



NEUBERGER BERMAN

Fixed Income Investment Outlook 4Q 2022

Policy Stays in the Crosshairs

Despite volatility, the basic storyline of inflation and the Federal Reserve should continue to drive market behavior. Over the months ahead, we anticipate continued tightening by the Fed and challenging European growth trends, with tail risks tied to the U.K., China weakness and policy overreach. A focus on shorter durations and quality, with opportunistic exposure to longer bonds and credit, merits consideration.

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Policy Stays in the Crosshairs

For the most part, 2022 has unfolded largely on script, with inflation proving stubborn and the Federal Reserve seeking to cut off the spigot. The debate and volatility has largely been regarding the degree to which the Fed will go in terms of the elevation and timing of its terminal rate to achieve its goals, and how this could affect growth rates. New dynamics have recently made the storyline more complicated, with the U.K. government's move to debt-heavy stimulus even as the Bank of England pledges it will not hesitate to raise interest rates; the potential for energy shortages in Europe this winter; and uncertainty around the trajectory of China's growth given COVID lockdowns.

In this publication, we highlight five key observations that inform our outlook. For our high-level views on market sectors, see the table on page 7.

1. With Stubborn Inflation, the Fed Remains Tight

U.S. inflation surprised on the upside in the September report. Although headline CPI eased from 8.5% the previous month to 8.3%, core inflation moved up to 6.3%. Although we continue to have conviction that U.S. inflation will head lower for much of next year, it will take continued effort by the Federal Reserve.

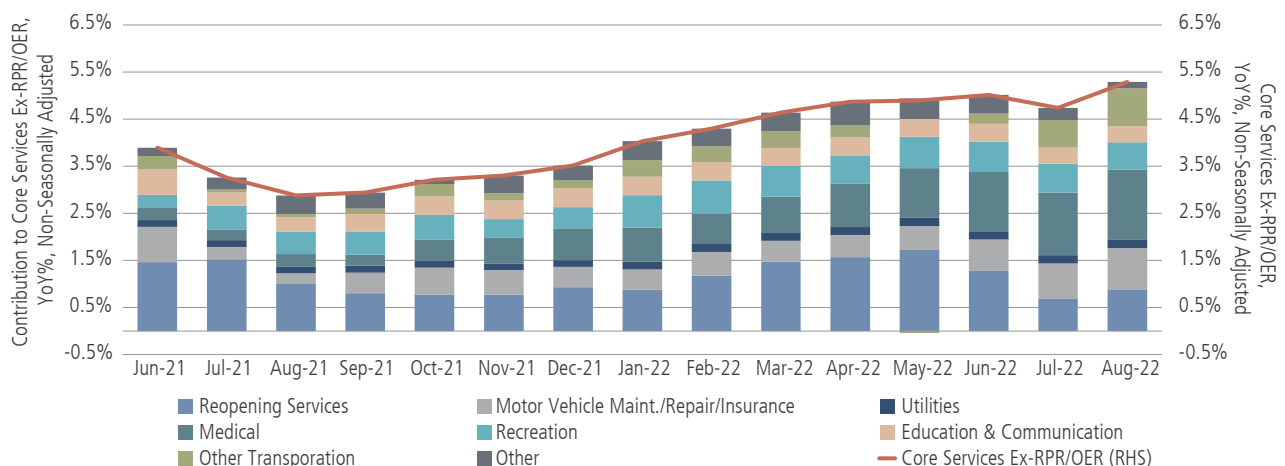
If we take a closer look at inflation trends, we find that while goods prices have softened and will likely decelerate further from here, we believe that shelter inflation is likely to stay elevated, with rents contributing strongly to Core CPI. In the automobile categories, higher vehicle prices are helping to drive up related fees, such as the cost of insurance, which may be relatively slow to decline. More broadly, wages are an ongoing upward pressure on prices, which seems unlikely to dissipate. Pandemic-related issues have impacted labor market supply, as have aging demographics and reduced legal immigration, along with continued strong business formation. The impact of wages is visible, for example, in medical care services, which are largely wage-dependent given the way compensation and pricing are structured.

