NEUBERGER BERMAN

Fixed Income Investment Outlook 3Q 2021

Course Correction or Policy Framework Change?

Faced with higher inflation numbers, the Federal Reserve has begun to create more meaningful parameters around its evolving stance on monetary policy. Although the changes could be less dramatic than many expect, we believe that investors should be prepared for higher market volatility and an upward bias on interest rates, even as an environment of strong economic recovery supports tight credit spreads. We outline our views in this report.

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Investment Implications

- At its June meeting, the Federal Reserve implied that the period in which it will allow inflation to run "hot" under its average inflation targeting policy may be shorter than expected.
- Market volatility is likely to rise, with wider ranges in rates and credit spreads as markets manage the transition away from ultra-accommodative policy. Markets could be more responsive to the economic data that could impact Fed policy.
- The probability of "right-tail" economic outcomes has been reduced, with the Fed signaling that an extended period of 3.5%+ inflation rates is not desirable.
- We expect a continued range-bound environment, with upward bias in interest rates reflecting a durable global economic recovery.
- The underlying drivers of tight credit spreads, strong economic growth and low default rates are unlikely to be materially impacted by the evolving central bank landscape.

Course Correction or Policy Framework Change?

In the day-to-day task of investing, it's often easy to ascribe significance to individual central bank meetings, speeches or policy pronouncements that, with a bit more time, simply blur into background static. We've written previously about the importance of separating the "signal" from the "noise" of markets. Our suspicion is that the Federal Reserve meeting of June 16, which engendered sharp moves in interest rate and inflation markets, will ultimately be viewed as more "noise" than "signal." However, we see a few key implications for fixed income investors, particularly as we enter the second half of 2021.

It's important to first review where we've come from. Over the past 12 – 18 months, the Fed has been, with increasing clarity, vocalizing a new framework with which to conduct policy. The central bank's goals haven't changed—full employment and low inflation—but the framework to achieve them has morphed.

Since at least the global financial crisis, the Fed's framework was to rely on changes in unemployment to guide policy, based on the idea that these changes would ultimately feed into inflation. The new framework, formally adopted in August 2020, emphasized inflation directly. Under the moniker of Flexible Average Inflation Targeting (or Average Inflation Targeting), the Fed promised to conduct policy to achieve its 2% inflation goal over time. The key implication for investors was that the Fed would tolerate and even encourage periods of above-2% inflation in order to achieve a longer-term goal of "average" 2% inflation.

Enter the June 16 meeting, which occurred against a backdrop of two key economic developments: Employment growth in the U.S. has been relatively disappointing despite the reopening of the economy, and wages and inflation rates have surprised to the upside. For the Fed, this is a challenging mix. An important factor contributing to weaker employment growth has been the demographic effect: Workers age 55 and over, who supplied millions of jobs after the global financial crisis, have returned sparingly to the labor force, and some may not ever do so given aging and changing life choices post-COVID, which has contributed to higher wage pressures. At the same time, inflation has surprised higher. As highlighted in the following display, core CPI (year-over-year) through May is at 3.8%, well above the Fed's objectives. For investors and the Fed, it is unknown whether this is a new equilibrium, with weaker employment growth that feeds into higher wages and higher inflation.

INFLATION HAS MOVED SHARPLY HIGHER

Core CPI and Components

Source: Bloomberg.

The Fed's response at the meeting was to message that the period in which it will allow inflation to run "hot"—the new policy under average inflation targeting—may be shorter than market expectations. Said another way, the combination of actual inflation, and employment and wage developments, seems to have prompted a bit of Fed re-think about the appropriateness of zero rates and $120 billion in monthly bond purchases.

Before digging into the impacts for various fixed income asset classes, we have four overarching conclusions from this Fed meeting.

