June 30, 2022

INSURANCE INSIGHTS | MACRO STRATEGY

Relative Value & Tactical Asset Allocation

Key Takeaways

- High commodity prices, rising inflation and the tightening of global monetary policies are likely to drive global economic growth slower and continue to put pressure on assets.
- A hawkish Fed and rising U.S. recession risk could result in a very flat or even inverted yield curve by the year-end.
- Credit spreads could widen more, in our view, as corporate earnings growth and profit margins may continue softening.
- Consumer balance sheets remain healthy, but some weaker borrowers are likely feeling stretched.
- Housing and commercial real estate related sectors should benefit from higher inflation and low unemployment. Mortgage-related products are overweighted.
- Private asset spreads have been compressed due to lagged pricing and valuations are rich relative to public assets.
- Given our late-cycle views, we prefer up-in-quality credits and long duration assets over risky assets, such as High Yield Bank Loans, High Yield, and Equity.

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Slower Global Economic Growth:

The global manufacturing Purchasing Managers' Index ("PMI") index (Figure 2) suggests that global economic growth could be slower. Most central banks are tightening their policy to fight rising inflation.

U.S. – Signs that inflation will ebb have not been arriving fast enough and, despite the impact of non-core items on overall inflation, the Fed has shifted to a more aggressive stance despite signs of a more fragile consumer and increased risk of recession**.**

Europe – Short term indicators like PM surveys have softened but remain consistent with positive growth momentum in Q2. However, the outlook for the region over H2 2022 and in to 2023 has deteriorated due to numerous negative shocks.

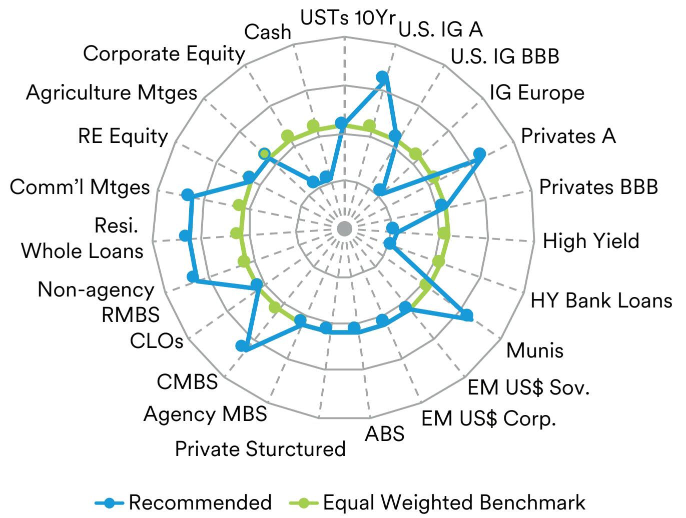
Asia – Domestic demand should help to offset softening external demand in coming months. Inflation pressure has finally arrived in Asia, with still considerable upside food price pressure ahead even if energy inflation stabilizes.

Latin America – Commodity prices are supportive to external and fiscal accounts, but higher rates in developed markets and domestic politics pose risks.

More Hawkish Fed, Flattening U.S. Yield Curve:

We expect the Fed to move more aggressively this year and for 10-year yields to decline to 2.75%. Aggressive Fed action to restrain inflation is likely to slow growth more sharply than we previously expected even as high inflation in certain sectors is acting as a brake on consumption. Consumers appear increasingly stressed, relying more on credit and decreasing their rate of savings. Additional rate hikes in combination with still-high inflation will likely further pressure consumers and negatively impact growth, this year and next. Economy-wide margins have begun to decline, and it seems likely that firms would begin to reduce labor demand and investment as CEO confidence in the economic outlook falters, echoing the decline in consumer confidence measures. Layering in the delayed impact of 2022 rate hikes into this environment, we think it likely the economy could dip into recession around mid-to-late 2023.