In terms of policy, early in the tightening process, the Fed seemed relatively focused on CPI, but now seems likely to pivot back to Core, its traditional focus. In our view, the Fed is likely to be particularly conservative in leaving rates higher for longer in order to avoid a “double-dip” rise, as occurred in the 1970s. It will likely look for a convincing decline in inflation before starting to cut rates.

In our base scenario (a 70% probability), we assume that monetary policy will normalize as the Fed’s dual mandate goals are achieved. As part of this process, the central bank is likely to look to maintain rates “higher for longer” in restrictive territory with terminal rates of around 4.5 – 5.0%. Overall, policy rate hikes and balance sheet adjustments would drive nominal and real yields higher while inflation expectations remained stable. In this scenario, we would assume 10-year U.S. Treasury yields of 3.5 – 4%.

U.S. INFLATION DYNAMICS: CORE SERVICES INFLATION IS NOT DECLINING

We see little relief in non-rent categories in core services, with medical inflation a key issue.



Source: Bloomberg. As of August 2022. Neuberger Berman calculations on Core Services ex-RPR/OER as well as contributions. Reopening Services includes Lodging Away From Home, Car and Truck Rental and Airfares.

2. European Growth Remains a Key Concern

Europe is facing several quarters of growth uncertainty, largely driven by the energy picture. The specter of a potential cutoff in energy supply from Russia has helped lift natural gas prices in the region to unprecedented levels; it caused Germany to postpone the removal of nuclear power plants from its energy grid, and has prompted increased storage and calls to reduce usage as we move toward the winter months. Recent news of leaks in the Nord Stream 1 pipeline (rumored to have resulted from sabotage) have reinforced concerns and calls for energy independence, as Europe seeks to source additional supply from other regions.

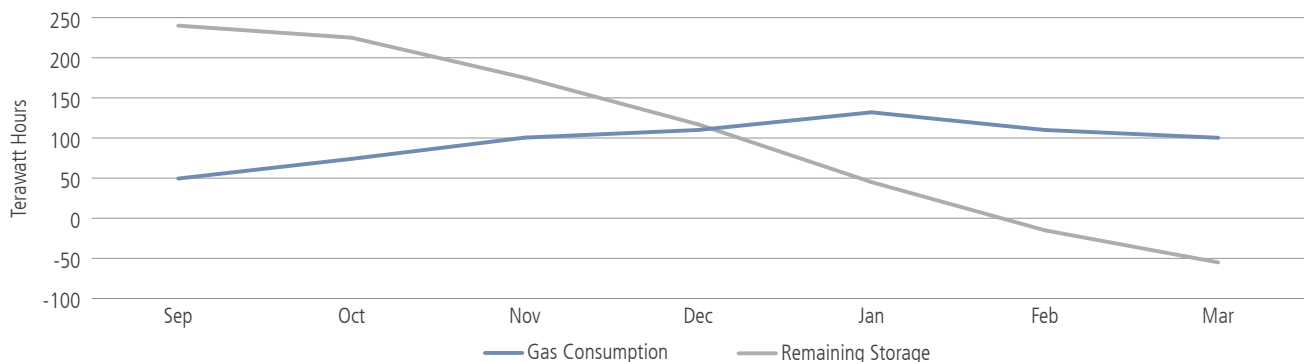
At this point, we believe that the energy picture is not dire. As shown in the display, based on relatively normal weather conditions and the ability to take emergency use of coal and other traditional sources, we believe that Germany's natural gas shortfall will amount to about a half a month of consumption of the commodity. That said, the impact of a worst-case scenario on economic growth could be significant, with a 5 – 10% reduction.

Causing further harm to the European economy, currency devaluation versus the dollar has exacerbated inflation, making the task of central banks more difficult.

In our base economic case (70% probability), we seek the European Central Bank exiting its Zero Interest Rate Program, with a future policy path that frontloads interest rates ahead of an imminent economic slowdown driven by high gas prices. A combination of global monetary policy adjustment, elevated inflation and the ECB's anti-fragmentation tool would drive nominal yields higher while limiting a disorderly rise in real yields. In this case, we would anticipate a terminal rate of 2.25 – 2.75% and 10-year Bund yield of 1.75 – 2.75%.