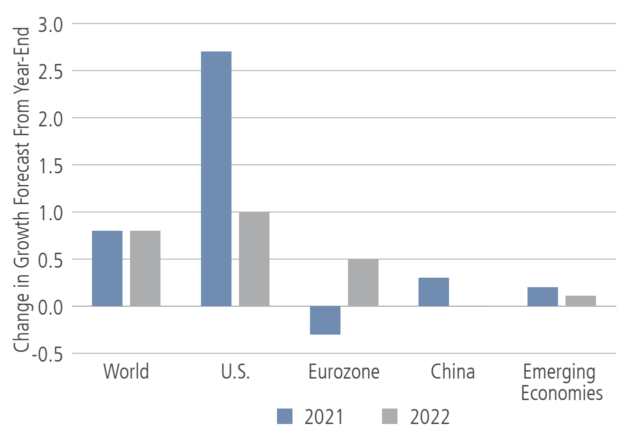
First, market volatility is likely to rise, which is our core view for the rest of the year. Previously, we expected tapering and changing policies from the Fed and ECB in the second half of 2021, and see no reason to change this view. That said, monetary policy isn't likely to be the same as 18 months ago, and, even with perfect central bank communication and foresight, the markets will need to adjust to less monetary accommodation. We expect wider ranges in rates and credit spreads as markets manage the transition away from ultra-accommodative monetary policies.

Second, markets are going to be more responsive to actual economic data. We interpret the Fed's messaging at this meeting not as an abandonment of average inflation targeting, but as a guide to how this policy will be practically implemented. Significant developments, either to the upside or downside in growth and inflation, will impact the trajectory of Fed policy. Movements in interest rates and the yield curve since the Fed meeting could easily be reversed if weakness in growth and inflation develops.

Third, the probability of "right-tail" economic outcomes has been reduced. One implication of the Fed's message is that an extended period of 3.5%+ inflation rates is not desirable. Investing for long periods of significantly above 2% inflation will likely not make sense as the Fed has defined its threshold for accommodating higher inflation rates, even against a backdrop of the average inflation targeting framework. That said, this Fed meeting should be viewed as offering some practical guidance for investors in interpreting the new policy framework, but not as an abandonment of this policy.

LED BY THE U.S., GLOBAL GROWTH EXPECTATIONS HAVE ACCELERATED

Percentage Points



Source: Bloomberg. Consensus growth estimates as of June 22, 2021.

Finally, when the Fed eventually starts its liftoff of rates, depending on the level and path of inflation, the pace could be steeper than current expectations. The rapid shift at this meeting is a subtle indication that the Fed will not hesitate to employ aggressive monetary policy adjustments if there are strong signs of significant upside risk to the inflation outlook.

So where does that leave us for investing and positioning into the second half of the year? Our views across multiple parameters are as follows:

- **U.S. interest rates:** We expect a continued range-bound environment, with upward bias in interest rates reflecting a durable global economic recovery. For U.S. 10-year Treasury rates, we do not expect much movement outside 1.40% – 2.00%, and remain biased toward modestly higher rates as both U.S. real rates and inflation rates move higher.

- **U.S. inflation breakevens:** U.S. 10-year breakevens are likely to trade in a tighter, 2.20% – 2.50% range. If there is one likely durable conclusion from this Fed meeting, it is that the odds the Fed will tolerate a more structural move higher in inflation rates are quite low.

- **Credit spreads:** The underlying drivers of tight credit spreads, strong economic growth and low default rates are unlikely to be materially impacted by the evolving central bank landscape. We anticipate minimal spillover to spreads, and expect credit and securitized markets to remain at relatively tight spreads.

While the changing Federal Reserve narrative was the main event of the second quarter, the third quarter should also be a turning point (albeit slightly differently) for the Eurozone, as activity normalizes. European service sectors have been reopening step by step as the pandemic has been brought under control. In addition, from July, the Euro Recovery Fund will start to distribute "grants" to individual countries, supporting capital expenditure for the coming quarters.

In such a context, the European Central Bank will have the objective of maintaining the decoupling of euro bonds from global bonds. Moreover, it will not let financial conditions tighten prematurely. The periphery is still fragile, and, to fund domestic public expenses, needs ECB support through the Pandemic Emergency Purchase Programme (PEPP).