Figure 1 | Tactical Asset Allocation Recommendation



Note:

1. The recommendations in the chart above are solely based on our macroeconomic views, sector fundamentals and market expectations by the authors, **which may be different from MetLife's and Portfolio Managers' views**.
2. The recommendations are not associated with any MetLife's or Clients' portfolios.
3. No portfolio specific constraints are considered in these recommendations.
4. The recommendations reflect a relative directional overweight/underweight among the assets, without absolute weightings.

Corporate Credit Spreads May Continue to Widen:

Corporate earnings slowed down significantly in 1Q22. U.S., European, and emerging market fundamentals continued to improve on profitability and stable debt. While we expect credit metrics will continue to improve marginally in the coming quarters, we lowered fundamental outlook to neutral for U.S. markets on mounting macro headwinds. We expect spreads will trend wider on heightened uncertainty of Fed policy, stubbornly high inflation, and the repercussions of the Ukraine war.

U.S. Investment Grade – Both revenue and EBITDA continued to improve during the quarter while total debt remained stable. The gross leverage ratio declined to 2.48x in 1Q22 from 2.54x in 4Q21 while the coverage ratio improved to 13.56x from 13.05x (Figure 3). Both the leverage and coverage ratios are better than pre-pandemic levels. Spreads are near fair value, but investment grade yields rose to the highest levels since 2010 and we believe current yield levels are attractive.

High Yield – Defaults remained benign in 2022. Valuations improved given the most recent spread widening, but we believe that the high yield market has not fully priced in adequate downside risk yet and expect that spreads are likely to widen further.

Leverage Loans – Although the default outlook remained benign (Figure 4), we feel the best is already behind us as the distressed ratio (price < 80) rose in May. In addition, the momentum of positive rating actions also stalled as downgrades outnumbered upgrades in May, the first time since November 2020. Technicals weakened as we have seen first fund outflow since October 2020 and CLO formation has also slowed.

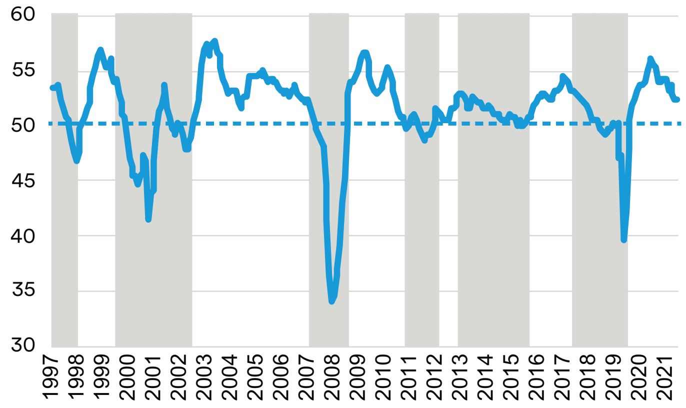
Municipals – For general obligation bonds, we expect continued growth of total state and local government tax revenue but likely at a more moderate pace through FY22. For revenue bonds, the federal government continues to provide financial support to hospitals. Air traffic continues to recover from the 2020 lows. Toll road revenues have largely recovered to pre-pandemic levels. Valuations improved due to recent spread widening, and we believe taxable municipals market will be more resilient in a challenging macro environment.

Emerging Market (EM) Investment Grade – Emerging market sovereign outlook remains neutral. However, 2Q growth is set to be lower on China's zero- Covid policy, Russia's recession and soaring inflation along with the tightening in global financial conditions. For EM corporates, our outlook remains positive as revenues and EBITDA remained very strong in 1Q22. While we don't expect overall debt levels to increase, leverage ratios may level off. CAPEX stability and improving EBITDA should lead to slightly increased free cash flow levels in upcoming quarters.