NATURAL GAS: OUR BASE SCENARIO FOR GERMANY

We anticipate a modest shortage, equivalent to one-half month consumption.



Key assumptions:

- Typical winter weather (not severe)
- No gas imports from Russia
- Gas consumption cut by 10% for corporates and 5% for households (plan for EU member states to voluntarily reduce gas consumption by 15% from August 15, 2022)
- Other emergency solutions to come in Germany:
 - Lignite/coal power plants to replace gas used to produce electricity (12% of gas consumption)
 - LNG floating terminals: two to start gradually in November, one in December and others next year (30% of gas consumption)

Source: Neuberger Berman views.

3. More Expansive Policies to Come?

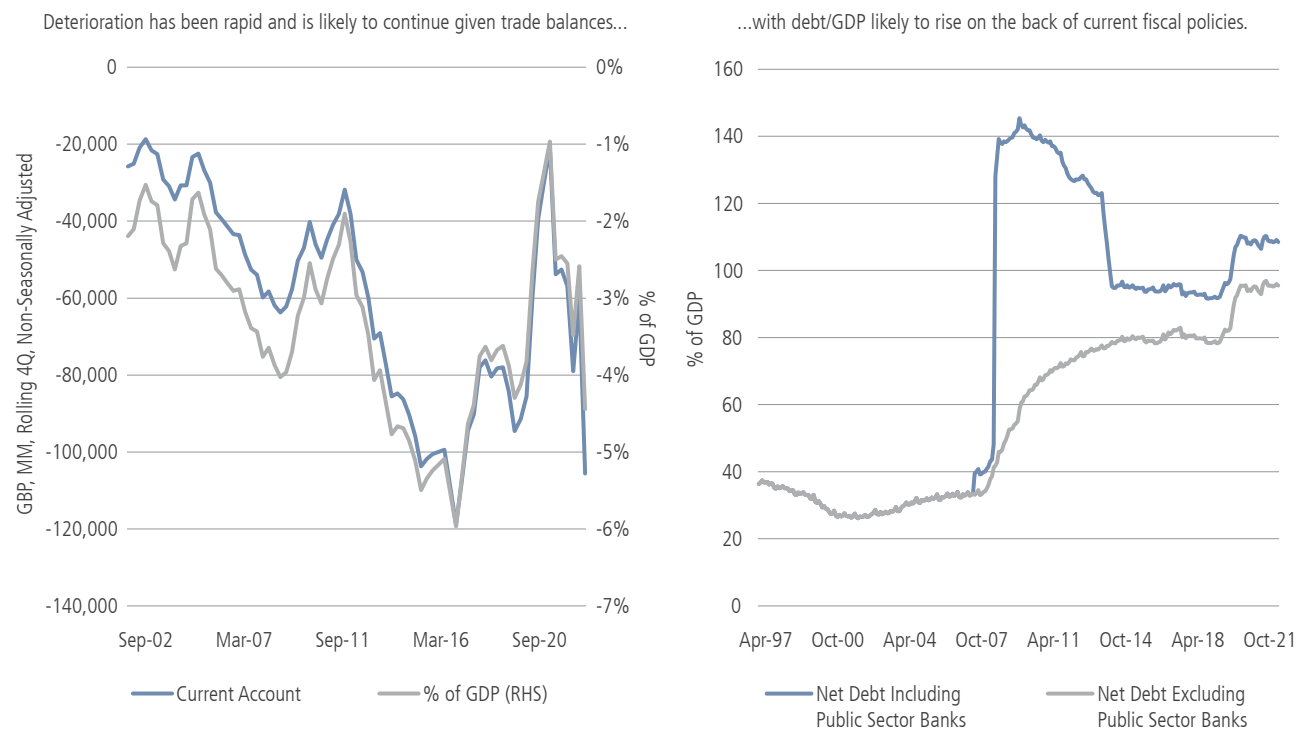
Despite the general monetary trend toward stiff tightening on a global basis, individual countries continue to initiate moves to salve the wounds of their populations even if they have a stimulative—and by extension, inflationary—impact. Germany is providing subsidies to small firms to offset energy costs, and the U.S. is promising cancelation of a large swath of student debt, to name two examples.

