NEUBERGER BERMAN

Fixed Income Investment Outlook 2Q 2022

Investing Through Inflation and Growth Uncertainty

Global growth uncertainty has accelerated while inflation appears likely to persist. Still, we anticipate neither recession nor stagnation; moreover, central bank tightening expectations have likely peaked, potentially normalizing interest rate volatility and supporting spread sectors. In our view, investors should position themselves for a two-way market, emphasizing liquidity and looking for opportunity in investment grade credit, securitized products and high yield.

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Investment Implications

- Growth uncertainty is elevated given higher commodity prices and geopolitics; the U.S. consumer and fiscal spending in Europe are potential buffers; we don't anticipate recession or stagflation, though risks have increased.
- Inflation is likely to persist; although goods impacts may ease, services prices are accelerating and may prove stickier; Europe's search for energy and increased defense spending could add to inflationary pressures.
- Central bank tightening expectations have peaked, with growth uncertainty allowing policymakers to look through elevated inflation and adjust rate strategy; interest rate volatility should normalize, supporting spread sectors.
- Investors should prioritize liquidity and position themselves for more two-way markets; areas of opportunity could include segments of investment grade credit, securitized products and high yield.

Investing Through Inflation and Growth Uncertainty

Monetary tightening should dampen economic growth, but a recession seems unlikely this year—opening up opportunities in credit.

The global growth landscape accelerated last year amid COVID recovery and ample liquidity, but as is well known, strain in the global supply chain, labor market dislocation and surging demand contributed to a historic surge in inflation, with headline CPI rising to a four-decade high. At first dismissing the price increases as "transient," the Federal Reserve took a hawkish turn in its messaging, and has committed to multiple rate increases this year, with similar positioning by the Bank of England and more moderate guidance from the ECB—transitions that remain unshaken despite market volatility triggered by the Ukraine conflict.

Today, fixed income markets are being heavily influenced by questions around the impact of shifting policy and whether it could move already decelerating growth into negative territory—with widening credit spreads resulting even as Treasury rates rise. Although retreating from peak levels, inflation is likely to run above central bank objectives, maintaining pressure on the banks to conduct an extended hiking cycle, but likely with softening overall interest rate volatility from here, given that expectations are consistent with what we consider likely outcomes. Although there is a high degree of uncertainty around growth, our view is that the U.S. and globe can avoid a recession this year, with positive implications for a range of risky assets.

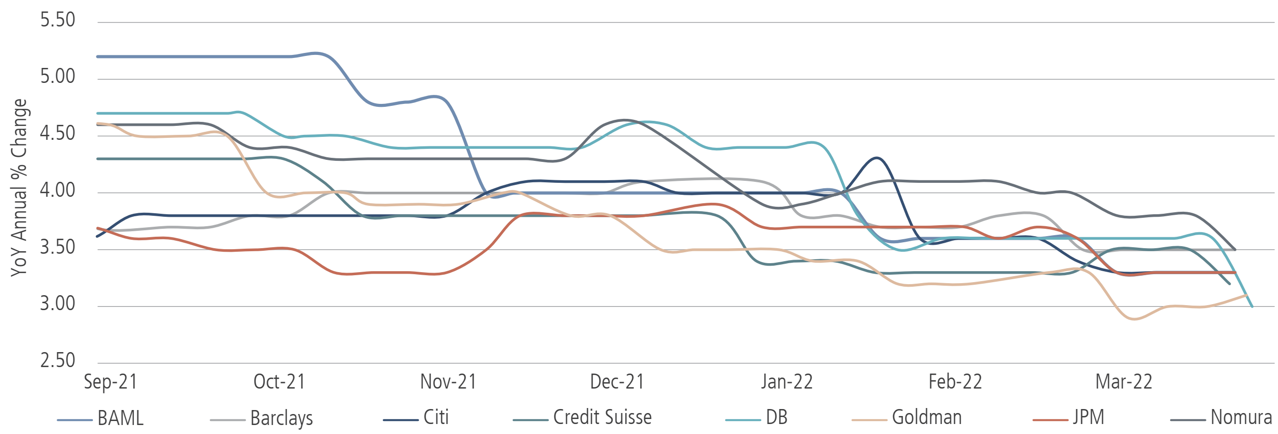
In assessing the current climate, we have structured our ideas around four dominant themes, which we explore at a high level in the rest of this quarterly.

