



NEUBERGER BERMAN

Fixed Income Investment Outlook 3Q 2023

Last Mile for Tightening

Central banks are finding it hard to finish the long journey toward inflation normalization, but we believe that policy rates are likely at or near their peaks—and could be maintained at elevated levels for some time. In an environment of slowing growth, restrictive monetary policy and rising idiosyncratic risk, we favor shorter durations, quality and a focus on security selection.

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Last Mile for Tightening

With roughly 500 basis points of rate hikes in the rearview mirror, the Federal Reserve has enjoyed significant progress in curbing U.S. inflation, which has fallen from a headline peak of over 9% last year to 4% in May. Goods prices have fallen, housing is turning the corner and even services seem ready to ease. However, core inflation has been stuck at the same level of around 5% for four months, and doubt is creeping into policymakers' optimism that they can gradually tame rising prices.

Indeed, developed market central banks have recently taken a more hawkish tone. In surprise moves, both Australia and Canada increased interest rates by 25 basis points in June and the U.K. continued its hiking process with a 50bps increase. Although the Fed paused its tightening, its policymakers raised their terminal estimates and Chair Jerome Powell seemed to suggest that two more increases could be in store this year. The European Central Bank, meanwhile, hiked rates as expected, but its forecasts for its terminal rate came in higher, suggesting that more work needs to be done.

Despite ongoing disinflation, short-term price trends are keeping central banks "on the front foot" as they seek to drive inflation back toward target levels. That said, the overall policy environment remains fairly stable, and we believe that market rates are unlikely to change significantly for a while. Ten-year U.S. and European government yields are both at roughly the middle of their trading range for the year, while shorter maturities are at the higher end of that range. If anything, the current hawkish tone may freeze yields in the near term or increase them modestly until the cumulative effects of tightening further impact inflation trends and ease pressure on central bankers. Overall, we continue to believe that inflation will recede this year and next, possibly reaching close to target levels by the end of 2024.

In terms of positioning, we are emphasizing shorter duration in a "higher-for-longer" rate environment, although we would favor adding duration should yields move higher from here. Like government bonds, credit and securitized debt continue to be range-bound, while mortgage-backed securities may hold particular appeal at these levels. Overall, investment grade and high yield spreads have tightened somewhat, but increased dispersion is opening the door to select opportunity, which would expand should spreads widen somewhat. Given the already mature central bank cycles in emerging markets, the coming end of Fed tightening and relatively stable economic fundamentals, we continue to see value in emerging markets debt.

We provide details on our investment themes in the pages that follow.

1. Inflation Should Continue to Decline

Despite hawkish messaging from central banks, inflation has generally been coming in as expected—slightly weaker for headline numbers but stable for core inflation. In May, for example, U.S. CPI was 0.1% month over month and 4% year over year, while core inflation was 0.4% on a monthly basis and 5.3% versus last year. Within the core components, goods were up by a robust 0.6% MoM on strong used car prices while services increased 0.4% MoM. Still, we believe that inflation will slowly step down over the remainder of the year. Gains in core goods have largely been on the back of large increases in used car and truck prices, which should prove transitory. Meanwhile, shelter prices are already cooling and should continue to normalize despite a stabilizing housing market. Finally, as the labor market eases to more typical levels of balance, core services prices (excluding shelter) should remain at current levels or move slightly lower. All told, we project that headline and core CPI will end 2023 at 3% and 4% YoY, respectively. Looking into 2024, we believe both headline and core inflation could end the year between 2% and 2.5%—within reach of the Fed’s target.

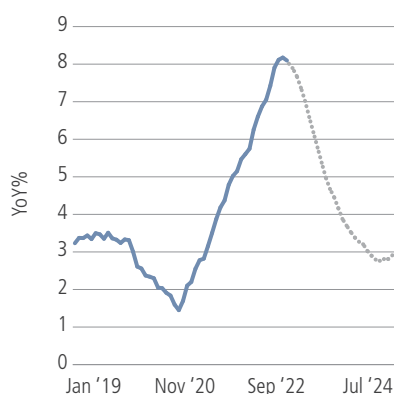
In Europe, inflation is also showing progress, with headline figures dropping to 6.1% YoY in May and core inflation easing to 5.3%. However, ECB inflation projections remain relatively robust, with the central bank anticipating core inflation of 5.1% this year and 3% in 2024 (vs. an estimated 4.7% and 2.5%, respectively, in March). Energy and food prices remain an issue tied to a tight labor market and increased unit labor costs. Still, at the ECB’s last meeting, President Christine Lagarde did mention small signs of softening inflationary pressures, even as overall trends remain too high.