However, the case that caught the attention of the world last quarter was the United Kingdom, which announced unprecedented tax cuts and spending equal to 10 – 15% of GDP, much of the spending occurring over the next 12 months (it subsequently pulled back on some rate reductions). The intent was to use supply-side strategy to jump-start growth, but the reaction in the markets was not favorable given the potential need for new debt—with the move expected to result in roughly a 50% increase in U.K. debt sales at an inopportune time. Investors abandoned the pound given the potential negative impact on current accounts, moving it closer to parity with the U.S. dollar and at multidecade lows. U.K. two-year yields, meanwhile, moved up 100 basis points in three days, taking into account further potential rate hikes to counteract the inflationary impact of the new fiscal policy.

The action created spillover effects in other rate markets, although the broader effect may be a function of whether other countries increasingly adopt such unconventional fiscal policy to help buoy their economies; for example, assuming a center-right coalition in Italy, we could see interest in more populist-oriented supports despite inflationary pressures.

UNITED KINGDOM: CURRENT ACCOUNT CRISIS IN THE MAKING?

The U.K. will have to find additional sources of financing as both its current account deficit and debt are likely to expand.



Source: Bloomberg, ONS. As of 1Q22 for Current Account. As of July 2022 for debt/GDP.

4. Portfolio Construction: Shorter Durations, Higher Quality

For the quarters ahead, a basic assumption on our part will be further tightening by the Federal Reserve and other developed market central banks, counterbalanced by the potential for slower tightening by emerging markets, which began their tightening cycles much earlier. This, in turn, is likely to result in a general upward trend in yields until such time as the market becomes confident that we are close to a terminal rate.

Beyond that basic premise, we see three key areas of potential tail risk. One relates to the U.K.'s fiscal measures and whether they contribute to a repricing of risk and resetting of yields on a global basis. The second relates to China growth and the country's continued use of a weaker currency to support its trade balance. Finally, we see potential for developed central banks to meaningfully overtighten, given their tendency to look backward when setting policy—this was a source of weakness in missing early cues on inflation and could weaken the response when global slowing has advanced.

In dealing with the current environment, we believe a focus on shorter durations, to counter policy rate risk, may be appropriate. We are tending to favor higher-quality assets (of which we would include high-yield BBs and above), held to maturity to earn income. We also favor longer-term government and investment-grade bonds at low dollar prices to generate positive convexity should the market turn, albeit with risk of capital loss on the lower end given current prices. More generally, we believe this environment is well suited to active management given the array of macro events and the volatility opportunities they are creating across liquid assets.

CONSTRUCTING A PORTFOLIO FOR 2023

Focus on income, total return opportunities in long duration, and tactical trading.

Risk of a Financial Accident Is Rising: Areas to Watch	Key Portfolio Considerations
<ul style="list-style-type: none"> • U.K. (Aa3/Aa) twin deficits are causing a repricing of risk and yields globally • China growth continues to struggle, and the country continues to use a weaker currency to support the trade balance • Central banks overtighten on backward-looking inflation figures 	<ul style="list-style-type: none"> • Short duration, higher-quality assets (through HY BB) to earn income via hold to maturity • Longer-term government and possibly investment grade bonds at low dollar prices for positive convexity when market turns with risk of capital loss on the lower end given current prices • Active management via trading as numerous macro events are happening and volatility is creating opportunities across liquid assets

Source: Neuberger Berman views. As of September 23, 2022.

5. Sector Strategy: Leaning Away From Recession

Finally, it may go without saying but we would reduce exposure to sectors that are most affected by consumer-led recession; for example, investment grade credit, cyclicals, consumer products and health care may be areas to underweight, while U.S. banks, telecom and utilities might be more favored given their all-weather qualities. Among bank loans, pharma, industrials and ad-based media may show weakness, while software, energy, and containers and packaging may show more potential. In emerging markets, we favor markets that are most resilient in the face of rising U.S. rates, with more stable monetary policy and current accounts.