I. Global Growth Uncertainty Is Rising

The global growth outlook has been affected by key cross-currents in rising commodities and geopolitical events. However, a number of factors should enable the global economy to avoid recession in 2022. First, although easing, the U.S. economy and (developed market counterparts) were in a strong position entering the current bout of inflation, providing a substantial cushion to withstand policy changes. This is in sharp contrast to past scenarios when growth was minimal and thus vulnerable to shocks.

GROWTH FORECASTS: EASING FROM HIGH LEVELS

2022 U.S. GDP Forecasts

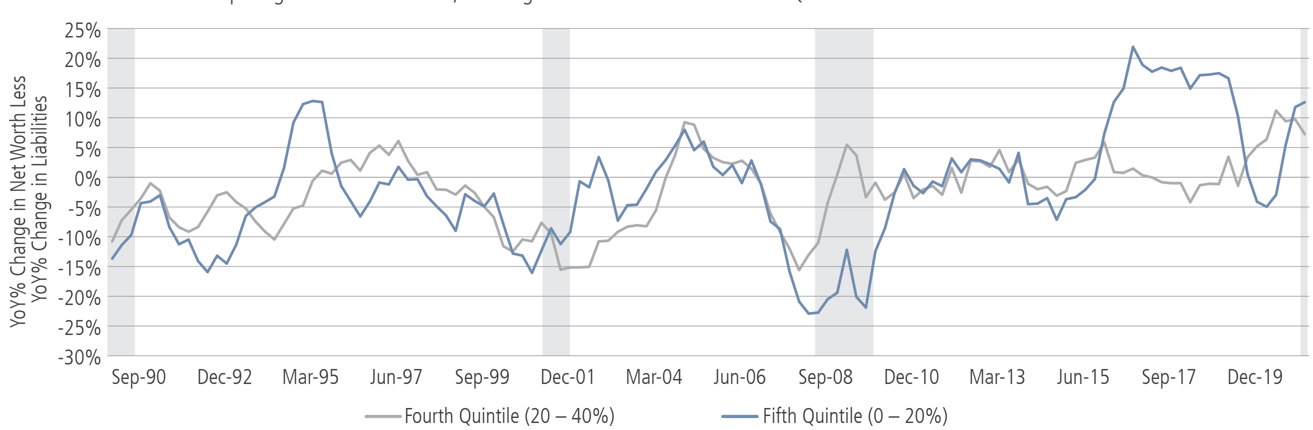


Source: Bank of America, Barclays, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, J.P. Morgan, Morgan Stanley, Nomura. As of March 2022.

Key buffers also could help protect the expansion. In Europe, we find fiscal spending trends to be reassuring, as governments have gotten the message that coordinated economic support should expand beyond monetary policy. In the U.S., the consumer remains in excellent shape. As shown below, debt levels are close to record lows while savings remain ample. This is not just a story of the high income brackets; lower and middle income people are seeing particularly solid wage gains and wealth creation.

BROAD STRENGTH IN U.S. CONSUMER

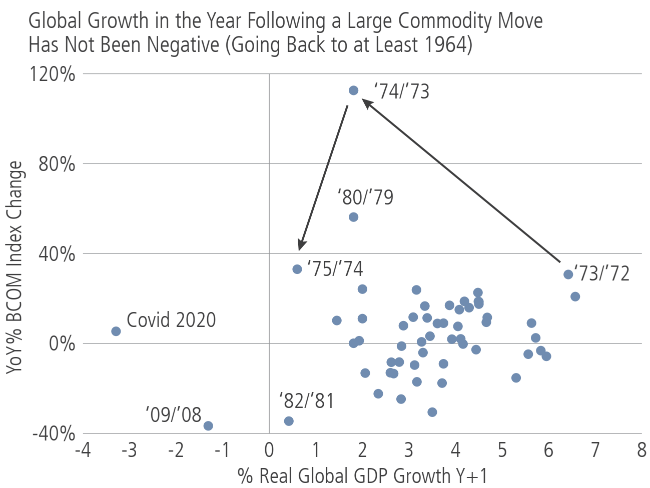
Growth in Net Worth Is Outpacing Growth in Liabilities, Creating an Asset Buffer in Lowest Two Quintiles of Income

