NEUBERGER BERMAN

Fixed Income Investment Outlook 4Q 2023

Staying Airborne

Tight monetary policy is slowing growth, but we see room to avoid a hard landing in the U.S. while Europe and China remain key risks on a global basis. In a higher-for-longer rate environment, shorter maturities offer opportunity, with potential for modest duration extension in the two- to seven-year range. Within credit, we favor enhancing quality and are finding particular value in securitized markets.

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Staying Airborne

Slowing growth could still be enough to avoid a hard landing, but in a higher-for-longer rate environment yields may provide the bulk of near-term total returns.

Coming into 2023, many anticipated a dramatically slowing economy that would lead to progress on inflation and eventually cause central banks to pull back on monetary tightening. However, such expectations underestimated the overhang of COVID-era stimulus and U.S. spending tied to climate and infrastructure. Flush with excess savings and willing to utilize credit, consumers have continued to spend at a robust pace, moving from goods purchases to services and travel. Corporate earnings, although down, have been far more resilient than many expected. Meanwhile, inflation has made an encouraging move downward, but still remains well above target. This has reshuffled expectations around the Federal Reserve's policy stance, which helped drive an upward shift in longer yields over the past few months.

There are signs of breaks, however. In the U.S., consumers appear to be hitting their limit, as savings are depleted, federal student loans begin to be repaid and credit card balances become overstuffed. The industrial economy, meanwhile, seems ready to rebound given the demand for reshoring and infrastructure spend. China faces structural headwinds even as authorities are reluctant to execute meaningful stimulus. In Europe, rate tightening (combined with the Ukraine war) seems to be having a more pronounced impact on economic growth. The net impact is likely to be economic bifurcation, with slowing but still positive trends in the U.S. and more weakness in Europe. Emerging markets could also sag, depending on the nature of the particular economy, although Latin America may be more insulated than in past periods of stress.

From a policy perspective, we believe central banks are generally close to done, with the Fed perhaps hiking one more time this year, and the ECB and U.K. on hold. However, a slower but still resilient U.S. economy and structural constraints on inflation are likely to keep us in a "higher-for-longer" rate environment as central banks wait to see the lagging impacts of aggressive tightening. Meanwhile, expectations for elevated fiscal spending and deficits could drive risk premia higher at the longer end of the bond market.

For investors, the coming months will likely see the bulk of total returns emerge from high interest rates rather than credit spreads. In our view, the environment favors leaning into shorter durations to capture now exceptional yields, but also extending duration somewhat in the two- to seven-year range to lock in those yields in advance of potential monetary easing. We remain well-disposed to credit, but favor trimming exposure in rallies. Given likely (if moderate) default pressures, we would look for more conservative high yield securities, while credit quality will also be important for U.S. municipal bonds. In emerging markets, headwinds lead to emphasis on sovereigns and the more insulated Latin American countries. Structured credit remains a bright spot given the market's unique dynamics.

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

1. Global Growth Is Slowing, but Positive

Various signs suggest that the global economy is slowing, although growth will likely remain in positive territory.

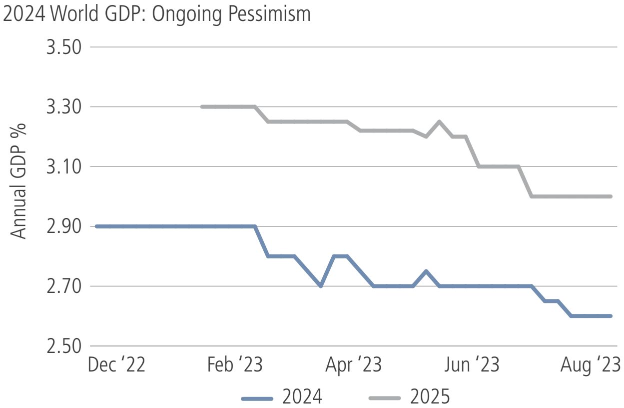
China is a key focal point for weakness, as the government remains reluctant to take meaningful steps to bail out the leveraged real estate sector. National security is instead a priority for authorities, as is independence in sourcing of key industrial components. Despite bright spots in electric vehicles and green energy, we see little reason to anticipate a structural rejuvenation of China's economy any time soon.

Europe is also facing substantial weakness; without the offsetting influence of U.S. infrastructure spending and consumer COVID windfalls, the ECB's rate hikes have fed more directly into softer business activity, while strains from the Ukraine war have exacerbated growth weakness. Germany seems particularly vulnerable at this point, given the structure of its economy.