Thus, the ECB has introduced new flexibility in its bond-buying program for the third quarter. It has committed to buying a significantly higher amount compared to the first quarter, but not the second—meaning that if market conditions are reasonable, it could reduce its buys versus Q2 by €5 – 10 billion per month. This should enable a smooth start to PEPP tapering, which could be justified later with the first signs of inflation acceleration in Northern Europe. More immediately, the pace of purchases will likely be reduced given lower issuance from governments.

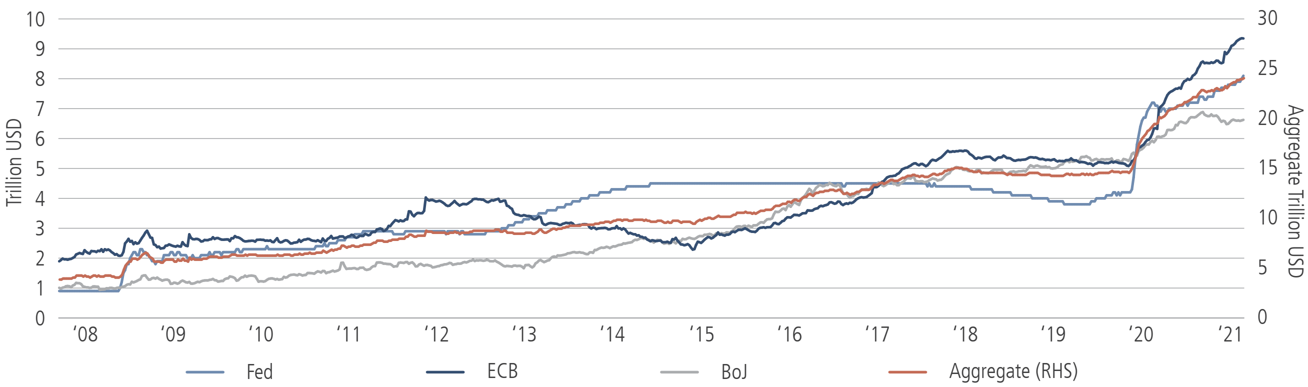
Recent ECB forecasts have supported optimism on the economy, increasing projected GDP from 4% to 4.6% for 2021, which we believe could push the Bund yield close to 0% in the third quarter, with some volatility in periphery spreads. In our view, the ECB's September forecasts should show more acceleration, leading the central bank to schedule the end of the PEPP for March 2022.

Overall, similar to the Federal Reserve, a policy transition is beginning, but we expect the ECB to actively manage any market spillover from the Fed's shift as conditions in the Eurozone continue to warrant a more aggressive easy policy stance.

In Asia, the People's Bank of China will likely maintain its largely neutral stance. While economic growth is almost certain to achieve the conservative targets set for this year, the lack of buoyancy in consumer spending and persistently benign CPI should prevent any significant hawkish tilt in policy settings.

China's policy stance is geared toward stabilizing leverage, which was ramped up last year in response to the pandemic, while the intent is to gradually bring down credit growth to a level in line with nominal GDP growth; however, this will likely be achieved through targeted and macro-prudential measures rather than broad-based tightening, and is already feeding through via deleveraging in the property sector and in a reduction in shadow credit. A recent increase in credit concerns around a few high-profile issuers should also result in liquidity being kept "reasonably ample" and funding rates being maintained in a comfortable range. Toward the fourth quarter, we expect policy-tightening in specific sectors (focused on real estate and environmental concerns) to have a moderating impact on growth. However, this is unlikely to be enough to result in a material policy easing.