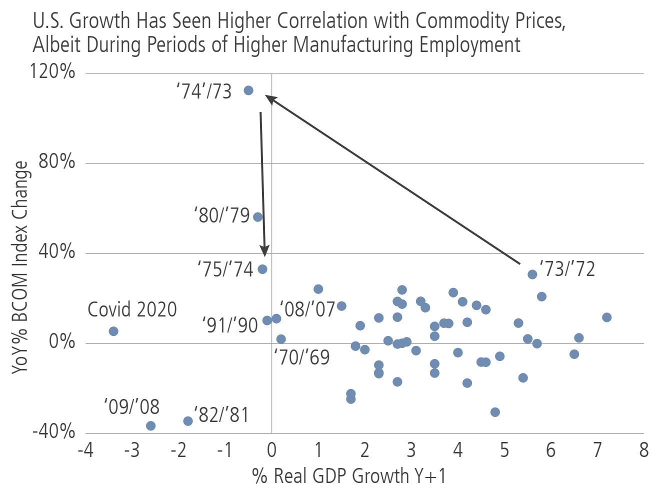


Source: NBER, Federal Reserve, as of 4Q21. Total liabilities and net worth, non-seasonally adjusted.

Moreover, we do not see commodities as a dire threat. Looking at the past, recessions usually follow periods of overinvestment and resulting market weakness, or problems in the financial system. We don't see either as present today. Although some have compared the current climate to the stagflation of the 1970s, commodities saw a 270% gain over the course of three years back then before the U.S. economy moved into recession. Indeed, growth has typically remained positive in the year after a substantial move in commodity prices, while growth and commodity prices have often been highly correlated, albeit typically during periods of higher manufacturing employment.

GROWTH AND COMMODITY PRICES: OFTEN ALIGNED





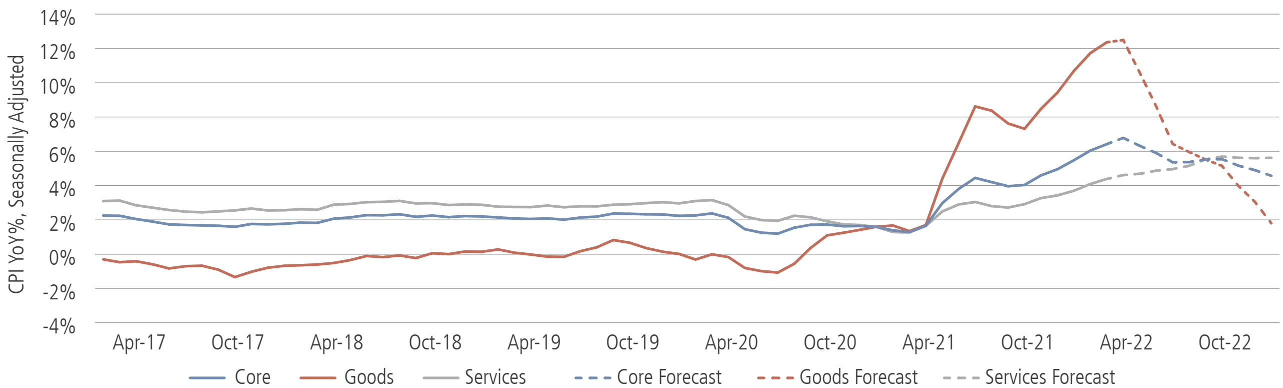
Source: Bloomberg. As of 2020/2019 for Global GDP/Bloomberg Commodities (BCOM) Index. As of 2021/2020 for U.S. GDP/BCOM.

