NEUBERGER BERMAN

Fixed Income Investment Outlook 4Q 2020

Searching for Relative Value

With a sharp market recovery since early in the pandemic, spreads on many fixed income securities have narrowed to close to pre-crisis lows. Economies are generally regaining strength, but their trajectory could be heavily influenced by the coronavirus, the potential for vaccines and political uncertainty. In this unusual environment, we believe fixed income investors should focus on three essential questions: What could growth look like? How will inflation fit into the picture? And what segments of the market appear attractive on a relative basis? We explore these issues in the pages that follow.

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Investment Implications

We anticipate a gradual economic recovery supported by stimulus and increased consumer demand, although much depends on the path of the virus, timely success in developing a vaccine, and near-term fiscal policy:

Interest Rates. Front-end rates remain pinned; the path of inflation will determine long-end dynamics.

Investment Grade Credit. Record supply after the COVID-19 shock is giving way to a light issuance calendar. We are focusing on industry- and issuer-specific opportunities.

Agency Mortgage-Backed Securities (MBS). Central bank purchases, heightened demand for high-quality spread and increased Treasury issuance are constructive for MBS, although prepayment risk remains.

High Yield. Visibility has improved into troubled sectors and credits, as well as potential future defaults. We see an ample opportunity set within the asset class from a credit-selection perspective.

Floating-Rate Loans. Lagging third-quarter performance versus high yield has led to improved relative value.

Emerging Markets. Hard currency spreads and local yields across emerging countries remain attractive, while we see potential for attractive currency performance in our base case of gradual recovery in global growth.

Searching for Relative Value

Growth questions and potential inflation are among the issues fixed income investors face in seeking opportunity in the current environment.

The fixed income market has experienced a sharp rebound since the early days of the pandemic, with spreads on many fixed income securities narrowing to close to pre-crisis lows. Economies are generally regaining strength, albeit inconsistently based on local outbreaks and sensitivity to COVID-related weakness, while full recovery appears dependent on the approval and distribution of vaccines. Politics is creating additional uncertainty, given the potential for policy change tied to the U.S. election and ongoing struggle by the U.K. and EU to reach a Brexit agreement prior to the year-end deadline.

In this unusual environment, combining low yields and ongoing market volatility, we believe fixed income investors should focus on three essential questions: What could growth look like? How will inflation fit into the picture? And what segments of the market appear attractive on a relative basis? We explore these issues below.

The Road Thus Far

In our view, fixed income performance has resulted from a convergence of improved fundamentals, the low interest rate environment and central bank support. Actions by the Federal Reserve, ECB, Bank of Japan and others helped avoid worst-case scenarios by maintaining liquidity and financial stability in a time of crisis.

In the initial phase of the lockdown-related market collapse, the Fed immediately moved short-term rates back to zero and reinstituted a range of quantitative easing programs to keep markets functioning and maintain access to liquidity and credit. More recently, it has reworked its approach on inflation policy, suggesting that it will no longer initiate proactive rate increases, but await evidence of price increases before acting. The ECB has maintained its commitment to supportive policy, even suggesting that it may adjust its policy framework in light of still-weak inflation numbers.

From a fiscal perspective, the U.S. introduced stimulus totaling more than $3 trillion, but recent efforts have stalled in the run-up to the federal election. In Europe, the Euro Recovery Fund represents a constructive step toward fiscal integration with a $750 billion aid package backed by common debt that should help more vulnerable peripheral countries as implementation begins in 2021.

Global Growth: Multiple Paths

Looking ahead, low interest rates and generally easy financial conditions should continue to support the economy, but its path likely depends on the successful development and distribution of COVID-19 vaccines, the generation of additional fiscal stimulus, and consumer behavior. The recovery in China, despite some localized virus flare-ups, should be supportive to the global economic picture. With these dynamics in mind, we believe two scenarios are among the most likely:

K-Shaped Growth. A key recent dynamic has been companies and industries' truly variable responses to the pandemic, depending on their cyclical exposure, ability to adapt, and in some cases benefits from economic shifts tied to the pandemic. Assuming some virus resurgence, a lack of fiscal response and/or consumer caution, we could see some sectors continue to improve while others stall or decline. Continued weakness of some especially COVID-sensitive sectors, such as transportation, leisure and hospitality, would make it hard to achieve meaningful headline growth. In this environment, sector selection would remain crucial.