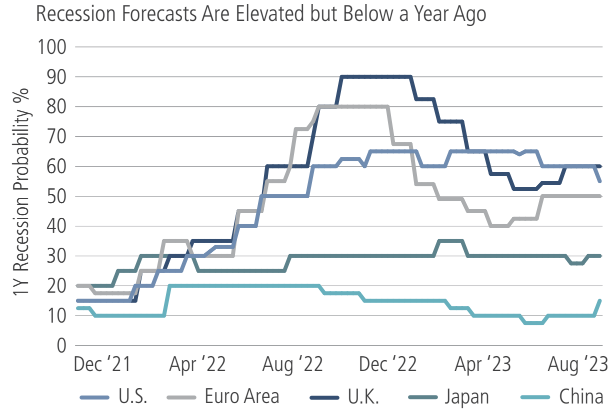
While more resilient, the U.S. is starting to see slowing spending, with consumers beset by the cumulative effects of savings drawdowns (with much remaining excess savings likely among wealthier cohorts), higher credit card balances, reduced wage growth and a tighter housing market. In pockets of consumer lending, delinquency rates have been on the rise.

MODERATING GROWTH PICTURE

2024 World GDP: Ongoing Pessimism



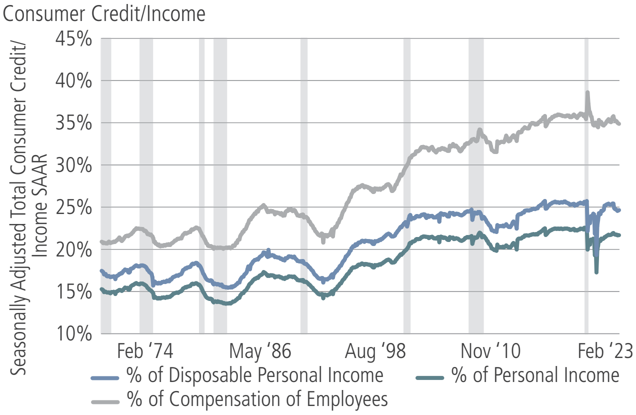
Recession Forecasts Are Elevated but Below a Year Ago



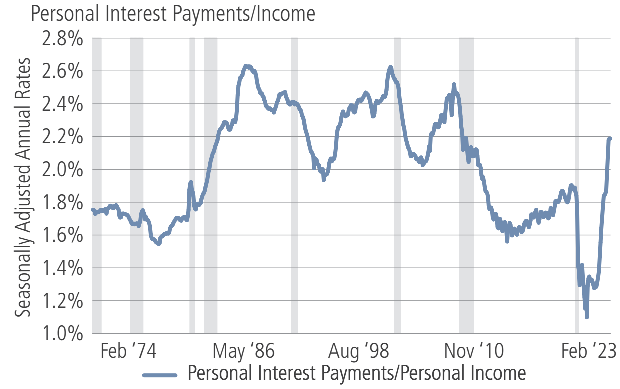
Source: Bloomberg forecasts, as of September 20, 2023.

U.S. CONSUMERS MAY BE TAPPED OUT

Consumer Credit/Income



Personal Interest Payments/Income



Source: Bloomberg, as of July 2023 (left) and August 2023 (right). Gray bars show past recessions.

2. Interest Rates: Higher for Longer

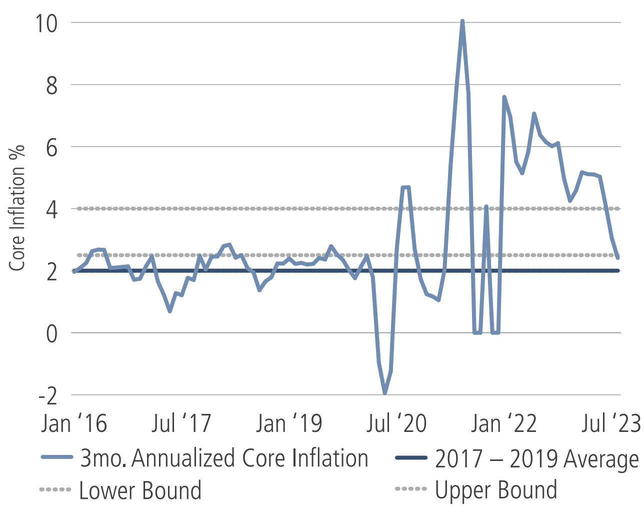
The Fed has remained hawkish in its messaging, pausing at its September meeting, but anticipating an additional interest rate increase this year. FOMC members' dot plot suggested a higher fed funds rate at the end of 2024, which contributed to a re-rating of 10-year Treasury yields to above 4.5%.