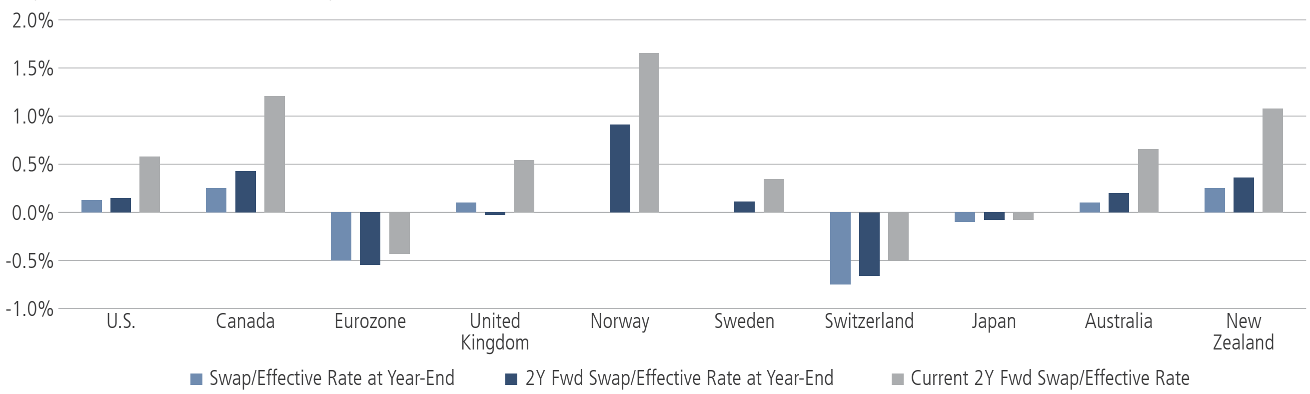
COULD CENTRAL BANK BALANCE SHEETS BE NEARING A PEAK?



Source: Bloomberg. Data as of June 16, 2021. ECB and Bank of Japan balances converted to U.S. dollars in each period using average price.

DEVELOPED MARKETS: EXPECTATIONS HAVE INCREASED FOR FUTURE RATE HIKES

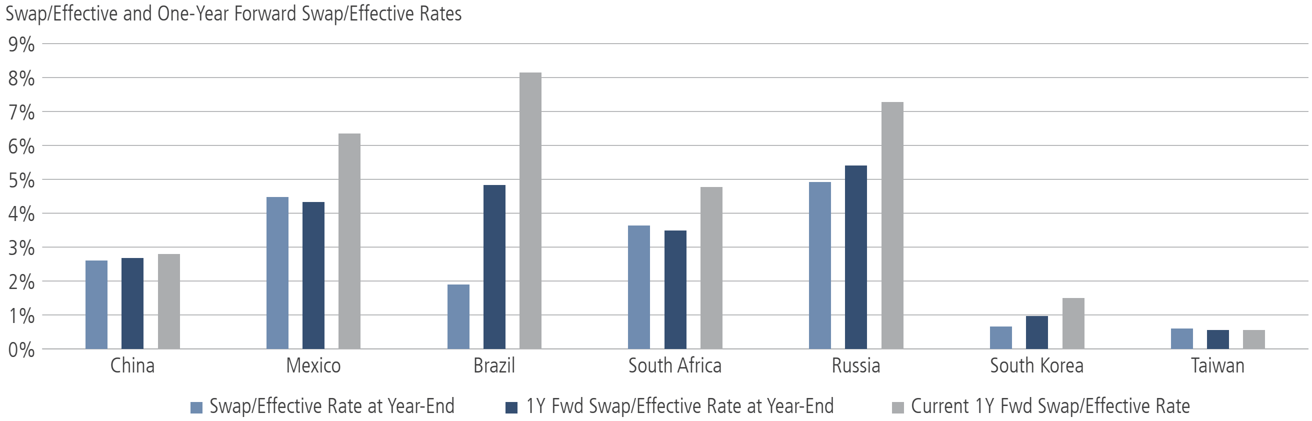
Swap/Effective and Two-Year Forward Swap/Effective Rates



Source: Bloomberg. As of year-end 2020 and June 18, 2021.

EMERGING MARKETS: LESS WAIT ANTICIPATED FOR RATE INCREASES

Swap/Effective and One-Year Forward Swap/Effective Rates



Source: Bloomberg. As of year-end 2020 and June 18, 2021.