U.S. GOODS DISINFLATION IS LARGELY OVER, BUT RENTS AND CORE SERVICES SHOULD IMPROVE

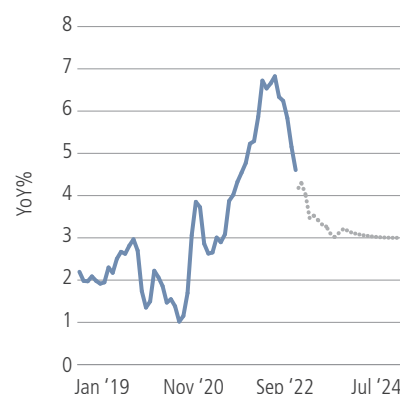
Goods’ contribution to inflation improvement is largely over.



Shelter inflation is near its peak and should be the driver of lower inflation.



Core Services Ex-Shelter should improve but remain stickier.



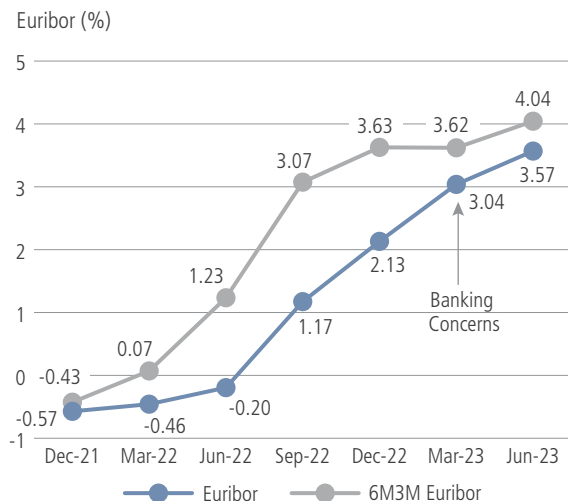
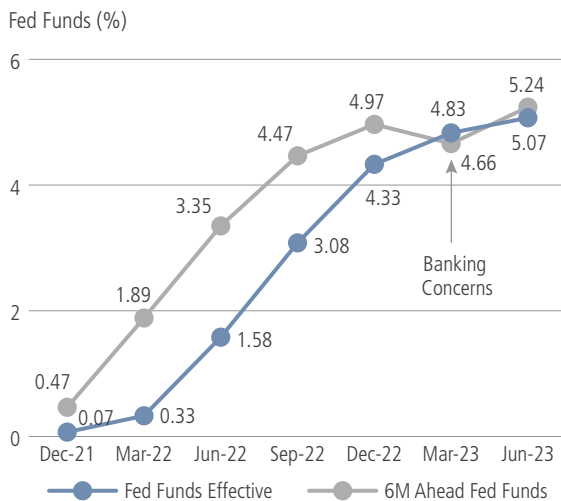
Source: Bloomberg, Neuberger Berman calculations and forecasts. Actual data as of May 2023.

2. Policy Rates Are Peaking

The Fed has moved aggressively in a relatively short time in bringing the fed funds rate from about zero in early 2022 to its current 5 – 5.25% range. Now the question is whether it will continue to apply monetary brakes or see enough evidence of fading inflation to hold steady or even start to ease. Given recent hawkish surprises, we believe it's possible that the central bank will follow through on an additional two rate hikes, as reflected its current 2023 dot plot. On the other hand, the lagging impacts of its aggressive measures, still evolving banking weakness and generally tighter financial conditions could tip the scales toward extending the existing pause amid a slowing economy. Indeed, we continue to believe that the fed funds rate is at or near its peak and that the Fed may not reach its current estimated terminal rate of 5.50 – 5.75%. At a minimum, it has prepared the market for two-way risk, depending on how pricing and economic growth play out in the months ahead.