II. Inflation to Persist

In our view, inflation levels are likely to peak over the coming months, but then leave conditions at uncomfortable levels for central banks, contributing to an extended period of rising rates, including six more increases in 2022 alone. Goods inflation, which has been the fulcrum of price increases, is likely to ease, only to be supplanted by gains in services. By the end of the year, our base case calls for core inflation of 3 – 4%—roughly double customary levels post-Global Financial Crisis, but still down from recent highs.

U.S. INFLATION SHIFTS: MORE SERVICES, FEWER GOODS

Core Inflation Is Likely to Peak in the Coming Months Based on Goods Deceleration, While Services Likely Won't Peak Until 4Q22

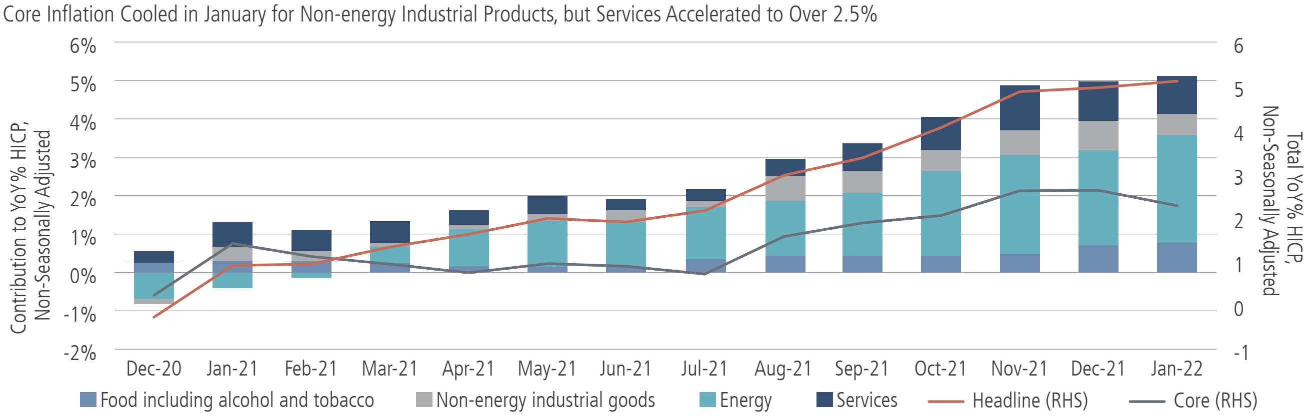


Source: Bloomberg, Neuberger Berman forecast. Actual through February 2022. Forecast calculated using MoM seasonally adjusted data and converting to YoY% without adjusting for seasonal effects. Weights are also held constant at February 2022 levels without dynamically changing them.

The trends may be similar in Europe, with labor issues and wage gains helping to drive higher services prices in recent months. Even Japan may see an upward shift, suggesting the potential for positive inflation rates over the next 12 months.

LABOR COULD ADD TO EUROPE'S HEADACHES

Core Inflation Cooled in January for Non-energy Industrial Products, but Services Accelerated to Over 2.5%



Source: Bloomberg. As of January 2022.

The story across geographies of labor shortages is similar. Many have left the job market, and for structural reasons—retirement, movement, etc.—are unlikely to return. This in turn could lead to continued wage gains.

All told, the environment is likely to require central banks to be "front-footed" on interest rates—something that has contributed to negative returns across fixed income and will likely continue to be a challenge. This inflation and rate dynamics have already led to rising yields and a flatter yield curve in the U.S. while Europe has also seen a steeper yield curve, given expectations for slower rate increases there.