Fixed Income Asset Class Overviews

Global Investment Grade: Strong Technicals, Valuation Challenge

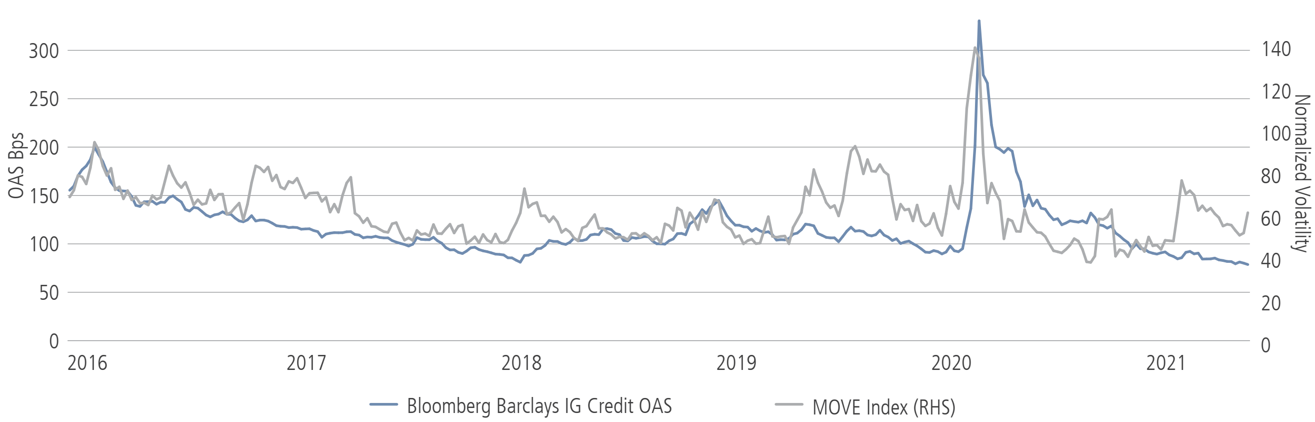
Investment grade credit has been on a steady path of tighter and tighter spreads over the course of the year. Strong technicals and improving fundamentals have been a consistent support for the asset class, even as valuations have become more challenging. In the U.S, spreads are about 15 basis points (bps) tighter while spreads in Europe are about 10bps tighter. Higher beta/yield credits and sectors have generally outperformed with the theme of economic reopening. BBB industrials associated with travel or consumer spending have led over the past six months. Supply has remained robust after record levels in 2020, but the pace of issuance has recently slowed, which should help keep technicals strong.

In our view, the third quarter will find credit markets dealing with shifting winds after what have been consistent tailwinds so far this year. We are confident that fundamentals will continue to improve, and our research team believes that in 12 months credit metrics will likely be stronger in aggregate than today. Improved cash flows due to economic activity combined with some deleveraging should keep the positive economic story rolling along. The supply side of the technical picture should also remain positive for spreads. Many companies have already brought forward their issuance this year on concerns that easy monetary policies would diminish. This should result in reduced issuance in the latter part of the year. Strong demand is a little more in question on the technical side, but U.S. credit in particular should continue to be supported by foreign buying, which remains at a high level due to relatively low hedging cost. The result of low hedging costs is an attractive all-in yield to foreign buyers of U.S. credit. The clear concern to the demand side of the picture is valuations. Spread levels globally today are at valuations that are tighter than we saw in January of 2020, before the COVID pandemic was impacting markets. Further spread-tightening will be a constant tension for the second half of the year between improving fundamentals and strong technicals versus tight valuations.

One of the clear challenges to continued spread tightening in general this year will be the changing narrative around monetary policy. A risk that is more specific to investment grade credit is event risk for individual credits that may be looking to be more aggressive with their business or financial risk profile in the midst of economic reopening. With low interest rates globally, tight spreads with strong credit demand, and high equity valuations, particularly in some sectors like technology, we should see more idiosyncratic risk. This may manifest in various ways: A leveraging merger, an LBO or a significant share repurchase can all result in downgrades for currently strong balance sheets. While we expect an increase in such activity in the latter half of 2021, it does not need to be the precursor for wider spreads.

Somewhat paradoxically, spreads may continue to tighten even as these events occur—because aggressive corporate behavior often coincides with strong capital markets. That said, individual credits may experience downgrades and/or spread-widening. We therefore believe that reducing such risks may be advisable here, particularly by shifting exposures from industrials to financials. In our view, solid banks with stable business models and strong balance sheets are relatively defensive in this environment compared to single A rated industrials that may be looking to take on a BBB risk profile. Importantly, such portfolio changes can typically be executed without sacrificing yield.