Housing Market Remains Sound, But Less Affordable:

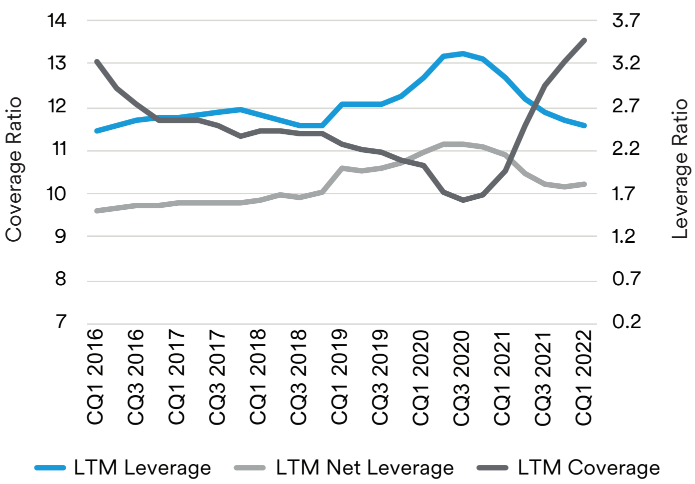
After weakness in May, a positive tone emerged for structured finance products in June. However, concerns persist regarding fundamental performance. Valuations look more attractive now. Delinquencies among weaker borrowers are growing as consumers spend down their excess savings. Concerns about persistent inflation and its impact may continue.

Figure 2 | Global Manufacturing PMI



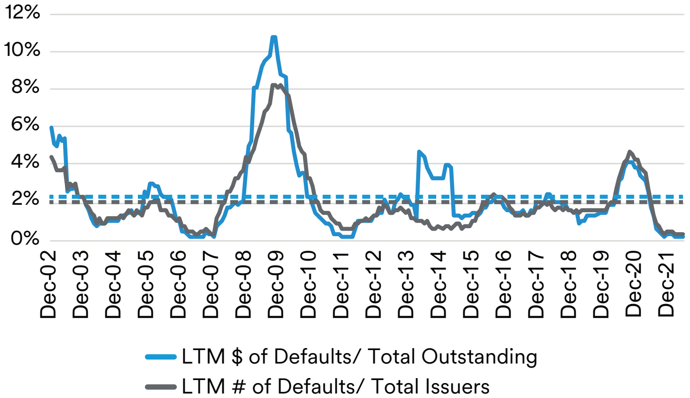
Note: Shaded areas denote recession.
Source: JPMorgan, MetLife Investment Management (MIM) and National Bureau of Economic Research

Figure 3 | U.S. IG Leverage and Interest Coverage Ratios



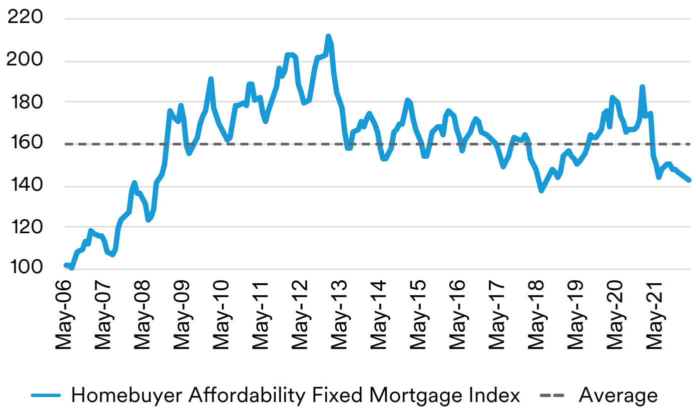
Source: S&P Capital IQ, MIM

Figure 4 | S&P/LSTA Leveraged Loan Index Default Rates



Source: LCD, MIM

Figure 5 | Housing Affordability



Source: National Association of Realtors, MIM

Residential Credit – All eyes have shifted to deteriorating affordability of home buying (Figure 5). While a national decline in home prices is not expected, regional differences will likely emerge. Many forecasters still skew towards positive home price appreciation through 2023. Borrowers are expanding their tools to manage home prices. Adjustable- rate mortgages are returning, but with significantly stronger credit profiles to help reduce risk.