As mentioned, other central banks have been mirroring the Fed's relatively hawkish messaging. The European Central Bank's June decision to raise rates by 25bps and end reinvestment of maturing bonds in its Asset Purchase Programme came at a time when it indicated higher outlooks for core inflation in 2023 and 2024, powered by rising labor costs. That said, the central bank reinforced the importance of data dependency, considering not only inflation, but economic growth and financial conditions. And while Lagarde indicated that another quarter-point hike was likely, she didn't mention the possibility of multiple rates from here, noting that "past rate increases are being transmitted forcefully to financing conditions and are gradually having an impact across the economy." Overall, we anticipate a 3.75% terminal rate in the eurozone, although like the Fed the ECB will likely wait for clear signs that core inflation has not only peaked, but started to fall toward its 2% target.

SHORT-TERM FORWARD RATES SUGGEST THE END OF HIKING IS NEAR



Source: Bloomberg. As of June 21, 2023.

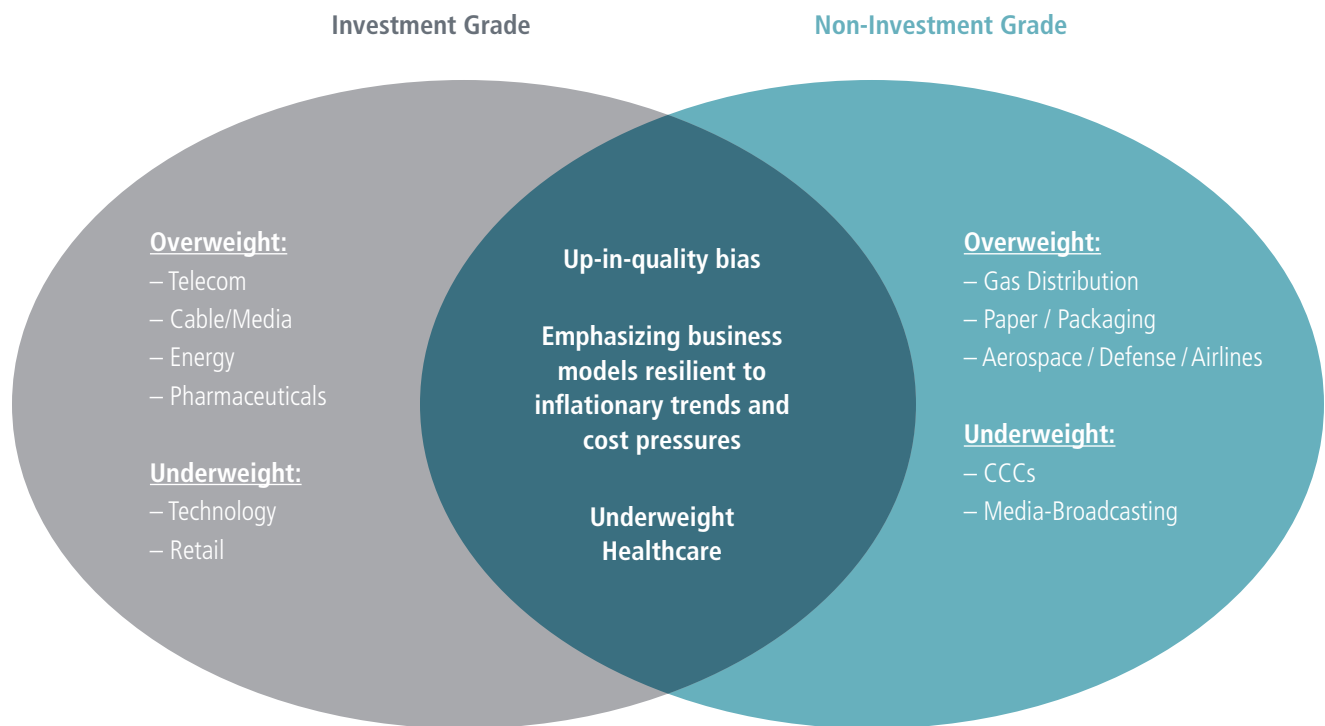
3. Credit Dispersion Is Accelerating

Economic resilience has supported credit conditions in recent months, which has translated into mild tightening conditions in investment grade and high yield spaces. However, as the central bank tightening cycle matures, and the effects of banking stresses and fading COVID supports continue to be felt, economic growth is likely to slow, and the disparities in issuer quality should become more apparent.