III. Central Bank Tightening Expectations Have Peaked

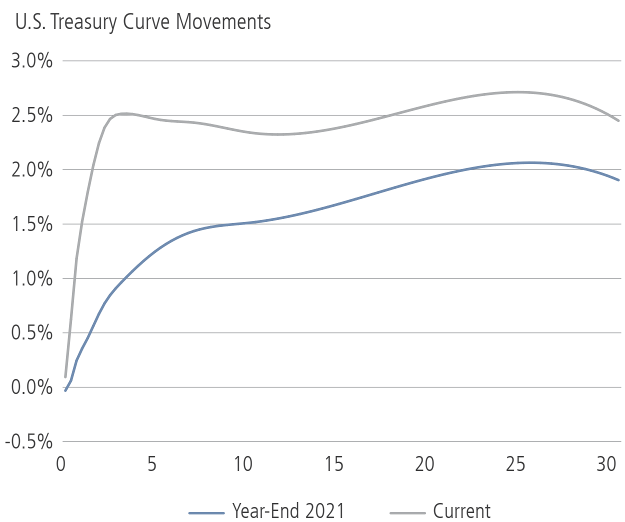
Broadly speaking, it seems likely that central bank tightening expectations have peaked, with growth uncertainty allowing policymakers to look through elevated inflation and adjust rate strategy over the next 12 months.

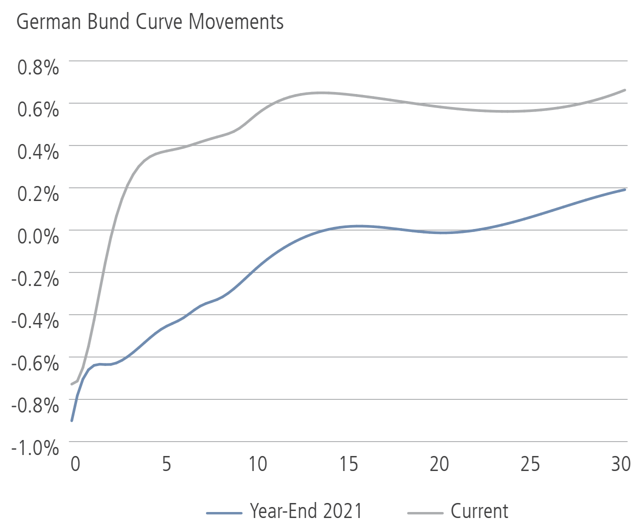
In our base scenario for the U.S. (70% probability), we assume a monetary policy shift from accommodation to normalization, with seven rate hikes and balance sheet adjustments this year driving the 10-year Treasury nominal yield to 2.7 – 2.9% in 12 months. Our more aggressive scenario (25% probability) involves a more aggressive campaign of 200 basis points this year, with the Fed's terminal rate reaching 3.5% in 2023 before settling in at 3.0%, and the Treasury yield at 3.1 – 3.3% in 12 months. Lower-than-expected growth and reduced inflation pressures would cause an early end to tightening, a terminal rate of 2.0% and a 10-year Treasury yield of 2.0 – 2.2%.

In Europe, the ECB plans to maintain its support, with its policy path highly dependent on economic data, given recent uncertainties. In our view, nominal yields for the 10-year Bund are likely to move up to 0.5 – 0.7% through a combination of global monetary adjustment, elevated inflation and trend-like growth. In our less-likely upside scenario, compounding effects of above-trend growth and supply chain frictions would continue upward surprises for inflation and wage growth, shifting rate expectations to a 2.0% terminal rate and the Bund to 0.7 – 0.9% in 12 months. On the downside (10% likelihood), an extension of the Ukraine conflict and an energy crisis might send growth below trend, resulting in the central bank recommitting to emergency programs and limiting the terminal rate to just 1.0%.

Given our base scenarios, we see the coming 12 months as a period during which interest rate volatility should normalize, supporting spread sectors.

INTEREST RATES: GRINDING UPWARD





Source: Bloomberg. As of March 31, 2022.

IV. Invest With Volatility in Mind

In our view, investors should prioritize liquidity in the coming months, as the ability to buy and sell risk in the midst of positive/negative outcomes has become more limited in recent years. This should help to capitalize on opportunities and manage exposures, with fixed income markets becoming more of a two-way street post-extreme COVID-era accommodation as central banks seek to address inflation. In our view, there may be money to be made within credit, looking to investment grade credit, securitized products and high yield.