Asset-backed Securities ("ABS") – Select ABS metrics are showing weakens. The Kroll Bond Rating Agency Tier 2 consumer loan index shows delinquencies for weaker borrowers increased significantly compared to few quarters ago. Higher quality consumers are significantly more stable with surprisingly high prepays indicating inflation has not yet impacted stronger borrowers.

Collateralized Loan Obligations ("CLOs") – CLO formation is running at 64% of 2021 pace for New Issue (non refi/reset). There has been a noticeable increase in "financial engineering" to distribute deals. While risk measures (e.g., weighted average rating factor and defaults) remain low, the widening spreads confirm to us the deteriorating bank loan fundamentals.

Commercial Mortgage-Backed Securities ("CMBS") – While residential price appreciation has slowed, commercial valuation has continued to accelerate. Industrial, which has enjoyed strong tailwinds from COVID/on-line needs has also attracted private equity firms. This is leading to faster valuation expansion. However, we do not believe that trends are sustainable.

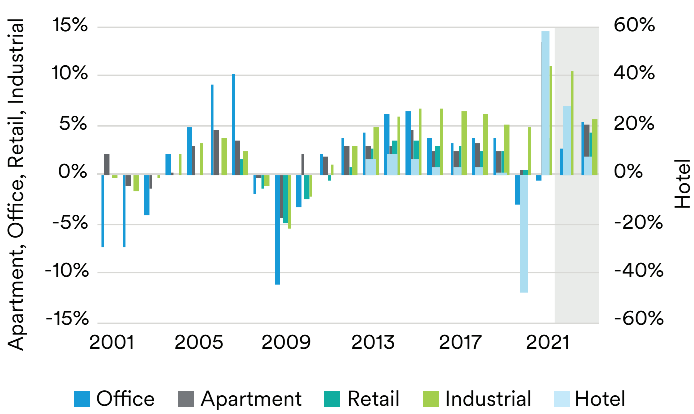
Agency Mortgage-Backed Securities ("MBS") - MBS spreads have adjusted to heightened fed activity and widened through most of Q2 2022. The current all-in yield looks attractive. Softness in the public RMBS market this year is likely to bring more opportunities with lenders that previously sold to securitization aggregators.

Private Structured Credit - Spreads have finally started to widen in Q2 after lagging public structured markets for much of the prior quarter. Alternatives financing transactions generally benefit from high collateral diversification, low advance rates, and robust deal triggers providing ability to better withstand severe declines in asset valuations.

Commercial Real Estate Likely Benefits from Higher Inflation:

Real estate fundamentals remain strong (Figure 6), in our view. Inflation has run above expectations, which has generally benefitted property income growth. Additionally, the labor market remains healthy. Equity buyers employing higher leverage are beginning to be priced out due to both higher borrowing costs and low starting cash yields. The hotel and retail sectors have surpassed pre- COVID levels of occupancy. While these property types are performing well, they may also have more downside risk if inflation (and higher energy prices) materially weaken consumer spending patterns later this year.

Figure 6 | Revenue Per Available Square Foot (RevPAF) Forecast



Source: MIM, CoStar. RevPAF represents total potential rental income adjusted for vacancy.

Strong Commodity Prices Are a Positive for Agriculture Mortgages:

U.S. farm incomes likely to remain elevated in 2022 due to historically strong commodity prices. Valuation is rich relative to history. Federal Reserve data indicates spreads have likely compressed given an increase in benchmark interest rates.

Equity Downtrend Remains:

Higher interest rates, earnings per share growth is expected to slow, profit margins are under pressure, and portfolio positioning for a downturn all have contributed to the continued U.S. equity downtrend.

Equity valuation is becoming attractive, as the S&P 500 trailing P/E ratio is at a current level of 16.6 down from 27.1 - the 2020 peak. Given the rising recession risk, soft earnings outlook and the continued downtrend, we underweight equity.

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