Overall, we are seeing more opportunity in high-quality securities where yields are appealing on both an absolute and real basis. With the failure of Silicon Valley Bank and other distressed institutions, various fixed income assets, particularly among mortgage-backed securities have gone “on sale” at prices that we perceive as providing generous potential rewards in the years ahead. With the high yield market seeing modest tightening over the past few months, we see less opportunity on a relative basis, but will be alert to widening that lends itself to increased weightings.

SLOWING GROWTH, RESTRICTIVE POLICY AND RISING IDIOSYNCRATIC RISK SUPPORT QUALITY BIAS, SECURITY SELECTION

Neuberger Berman Credit Views



Source: Neuberger Berman. For illustrative and discussion purposes only.

4. Emerging Markets: Net Positive, Though China Remains a Question

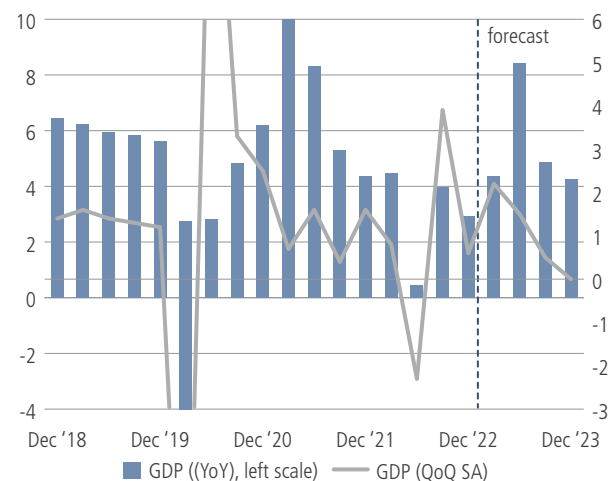
We anticipate a positive environment for emerging markets debt for the rest of the year, built on supportive technicals, attractive valuations and stable fundamentals, coupled with the coming end to aggressive monetary policy in the U.S. Questions remain around China's stalled recovery, but we believe the country's 5% growth target remains achievable (see displays), even if only targeted and measured stimulus is deployed, as signaled by recent monetary policy easing. Chinese growth impacts across emerging markets should be modest and uneven, but ultimately net positive.

In terms of segments, we believe that spread momentum, investor positioning and negative net issuance should support hard currency markets, while the risk of continued outflows has diminished considerably from extreme levels. With sovereign spreads roughly flat for the year, we think the scope for compression remains significant, led by high yield issuers, especially at the distressed end of the market, where we believe investors have excessively discounted potential weakness. On the corporate side, default rates should decline from double digits in 2022 to around 5% this year, with the majority relating to China property developers and Ukrainian issuers. Excluding those specific areas, the rate should be roughly in line with the historical average of around 3.3%.

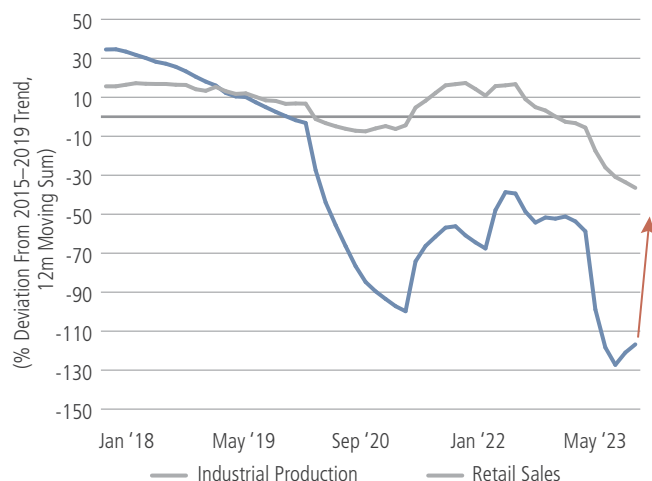
Technicals in local markets have also improved, with capital flows showing signs of bottoming out, while valuations remain reasonably attractive across various rates and currencies. Importantly, the process of disinflation is now accelerating in most emerging economies, with easing cycles within view following long monetary pauses at elevated interest rate levels, which should support currencies and extended durations.