Back to 'New Normal.' A more positive outcome would occur with gradual containment of the virus, improved treatment efficacy and the introduction of a vaccine late this year or early in 2021, with wide distribution sometime in the middle of next year. Additional fiscal stimulus would be an important component for stabilizing, or

improving, growth rates until a vaccine is fully distributed. In this case, we would likely see economic growth stabilize at modestly positive overall levels analogous to 2011 – 15, when lingering impacts of the global financial crisis hindered output. Here, with a generally improving fundamental backdrop, an understanding of balance sheet risk in light of valuation would take on increased importance.

At this point, the IMF is anticipating global contraction of about 4.4% for 2020, which is nearly a percentage point improvement from its projections in June, and an advance of roughly 5.2% in 2021. However, overall economic health again may be highly variable, and require both a bit of luck and appropriate actions by fiscal and monetary authorities. For markets, 2021 will likely have a reasonable growth trajectory, albeit from levels still depressed from 2020.

Keep in mind that, during 2020, monetary policy has served to mitigate downside risk and create some upside in the markets. In contrast, central banks are likely to be on pause during 2021, and while they should continue to reduce tail risk, any growth and investment upside will likely need to come from fiscal policy. As a result, next year's market could see more emphasis on the trajectory of fiscal stimulus, at least until the arrival of vaccines.

IMF GROWTH FORECASTS HAVE GENERALLY IMPROVED FROM JUNE

	CURRENT %		FROM JUNE	
	2020	2021	2020	2021
Global	-4.4	5.2	0.8	-0.2
U.S.	-4.3	3.1	3.7	-1.4
Euro Area	-8.3	5.2	1.9	-0.8
Japan	-5.3	2.3	0.5	-0.1
China	1.9	8.2	0.9	0.0
LatAm	-8.1	3.6	1.3	-0.1

Source: International Monetary Fund, October 2020.

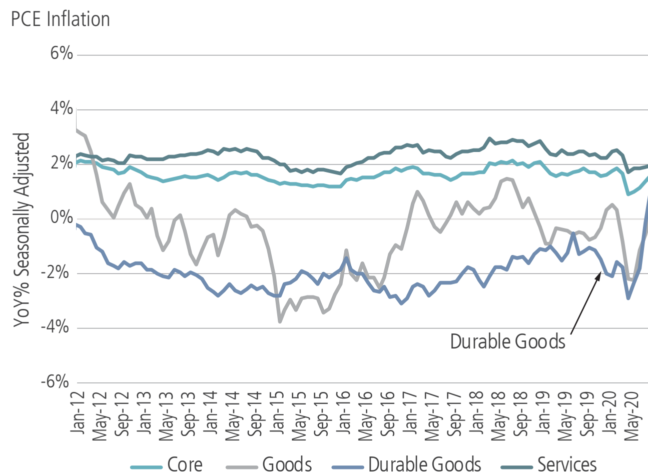
Inflation: Back in Sight?

In recent years, inflation has largely been a non-issue for investors, as central banks have been unsuccessful in attaining target inflation levels on a consistent basis, despite repeated efforts. However, the trajectory of inflation could become a renewed focus for markets given the regime change underway at central banks, including potentially several years of near-zero, short-term interest rates in the U.S. and the vast expansion of their balance sheets on a global basis, as well as growing government spending to limit the impacts of COVID-19.

Recent developments in consumer spending also suggest modest pressure toward a higher inflation rate: Purchases of durable goods such as cars and washing machines have increased, both outright and as a percentage of total purchases, resulting in rising goods inflation pressure. This is a significant change versus the past decade, when durables helped keep a lid on inflation. Moreover, the U.S. housing market has been robust in terms of overall sales volume. Thus far, this has had a muted impact on prices, but that could change with time.

DURABLE GOODS COULD HINT AT RENEWED INFLATION

PCE Inflation



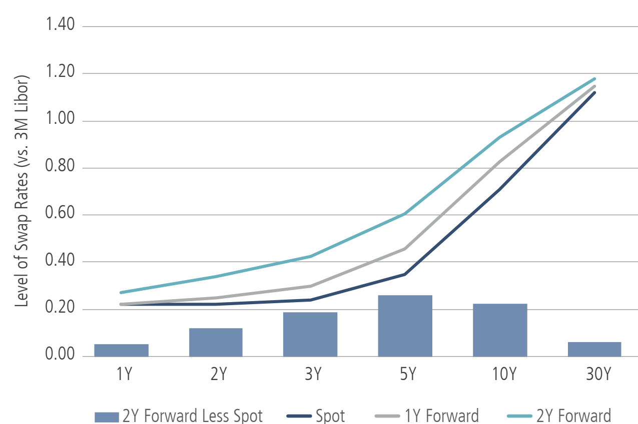
Source: Bloomberg. As of August 2020.

