields will ultimately drive investors toward quality investments that are supported by global central banks.

MARKET RETURNS AFTER SPREAD-WIDENING

IG Credit

Historical 1-Year Performance After Spreads Widened to 200+ Basis Points
(3/31 OAS: +255 bps)

1-Yr. Total Returns	Bloomberg Barclays U.S. Credit Index
Average	10.2%
Median	10.3%
High	27.6%
Low	-6.1%
Positive	18
Negative	4

High Yield

Historical 1-Year Performance After Spreads Widened to 900+ Basis Points
(3/31 OAS: +950 bps)

1-Yr. Total Returns	JPM Domestic High Yield Index
Average	34.7%
Median	36.9%
High	61.4%
Low	0.5%
Positive	25
Negative	0

EM Sovereign

Historical 1-Year Performance After Spreads Widened to 500+ Basis Points
(3/31 OAS: +627 bps)

1-Yr. Total Returns	JPM EMBI Global Diversified Index
Average	20.8%
Median	21.3%
High	41.6%
Low	3.3%
Positive	31
Negative	0

Source: JPM High-Yield and Leveraged Loan Morning Intelligence, Bloomberg Barclays, JPMorgan, Neuberger Berman (NB calculating forward return statistics for IG Credit and Emerging Markets Debt). Data as of March 31, 2020. U.S. High Yield bond performance is measured by the J.P. Morgan Domestic High Yield Index for the period January 1987 to present; IG Credit performance is measured by the Bloomberg Barclays U.S. Credit Index for the period January 2001 to present, and EM Sovereign performance is measured by the J.P. Morgan EMBI Global Diversified Index for the period January 2002 to present. "Positive" and "Negative" reflect the number of historical observations in which the index went on to generate a positive / negative 1-year return. Indices are unmanaged and are not available for direct investments. **Past performance is not necessarily indicative of future results.**

Market Views

Next 12 Months

	UNDER −−	−	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	○	○ →	●	○	○	Economic weakness, 0% short rates and massive liquidity infusion are likely to keep rates low across the curve.
United Kingdom	○	○	●	○	○	
Germany	○ →		●	○	○	Relatively strong fiscal position coming into COVID-19, with large social programs to maintain incomes; negative yields provide little reward but are unlikely to move higher given economic slowdown.
France	○	○ →	●	○	○	Room to expand economic stimulus, though positive impacts should be balanced against long-term effect on the fiscal deficit; ECB remains supportive.
Italy	○	○	○	●	○	
Spain	○	○	○	●	○	
Japan	○	○ →	●	○	○	Already weak backdrop worsened by virus; rebound in external demand looks unlikely and the Olympics have been postponed; environment and monetary intervention should cap any rise in rates.
Canada	○	○	●	○	○	
New Zealand	○	○	●	○	○	
Australia	○	○	○	●	○	
U.S. TIPS	○	○	○	●	○	
INVESTMENT GRADE SECTOR						
U.S. Agencies	○	○	●	○	○	
U.S. Agency MBS	○	○	○ →	●	○	Significant Fed purchases and near-term challenges to refinancing should drive tighter valuations.
U.S. CMBS	○	○	●	← ○	○	Liquidity remains challenged given lack of financial intermediation; market is reassessing fundamental expectations, particularly in consumer and energy; Fed support for some sectors should help prices.
U.S. ABS	○	○ →	●	○	○	With COVID-19 impacting the consumer, asset-backed cash flows may be vulnerable; low rates translate into low absolute yields.
U.S. Mortgage Credit	○	○	○	●	○	
U.S. Credit	○	○	○	○ →	●	Widening of credit spreads has been historic and indiscriminate; gradual expansion of overweight appears warranted.
Europe Credit	○	○	○ →		●	With fiscal and monetary support, higher-rated credits are generally well positioned, even with uncertain timeline toward normalcy.
U.K. Credit	○	○ →		●	○	Large fiscal package should bring U.K. credits through the early stages of the crisis; yield levels appear favorable relative to risk; Bank of England is also supporting the market.
Hybrid Financial Capital	○	○	○	●	○	
Municipals	○	○ →		●	○	Unprecedented decline in high-quality sector has led to significant value relative to Treasuries; selectivity is crucial given municipal revenue pressures.

	UNDER −−	−	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
HIGH YIELD & EMERGING MARKETS						
U.S. Full-Market High Yield	○	○	○	●	○	
U.S. Short-Duration High Yield	○	○	○	●	○	
Pan-Euro High Yield	○	○	○ →	●	○	Widened credit spreads should provide an attractive opportunity, with a focus on cash flows needed to survive the downturn.
Floating-Rate Loans	○	○	○	●	← ○	Price declines have improved valuations but elevated risk requires care in security selection.
U.S. CLO	○	○	○	●	○	
EM Hard-Currency Sovereigns	○	○	○	●	○	
EM Hard-Currency Corporates	○	○	●	○	○	
EM Hard-Currency Short Duration	○	○	●	○	○	
EM Local-Currency Sovereigns	○	○	○	●	○	
CURRENCY*						
U.S. Dollar	○	●	← ○	○	○	More overvalued with COVID-19 crisis based on PPP metrics; Fed will remain accommodative; recent drop in rates should weaken dollar if sustained when risk appetite normalizes.
Euro	○	●	○	○	○	
Pound	○	○	○ →	●	○	Undervalued with crisis, now back to Brexit-referendum lows vs. U.S. dollar; U.K. budget is expected to be stimulative for real economy.
Yen	○	○	○	●	○	
Swiss Franc	○	●	○	○	○	
Australian Dollar	○	○	○ →	●	○	Improved Asian sentiment/activity; Chinese infrastructure spending has helped with terms of trade; Australian policy coordination bodes well; AAA rated sovereign with ample fiscal capacity.
Swedish Krona	○	○	○ →	●	○	Valuation excessively discounts economic weakness; attractive based on PPP; generous welfare state can support incomes while strong fiscal position should allow further stimulus.
Norwegian Krone	○	○	○	●	○	
Canadian Dollar	○	●	○	○	○	
Mexican Peso	○	○	○ →	●	○	Very attractive valuation caused by significant unwinding of long positions during COVID-19 crisis.
Brazilian Real	○	○	○	○	●	
Chinese Yuan	○	○	●	○	○	
Russian Ruble	○	○ →	→	●	○	Prudent policies have created strong external buffers; impact of oil volatility limited by regulation; valuation is attractive.
Turkish Lira	●	← ○	○	○	○	Little effort made to tackle structural economic weakness; reserves have declined to negative levels; high corporate FX, dwindling buffers, currency flows and tourism slowdown affect outlook.

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*Currency views are based on spot rates, including carry.

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The Neuberger Berman Fixed Income Investment Strategy Committee consists of 17 of our most senior investment professionals who meet monthly to share views on their respective sectors to inform the asset allocation decisions made for our multi-sector strategies. The group covers the full range of fixed income combining deep investment knowledge with an average of 27 years of experience.

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