CHINA'S GROWTH MOMENTUM HAS LIKELY PEAKED

GDP growth to revert to trend in 2H (% , quarterly).



Expect targeted, measured stimulus as China aims for "high quality" growth.



Source: CEIC, Neuberger Berman. As of June 21, 2023.

5. Key Investment Themes: Shorter Duration, Quality, Attention to Underwriting

With central banks likely to maintain high policy rates for the near term, we believe that investors should turn their attention to shorter durations to capitalize on higher income with minimal interest rate risk, avoiding bets on inflation or correlations. That said, it's important to be alert to potential opportunities at the longer end of the market once it's clear that rates could reset from peak levels. In a slowing environment, we see high quality as offering value relative to lower-rated issues, which have seen spreads pull in given the recently resilient economy. In contrast to trends in place since the Global Financial Crisis, we believe that monetary policy will be less forgiving, reinforcing the importance of credit research and attention to the underwriting of particular issuance. Such an environment, in our view will enhance the value that active managers can provide across the global fixed income universe.

OUR KEY THEMES, OUTLOOK

Higher Rates for Longer Put Short Duration Strategies Front and Center

- We've exited the era of zero rates. Positive policy and short-term rates will endure.
- Clients can largely avoid bets on inflation or correlations and instead focus on earning income in short maturity strategies

Return of Yield to High-Quality Fixed Income Markets Has Major Implications

- Mid-single-digit returns are available across high-quality fixed income sectors
- Clients targeting a return objective can now almost certainly meet a goal with a higher-quality portfolio taking less credit or duration risk

Market Returning to Pre-GFC Investing, Underwriting Matters

- High-quality assets to set yields for the market vs. low quality during the QE era
- Credit risks will rise as the impact of higher interest rates flows through households and the corporate sectors

How We See 2H 2023

- **Fixed income should see inflows in 2023 as a result of changes in asset allocation.**
- **High quality fixed income markets will see strategic, multiyear re-allocations**
- **Credit and more risky areas of fixed income will see greater tactical opportunities**

Source: Neuberger Berman. For illustrative and discussion purposes only.

Market Views

Next 12 Months

	UNDER --	-	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	Maturing tightening cycle coupled with two-way market risk.
United Kingdom	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Germany	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
France	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Italy	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Spain	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Japan	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Canada	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
New Zealand	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Australia	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.S. TIPS	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
INVESTMENT GRADE SECTOR						
U.S. Agencies	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.S. Agency MBS	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	
U.S. CMBS	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
U.S. ABS	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
U.S. Mortgage Credit	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
U.S. Credit	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Europe Credit	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
U.K. Credit	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Hybrid Financial Capital	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	
Municipals	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	

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"/>	Spreads have narrowed despite economic slowing, reducing value opportunity.
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"/>	Spreads have narrowed despite economic slowing, reducing value opportunity.
Floating-Rate Loans	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>		<input type="radio"/>	Higher valuations have lessened the appeal of loans versus other asset classes.
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 type="radio"/>	<input checked="" 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 type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
CURRENCY*						
U.S. Dollar	<input type="radio"/>		<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	The U.S. economy is slowing but has proven more resilient than expected.
Euro	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>		<input type="radio"/>	Despite higher yields, signs of slower growth and manufacturing recession merit caution.
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 checked="" type="radio"/>	<input type="radio"/>	2Q depreciation has provided an appealing entry for long positions; the yen should perform well if the U.S. economy deteriorates and/or with risk aversion.
Swiss Franc	<input type="radio"/>	<input checked="" type="radio"/>		<input type="radio"/>	<input type="radio"/>	The franc's yield gap is widening versus other G10 countries (ex-Japan) and it remains expensive versus the euro.
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 checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Norwegian Krone	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Canadian Dollar	<input type="radio"/>	<input type="radio"/>	<input checked="" 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"/>	
South African Rand	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Brazilian Real	<input type="radio"/>	<input type="radio"/>		<input checked="" type="radio"/>	<input type="radio"/>	Healthy external balance, relatively cheap valuation, high real rate.
Chinese Yuan	<input type="radio"/>	<input type="radio"/>	<input checked="" 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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