Investment Strategy: Looking for Relative Value

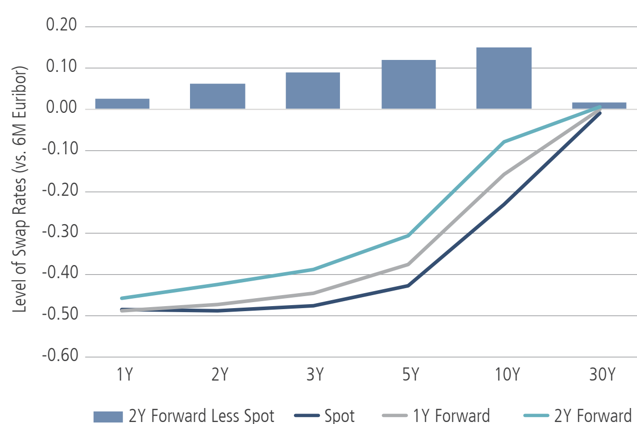
As discussed previously, we anticipate that interest rates will remain low for a long period of time, as central banks remain committed to engineering economic recovery from the impacts of the pandemic. In particular, we expect the front end of the yield curve to be pinned down by zero-rate policy. Theoretically, longer rates could creep up with economic strengthening and intensifying inflation, but the lack of a term premium in markets suggests skepticism that inflation targets can actually be realized. In addition, the markets perceive that the Federal Reserve would likely implement policies to effectively cap long-end interest rates, if we were to see any significant upward pressure in these rates.

MARKETS AREN'T CONVINCED INFLATION IS COMING

USD Spot and Forward Interest Rate Swap Curves



EUR Spot and Forward Interest Swap Curves



Source: Bloomberg. As of September 30, 2020.

In light of low interest rates, we continue to believe that developed market government securities generally lack appeal from a risk/return perspective. Rather, we believe that credit provides more opportunity, particularly in high yield, where there is now better visibility into troubled sectors, while many companies have worked to reduce their vulnerability. Within emerging markets, hard currency spreads and local yields in many countries remain attractive, and currency performance could benefit from global recovery. Agency mortgage-backed securities have stayed on our radar in light of demand for high-quality spread, particularly for more conservative fixed income investors.

COMPANIES HAVE MOVED TO SHORE UP LIQUIDITY, CREDIT QUALITY

TOPIC	ACTION
Cost cuts	Companies across all sectors cut costs from travel and entertainment to layoffs
Capex cuts	Over 10% of companies including nearly every energy company cut capex
Buybacks	Approximately 20% of S&P 500 companies cut buybacks
Dividend	Over 10% of S&P 500 and 35% of Stoxx 600 companies cut dividends
M&A	M&A volume is down nearly 60% YTD compared to 2019
Liquidity	More than100 IG companies borrowed an estimated $200bn under revolving credit facilities in 2020

Source: Bloomberg, company reports. As of September 30, 2020.

Conclusion: Fundamental Focus

The current environment remains unusual due to the relatively unpredictable nature of the coronavirus and the extensive monetary and fiscal stimulus in place to provide a bridge toward recovery, not to mention the wide divergence of policy views at stake in the U.S. election and friction toward achieving Brexit. At this stage, the low-hanging fruit tied to early recovery has largely been removed, but the potential for achieving relative performance remains well within the grasp of fundamentals-driven credit analysis. More broadly, managers will need to be cognizant of the potential impacts of broad stimulus in triggering renewed inflation as we move toward a more normal environment.

Market Views

Next 12 Months

	UNDER −−	−	NEUTRAL ◇	+	OVER ++
GOVERNMENT BOND MARKETS					
United States	○	○	●	○	○
United Kingdom	○	○	●	○	○
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 ++
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	○	○	○	●	○
Chinese Yuan	○	○	●	○	○
Russian Ruble	○	○	●	○	○
Turkish Lira	●	○	○	○	○

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

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