Still, the Fed has made progress on its goals. Although improvements in goods inflation may be largely over, we believe that shelter inflation is past its peak and could be a driver of price deceleration. Core services (excluding shelter) should improve, but that path may be a bit bumpier. Hourly earnings remain a key issue: Their growth, although slowing, is above what the Fed would consider its comfort level of 3 – 4%; and high-profile labor actions like the United Auto Workers strike may reinforce wage gains that undermine Fed efforts. Although not part of core inflation measures, high oil prices remain a wild card given their broad impact on the economy.

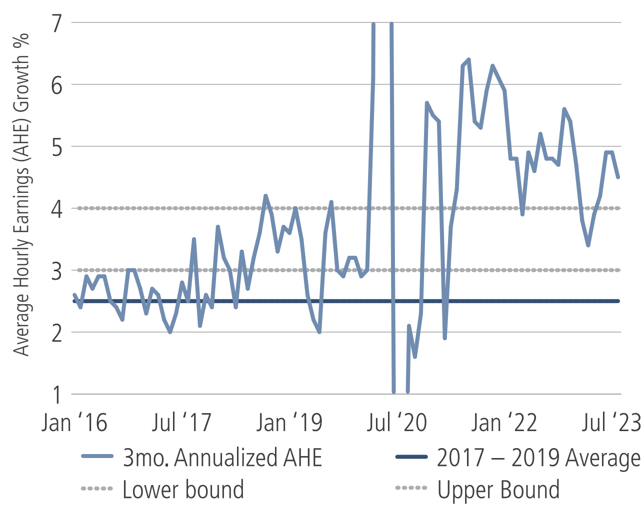
Overall, we are not yet seeing enough improvement in core inflation for the Fed to consider reducing rates, given the resilience of the U.S. economy. That said, the potential for further rate hikes is limited. A similar story prevails in continental Europe, where the ECB has signaled the coming end of increases, and in the U.K., where surprisingly soft inflation numbers have likely spelled the end of hiking.

THE FED IS MAKING PROGRESS

Core Inflation Is Receding



Wages Are Moving Lower



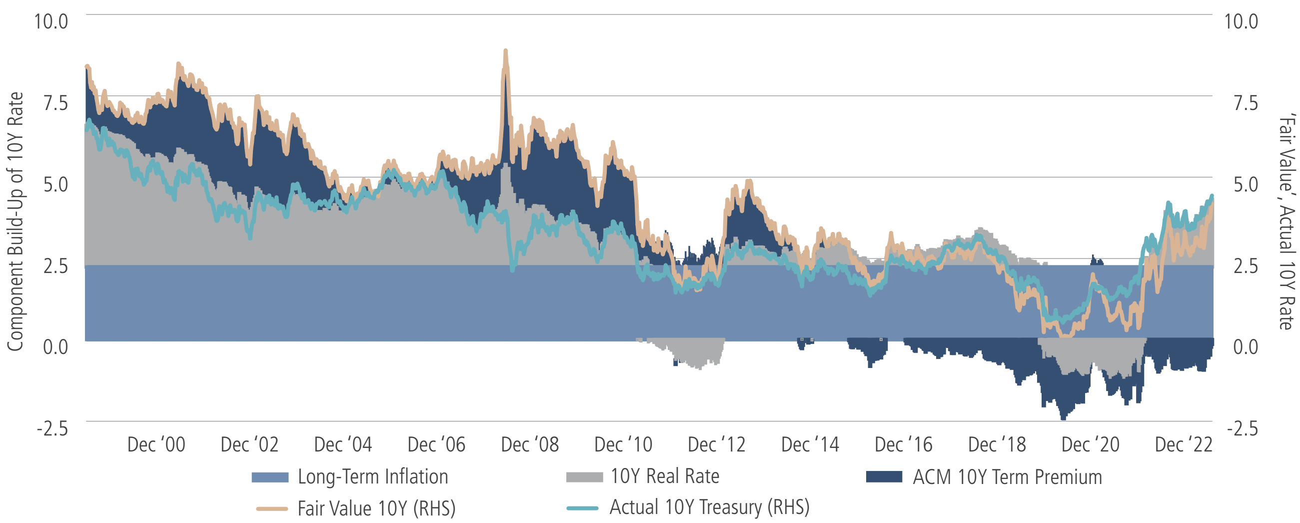
Source: Bloomberg, as of August 31, 2023.