WITH STRONG FUNDAMENTALS, IG SPREADS HAVE BEEN DECORRELATING FROM U.S. TREASURY VOLATILITY



Source: Bloomberg. Data as of June 18, 2021.

Global Non-Investment Grade: 'Taper Talk' Could Yield Opportunity

Among its implications, the Fed's likely policy shift could affect its purchase of non-investment grade credit, specifically high yield ETFs and "fallen angels." However, while impactful in April and May of 2020, the program now represents a very small percentage of total daily volume, so we see its unwinding of liquidity support for high yield as having minimal to no effect. If anything, we would view volatility spurred on by more "taper talk" as an opportunity to invest in credits at attractive valuations. Moreover, non-investment grade credit has generally performed well in prior periods of rising inflation and steepening yield curves—with recent strong performance of high yield, loans and CLOs suggesting that this continues to be the case.

Indeed, many high yield and loan issuers would actually benefit from improved pricing power and rising commodity prices as most have the ability to pass along price increases to buyers, especially given improvements to productivity and innovation brought about by coping with a pandemic. Also, the current economic environment and credit conditions are very favorable for non-investment grade credit, which offers a low-cost hedge against inflation, attractive relative yields, broad diversification across sectors and themes, and issuers geared to improving economic growth and pricing power.

Spreads in both U.S. and European high yield have compressed year-to-date (-67bps and -61bps, respectively) and the weighted-average bid prices of loans in both markets are now back to 2018 levels. In our view, valuations in high yield and loans reflect a very benign default outlook, which is a function of improving fundamentals and issuers' ability to refinance at lower rates. In fact, the year-to-date default rate is 0.2%, or an annualized rate of 0.5%, which would be a historical low. Also, current yields on high yield and loans suggest that investors could be overestimating default rates. High yield net leverage is dropping and is expected to settle out in the bottom quartile historically, and interest coverage on the index is near a record high. Loans' EBITDA growth is also firmly positive, and balance sheets overall are in good shape. Credit conditions are generally supportive of the tighter credit spreads and, in high yield, the share of BBs is at or near an all-time high of 53% of total outstanding.

Sectors and issuers that have seen much tighter spreads and strong returns year-to-date include those geared to reopening and improving economic growth, such as Entertainment/Leisure, Energy, Gas Distribution, Air Transport, Metals/Mining and Retail. While many of these sectors have performed well so far this year, we believe tighter credit spreads on the overall credit markets and within sectors call for active management to uncover idiosyncratic opportunities.

The durable income generation, much lower duration and inflation-hedging nature of non-investment grade credit could be beneficial features in a low-yield environment with rising inflation and stronger growth ahead. Loans are well positioned to benefit from "the search for yield," high relative yields given minimal duration, and the fact that they are floating rate. While absolute yield levels in global high yield markets are low compared to history, the increased share of higher-quality credits in high yield and the fact that we are starting a new credit cycle are important to keep in mind when thinking about spreads and yield levels. Further, the potential for spread compression remains as investor demand for lower duration yield persists.

Emerging Markets: Value Across Multiple Segments

After ending the first quarter largely unchanged, hard currency sovereign spreads tightened by around 25bps in the second quarter, bringing the aggregate spread of the EMBI Global Diversified Index to 330bps.

Notably, as the large upward move in U.S. Treasury rates that peaked in late March coincided with a shift of improving cyclical fundamentals across many emerging economies, the spread rally was dominated by high yield sovereigns, which saw spreads compress 60bps over the second quarter, while the investment grade universe remained effectively flat. As we assess first-half returns, which are essentially captured by the outcome of the second quarter, high yield sovereigns benefited not only from the disproportionately higher risk premium embedded in their spreads coming into 2021 relative to investment grade, but also on account of their lower duration profile, which helped keep yields unchanged in a rising-rate environment.