RELATIVE VALUE WITHIN CREDIT MARKETS

Reduce exposure to sectors that will be most impacted by a consumer-led recession.

IG Credit		
Favored Sectors	<ul style="list-style-type: none">• U.S. Banks• Telecom• Utilities	
Sectors to Avoid	<ul style="list-style-type: none">• Cyclicals• Consumer Products• Healthcare	
Emerging Markets Debt		
Country Overweights	Hard Currency <ul style="list-style-type: none">• Romania• Mexico• Ivory Coast	Local Currency <ul style="list-style-type: none">• Mexico• Romania• South Africa
Country Underweights	Hard Currency <ul style="list-style-type: none">• Saudi Arabia• Malaysia• Uruguay	Local Currency <ul style="list-style-type: none">• Thailand (UW Rates, OW FX)• Malaysia• Taiwan

High Yield	
Favored Sectors	<ul style="list-style-type: none">• Gas Distribution• Support Services
Sectors to Avoid	<ul style="list-style-type: none">• Retail• Consumer Products• Broadcasting
Bank Loans	
Favored Sectors	<ul style="list-style-type: none">• Software• Oil, Gas & Consumer Fuels• Containers & Packaging
Sectors to Avoid	<ul style="list-style-type: none">• Pharmaceuticals• Industrial Conglomerates• Ad-Based Media

As of September 26, 2022 and subject to change without notice. This material is intended as a broad overview of the portfolio manager's views and is subject to change without notice. The portfolio manager's views may differ from that of other portfolio managers, as well as the views of the firm.

Market Views

Next 12 Months

	UNDER --	-	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	○	●	○	○	○	
United Kingdom	○	○	●	○	○	
Germany	○	●	○	○	○	
France	○	●	○	○	○	
Italy	○	● ←	○	○	○	ECB policy adjustments, debt sustainability and political worries are likely to weigh on Italian government bonds.
Spain	○	○	●	○	○	
Japan	○	●	○	○	○	
Canada	○	●	○	○	○	
New Zealand	○	○	●	○	○	
Australia	○	○	●	○	○	
U.S. TIPS	○	○	●	○	○	
INVESTMENT GRADE SECTOR						
U.S. Agencies	○	○	●	○	○	
U.S. Agency MBS	○	○	○	●	○	
U.S. CMBS	○	○	●	○	○	
U.S. ABS	○	○	●	○	○	
U.S. Mortgage Credit	○	○	●	○	○	
U.S. Credit	○	○	○	●	○	
Europe Credit	○	○	●	○	○	
U.K. Credit	○	○	●	○	○	
Hybrid Financial Capital	○	○	○	●	○	
Municipals	○	○	●	○	○	

Market Views (continued)

Next 12 Months

	UNDER --	-	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
HIGH YIELD & EMERGING MARKETS						
U.S. Full-Market High Yield	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.S. Short-Duration High Yield	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Pan-Euro High Yield	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Floating-Rate Loans	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.S. CLO	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
EM Hard-Currency Sovereigns	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
EM Hard-Currency Corporates	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
EM Hard-Currency Short Duration	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
EM Local-Currency Sovereigns	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
CURRENCY*						
U.S. Dollar	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	Valuations are stretched, but risk aversion and the energy crisis are providing current support.
Euro	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Pound	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Yen	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Swiss Franc	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	Safe-haven status is generating demand amid a difficult geopolitical environment.
Australian Dollar	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Swedish Krona	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Norwegian Krone	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	The risk-off cycle is hurting procyclical currencies; even with a strong current account position and energy exports, the krone is being affected by sentiment.
Canadian Dollar	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Mexican Peso	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	The peso is acting as a global recession hedge given transfers from Mexicans in the U.S.
Brazilian Real	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	Improving real rates and hawkish policy are contributing to lower headline inflation; ample reserves and a healthy external balance are reducing the impact of global tightening; but the October election, commodity prices and dollar strength are risks.
Chinese Yuan	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Turkish Lira	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	

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

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