3. Opportunity at the Short End, Caution Further Out

In terms of rates positioning, the inverted yield curve suggests the merits of capturing ample yields in shorter maturities, but there could be value in locking in yields at longer durations in advance of rate reductions. As a result, we favor moderate extension of durations in the two- to seven-year range, believing that these maturities represent value over the intermediate term.

Further out, the picture becomes more uncertain, as higher inflation, combined with increased deficit spending and debt loads, may lead investors to require a steeper term premium than the largely negative levels over much of the past 10 years. Waiting for the term story to play out may be wise amid changing economic dynamics and the potential for higher rate structures to increasingly weigh on governments in the U.S. and elsewhere.

TERM PREMIUM ON THE RISE



Source: Bloomberg, as of September 22, 2023.

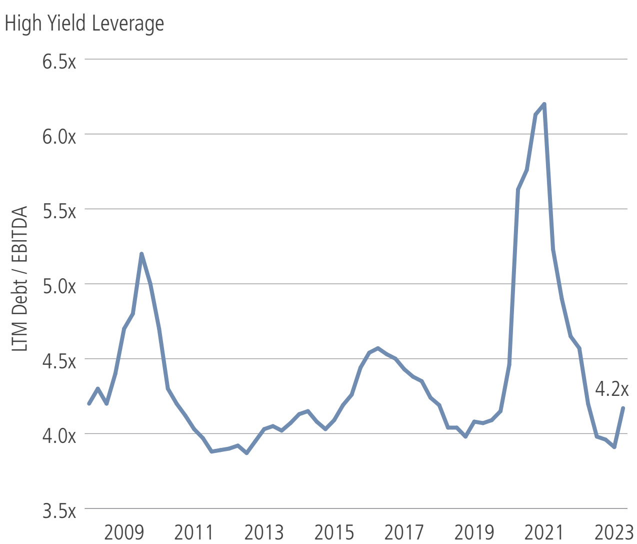
4. Credit Markets: Waiting for Wider Spreads

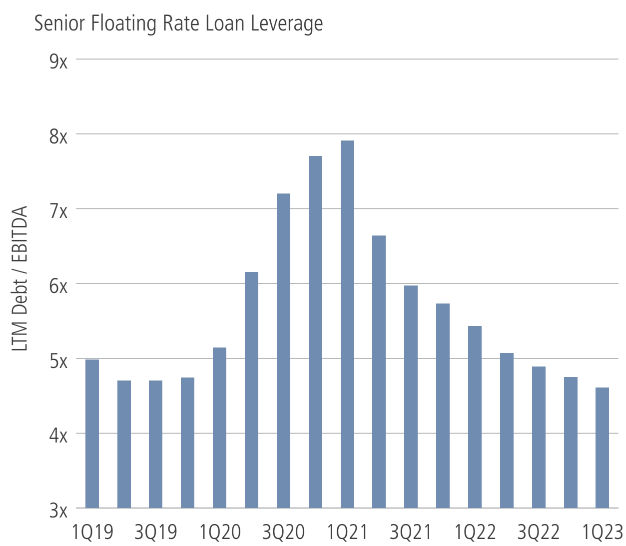
The strength of the economy has helped support credit, but we are now seeing signs of deterioration. Many companies took advantage of the low-rate environment to refinance and lengthen maturities, and thus have more capacity to ride out potential weakness. In this environment, we anticipate increased mergers and acquisitions as companies seek to expand while limiting costs and fending off the disruption associated with slower growth.

That said, the improved bulwark against macro weakness has not gone unrecognized, suggesting that we will need to wait for further spread-widening in investment grade before the segment becomes more broadly attractive. Within non-investment grade credit, still-modest default levels have been increasing, although spreads do not appear to discount more severe economic outcomes, reinforcing our bias toward credit quality within non-investment grade markets. A similar dynamic exists in municipals, where we could see negative fund flows pressure prices in the coming months—potentially creating opportunities to buy quality bonds on weakness.