Emerging market corporate spreads generally mimicked the behavior of their sovereign peers, with high yield corporates outperforming investment grade names, but within narrower ranges than in sovereigns. From a bottom-up perspective, with only a few exceptions, lower-quality high yield sovereigns tightened the most, while within corporates, there were no significant outliers across sectors other than in transport, where spreads now sit wider for the year versus tighter for the rest of the sectors. In local currency markets, upward pressure in yields remained during the second quarter, across regions except Asia, albeit at a less abrupt pace. Emerging market FX returns, however, were largely positive, unwinding the losses experienced in the first quarter.

Notwithstanding COVID-related challenges, which unfortunately remain acute in many countries across the emerging world, economies have proven to be surprisingly resilient, and unlike in 2020, they are now aided by the strong rebound in growth across developed markets and China. Growing demand for commodities, and higher commodity prices, have lifted export revenues for economies in Latin America, Africa, the Middle

East and Eastern Europe, while Asia has continued to benefit from growing demand for manufactured products in the U.S. and Europe. On the domestic front, while a full reopening across sectors has only been achieved by a very few countries, loose fiscal and monetary conditions have kept domestic consumption afloat.

As we expect vaccinations to be ramped up meaningfully in the second half of 2021 across the emerging world, we also expect growth dynamics to improve more meaningfully later in the year, effectively propelling economic growth rates to match if not exceed those in developed economies. In this scenario, where fundamental prospects for the balance of the year become more constructive for emerging markets, we believe spreads should continue to grind lower, potentially recovering fully to pre-COVID levels, or equivalent to another 30-40bps of tightening. In turn, not unlike in the second quarter, performance should continue to be led by higher-yielding sovereigns, where there remains plenty of scope for recovery after the extreme correction experienced in 2020.

In emerging corporates, on the other hand, we see fairly limited potential for further tightening of spreads, as improved fundamentals and low expected defaults have led to a recovery to pre-pandemic levels.

Regarding local markets, higher-yielding local rates are now trading in deeply positive real-rate territory as both inflation concerns and risk premia related to fiscal deterioration and political uncertainty (or both) have, in several cases, pushed up forwards market nominal rates into the high single digits. In addition, several emerging market central banks have already pivoted into monetary tightening cycles, leading to higher policy rates but also steeper curves.

For emerging market FX, the upshot of higher rates is that currencies are better supported. The combination of higher local rates coupled with stronger growth prospects, elevated commodity prices and still largely undervalued levels indicates that there remains meaningful scope for appreciation.

The Fed's transition toward removing the existing extraordinarily easy financial conditions is likely to become the biggest test for emerging market assets for the balance of 2021, and could be a risk for currencies, especially as higher front-end U.S. Treasury rates could trigger a U.S. dollar rebound. Broadly speaking, however, emerging economies are less vulnerable (lower external funding needs, competitive exchange rates) and in better condition, in terms of investor exposure and levels, than during many previous periods of Fed-induced policy volatility.

Municipals: Looking to Higher-Yielding Credits

The municipal bond market has experienced strong year-to-date spread tightening, as multiple factors have converged to lift overall risk appetite. Thus far, mutual fund inflows are on a record pace.

The credit environment has improved dramatically given the strong economic growth over the past three quarters, which resulted from the rapid reopening of the economy and the success of vaccine rollouts. As an example of the impact, the State of California has a $75 billion surplus in the current fiscal year. Municipals have also benefitted from a significant amount of fiscal support as the federal stimulus package in March had roughly $570 billion allocated to the major sectors of the muni market. Finally, fear of higher taxes and undersupply of tax-exempt bonds have pushed AAA municipals to unprecedented levels and, in turn, forced some investors to go lower in quality in the search for yield.

Although a rising tide lifts all boats, we are careful not to assume this is the case with municipal bonds. Issuers will not benefit equally from the stimulus or the reopening economy and we need to discriminate in our security selections. The most pronounced spread-tightening has occurred in "COVID recovery" trades like the New York metro area's MTA and the State of Illinois, which were battered at the height of the pandemic but more recently have drawn strong investor interest. From a sector standpoint, investments focused on economic recovery like airports, hospitals and other transportation-related credits have been some of the strongest performers so far this year.