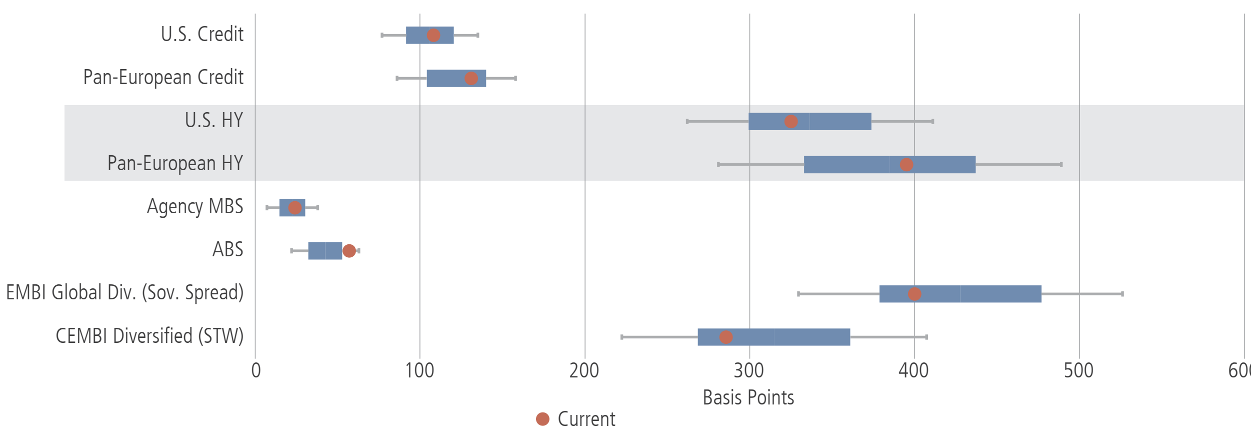
In the midst of high inflation reports this year, U.S. high yield spreads reached roughly 420 basis points at their widest, while U.S. investment grade was at about 120 basis points—essentially pricing in the likelihood of a recession, which we do not anticipate in our base case, providing an opportunity to add credit exposure.

Within investment grade credit, we are seeing compelling valuations in longer-duration industrials and communications, while securitized bonds in credit risk transfers and agency MBS also provide opportunity.

In high yield, we are concentrating on short duration, given interest rate risk, as well as U.S. BB-rated securities, which given strong credit fundamentals could see improved ratings over time, and in general have likely sold off not because of credit concerns, but due to interest rate dynamics. Indeed, BBs have generally underperformed lower-rated bonds so far this year, indicating that markets are seeing little reason to be concerned about economic deterioration. Leverage levels within high yield have recently returned to multiyear lows, while interest coverage is still historically elevated. Even the energy sector, once considered extremely risky, has pulled back from past excesses and increased in quality, with the potential to benefit from current energy market dynamics.

All told, the recent upward movement in rates and ongoing growth uncertainty have created an opportunity to put money to work, albeit with some caution given the significant change in market dynamics associated with inflation regime change.

SPREADS REMAIN AT ATTRACTIVE LEVELS



Source: Bloomberg. As of March 31, 2022. Ranges represent 52-week high/low. Bloomberg indices, JPM EMBI Global Diversified Index, JPM CEMBI Diversified Index.

Market Views

Next 12 Months

	UNDER – –	–	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	○	●	○	○	○	
United Kingdom	○	○ →	●	○	○	The BOE is unlikely to deliver market expectations of six more 25bp hikes before year-end due to signs of moderating growth.
Germany	○	●	○	○	○	
France	○	●	○	○	○	
Italy	○	○	●	○	○	
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	○	○	●	○	○	

	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	○	○	○	●	○	
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	○	○	●	○	○	
Swedish Krona	○	○	●	○	○	
Norwegian Krone	○	○	○	●	○	
Canadian Dollar	○	●	○	○	○	
Mexican Peso	○	○	●	○	○	
Brazilian Real	○	○	○ →	●	○	Commodity strength and high carry should support the real.
Chinese Yuan	○	●	← ○	○	○	Downside risks to growth in part related to zero-tolerance COVID policy; rates differential vs. the U.S. has shrunk meaningfully this year.
Turkish Lira	○	●	○	○	○	

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

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