Looking at emerging markets, an array of pressures are limiting return prospects for corporates in the near term, include weak earnings expectations, default trends and tight liquidity. China continues to face structural headwinds tied to deleveraging in state-owned enterprises, demographics and reduction in urbanization, but the government remains reluctant to take significant steps to support growth. Overall, we would lean more into sovereign names, particularly in Latin America, which is more insulated from global stresses than in previous cycles.

NON-INVESTMENT GRADE LEVERAGE LEVELS ARE MODERATE





Source: JP Morgan, as of June 30, 2023 (left) and March 31, 2023 (right).

5. Securitized Markets Offer Value

In our view, securitized products remain attractive across various sectors, maturities and risk profiles.

Amid slowing but still-positive consumer fundamentals, housing markets are supported by low inventories, favorable demographics and record homeowner equity. Still, commercial real estate is experiencing headwinds from resetting property valuations and tighter financial conditions.

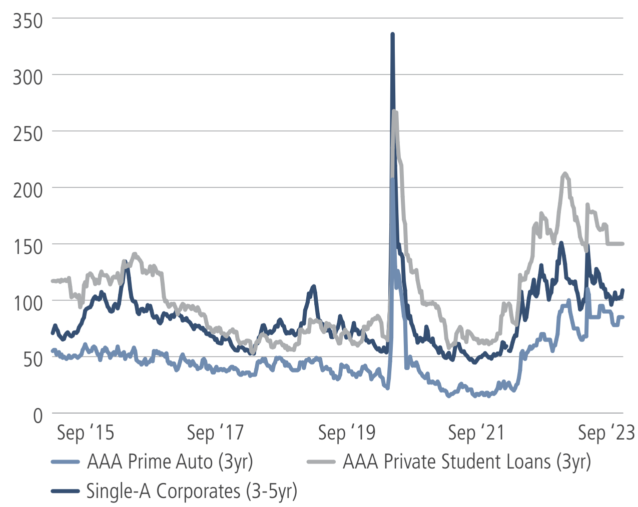
Much of the securitized landscape is trading at a discount, even as higher interest rates have caused prepayment activity (a key risk) to slow dramatically, with minimal expectation of a rebound. In terms of supply, last year's heavy primary issuance collided with soft bank demand and unprecedented fixed income outflows, while in 2023, issuance has slowed dramatically as policy rates approach their peaks. On the demand side, positive fund flows and attractive relative value have been supportive.

Overall, yields and spreads across many sectors offer historically attractive relative value, although security selection will be critical given rising fundamental risks.

VALUATIONS REMAIN COMPELLING

MBS Current-Coupon Spread vs. Treasuries (Basis Points)

ABS Spread vs. U.S. Treasury Curve (Basis Points)



Source: Bank of America, Morgan Stanley (left) and JP Morgan, as of September 30, 2023.

Market Views

Next 12 Months

	UNDER – –	–	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	○	○	○ →	●	○	End-of-cycle dynamics and asymmetric risk of economic weakness contribute to value in yields.
United Kingdom	○	○	○ →	●	○	Slowing economy and pause by Bank of England make elevated yield levels attractive.
Germany	○	○	●	○	○	
France	○ →	→	●	○	○	Spreads to Bunds should remain stable across the curve. Uncertain ECB policy outlook and higher oil price/inflation risk limits relative value upside.
Italy	○	○	●	○	○	
Spain	○	○ →	●	○	○	Post-election stalemate and strong recent economic performance highlight two-way risk.
Japan	○	●	○	○	○	
Canada	○	○	○ →	●	○	Signs of economic slowing; interest rates at elevated levels.
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	○	○	●	○	○	
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	○	○	○ →	●	○	Economy has performed better than feared, despite higher rates; relative yields are attractive; dollar appreciation could continue if risk assets correct further.
Euro	○	○	●	○	○	
Pound	○	●	○	○	○	
Yen	○	○	○	●	○	
Swiss Franc	○	●	○	○	○	
Australian Dollar	○	○	●	○	○	
Swedish Krona	○	○	●	○	○	
Norwegian Krone	○	○	●	○	○	
Canadian Dollar	○	○	●	○	○	
Mexican Peso	○	○	●	← ○	○	Potential headwinds from U.S. dollar strength, higher volatility and recent outperformance vs. other emerging market currencies.
South African Rand	○	○	○	●	○	
Brazilian Real	○	○	○	●	○	
Chinese Yuan	○	●	← ○	○	○	Muted economic recovery, poor growth, interest rate differentials and geopolitical risks.

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

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