Looking ahead, we remain constructive on lower-rated credits as income and yield will continue to be in demand. However, the type of spread compression and associated price appreciation we have seen year-to-date is unlikely to continue. Against a backdrop of stronger economic growth and good technicals, we believe bonds with excess spread can continue to deliver outperformance relative to the higher-rated parts of the municipal bond market.

One risk we are focusing on is uncertainty around the timing of Fed tapering. The municipal market is predominantly held by individuals, either through direct purchases or participation in mutual funds. Previous muni market sell-offs have mostly been triggered by an increase in interest rates and not credit concerns. Should the Fed's communication around potential tightening of monetary policy cause an unexpected jump in rates, it is possible that recent muni inflows driven by individual investors could turn negative and pressure the overall market.

Market Views

Next 12 Months

	UNDER −−	−	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	○	●	○	○	○	Although likely to moderate, Inflation could create upward bias in rates; low yields provide minimal return offset
United Kingdom	○	●	○	○	○	Hawkish central bank stance creating near-term headwinds for bond holders; lingering virus and Brexit risks
Germany	○	●	○	○	○	
France	○	●	○	○	○	
Italy	○	○	●	○	○	
Spain	○	○	●	○	○	
Japan	○	●	○	○	○	
Canada	○	○	●	○	○	
New Zealand	○	○	●	○	○	Lower rates and financial accommodation have reduced relative appeal; limited COVID restrictions could speed recovery
Australia	○	○	○	●	○	
U.S. TIPS	○	○	○	●	○	
INVESTMENT GRADE SECTOR						
U.S. Agencies	○	○	●	○	○	
U.S. Agency MBS	○	●	○	○	○	Heightened interest rate volatility with taper risk could reduce the appeal of MBS in the near term
U.S. CMBS	○	○	●	○	○	
U.S. ABS	○	○	●	○	○	
U.S. Mortgage Credit	○	○	●	○	○	Mortgage credit fundamentals are sound, but after meaningful tightening spread appreciation potential is limited
U.S. Credit	○	○	○	●	○	
Europe Credit	○	○	○	●	○	
U.K. Credit	○	○	○	●	○	
Hybrid Financial Capital	○	○	○	●	○	
Municipals	○	○	●	○	○	Strong performance tied to fiscal/monetary support and financial recovery has moderated market-level return potential

	UNDER −−	−	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
HIGH YIELD & EMERGING MARKETS						
U.S. Full-Market High Yield	○	○	○	●	○	Rally in non-investment grade has narrowed spreads, although strong fundamentals should prove supportive from here
U.S. Short-Duration High Yield	○	○	○	●	○	
Pan-Euro High Yield	○	○	○	●	○	
Floating-Rate Loans	○	○	○	●	○	
U.S. CLO	○	○	○	○	●	
EM Hard-Currency Sovereigns	○	○	○	●	○	
EM Hard-Currency Corporates	○	○	●	○	○	
EM Hard-Currency Short Duration	○	○	○	●	○	
EM Local-Currency Sovereigns	○	○	○	●	○	
CURRENCY*						
U.S. Dollar	○	●	○	○	○	
Euro	○	○	●	○	○	
Pound	○	○	●	○	○	
Yen	○	○	○	●	○	
Swiss Franc	○	●	○	○	○	
Australian Dollar	○	○	●	○	○	Despite the surge in commodity prices, the Australian dollar has corrected lower, creating a value opportunity
Swedish Krona	○	○	●	○	○	
Norwegian Krone	○	○	○	●	○	
Canadian Dollar	○	●	○	○	○	Valuations appear to overstate good news on recovery and commodities; long trade may be too crowded
Mexican Peso	○	○	○	●	○	
Brazilian Real	○	○	○	●	○	
Chinese Yuan	○	○	●	○	○	
Russian Ruble	○	○	○	●	○	A strong pick-up in growth, supportive terms of trade and a hawkish central bank all point to a stronger ruble
Turkish Lira	○	●	○	○	○	

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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 multisector strategies. The group covers the full range of fixed income, combining deep investment knowledge with an average of 29 years of experience.

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