June 30, 2023

INSURANCE INSIGHTS | MACRO STRATEGY

Relative Value & Tactical Asset Allocation

Q3 2023

Key Takeaways

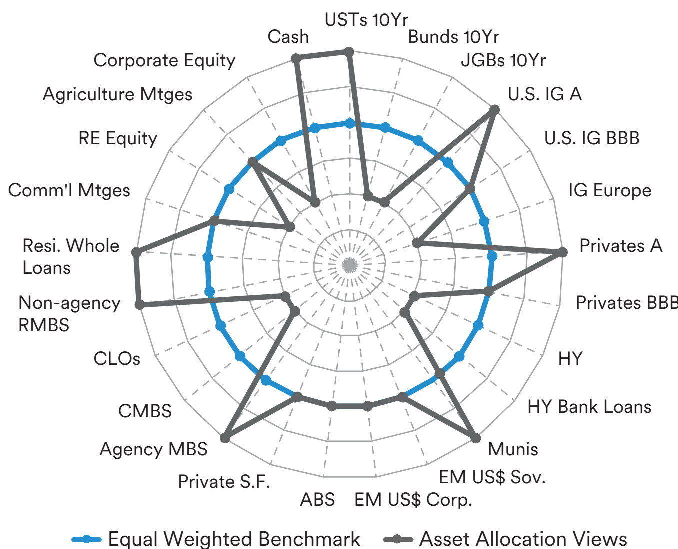
- Global economies are anticipating more economic headwinds in 2H23 with a higher risk of recession.
- Global monetary policy has diverged.
- Corporate credit fundamentals have softened, and the credit cycle is expected to turn.
- We are seeing resilient housing fundamentals, healthy consumer balance sheets, and strong farm incomes.
- Most commercial property types are well positioned, but office is the sector with the most concerns.
- Corporate equity may lose steam, while cash seems attractive.

MetLife Investment Management

The Bumpy Path to 2H23

As most central banks are nearing the end of the hiking cycle, JP Morgan's Global Manufacturing PMI Index remained at a level consistent with a contraction. It was the ninth consecutive month below the neutral level of 50 (see figure 2). **U.S. –** We continue to expect a recession to begin around midyear and believe that the Fed has likely completed its rate hiking cycle. There is evidence of a slowing in U.S. growth, which we believe signals the beginning of the end of the post-COVID-19 expansion. **Europe –** Despite the easing of supply constraints, the growth outlook remains subject to several headwinds, including sticky inflation, lagged tightening effects, and softening external demand. **Asia –** Although the regional growth backdrop has remained resilient, driven by domestic demand (except China), we are anticipating more growth challenges in 2H23. **Latin America –** Growth remained resilient in 1H23 but may start to lose steam due to monetary policy tightening, weaker commodity prices, and political uncertainty.

Figure 1 | Tactical Asset Allocation Views



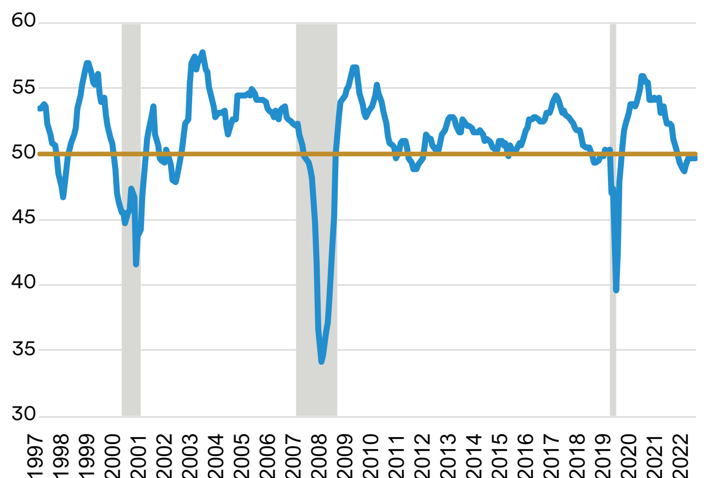
Note:

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

Global Monetary Policy Trends to Diverge

U.S. Treasury – We look for the Fed to cut rates by 0.25% by year-end, and for the 10-year yield to be lower in the coming months. **JGBs –** We expect the BoJ to widen the band for yield curve control from 0.5% to 1% in the next couple of quarters, and we look for JGB 10-year yields to end the year at around 0.65%. **CGBs –** China's slowing growth and low inflation may suppress CGB 10-year yields. **Bunds –** Valuation looks fair; however, we expect that an accelerated pace of quantitative tightening over the second half of 2023 may lean against any material rally at the longer end in Europe.

Figure 2 | Global Manufacturing PMI



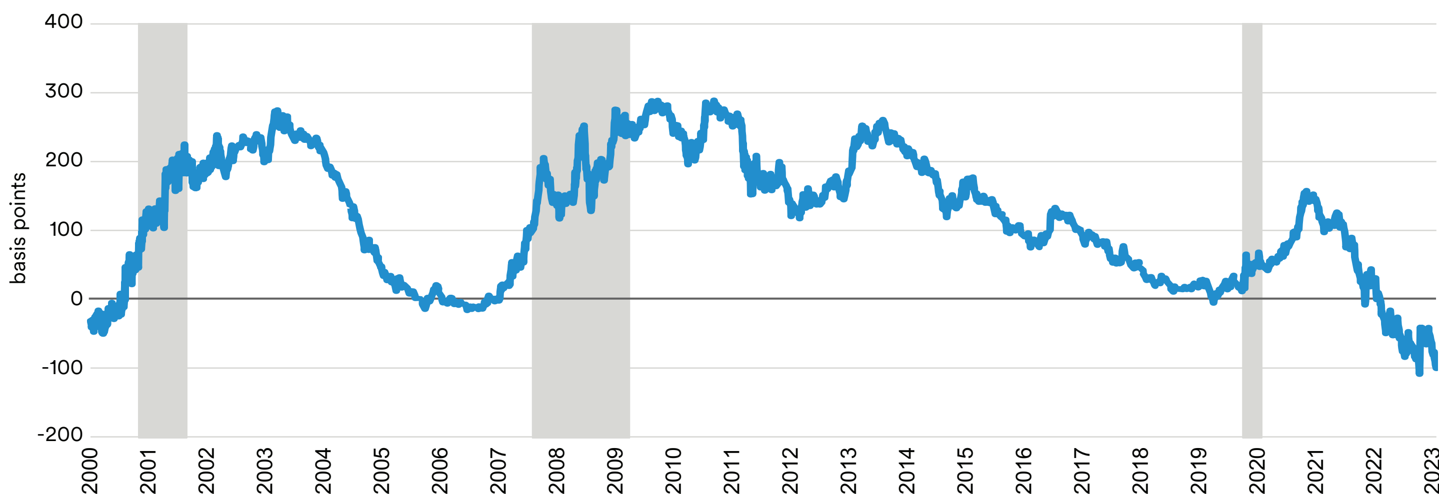
Note: Shaded areas denote recessions.
Source: Federal Reserve Bank of New York, J.P. Morgan, MetLife Investment Management (MIM)

The Credit Cycle is Expected to Turn

The credit market had a strong recovery following the regional bank turmoil in March. There are good reasons to be optimistic: 1) the policy tightening cycle is nearing an end; 2) the U.S. debt ceiling issue has been resolved; 3) stronger-than-expected earnings in 1Q23 with more optimistic earnings forecasts for 2024; 4) the U.S. economy remains resilient; and 5) the AI boom. However, the momentum is unlikely to be sustained — a deeply inverted yield curve (see figure 3), continued restrictive monetary policy, tightening lending standards, and further credit deterioration are expected in 2H23. Valuations across credit markets are close to historic averages, and pricing appears more like what we should expect mid-cycle. We do not think credit markets have priced in sufficient downside risk

yet. Looking forward, the credit cycle is expected to turn in the coming quarters, with spreads widening further on heightened recession risk in 2H23. As a result, we continue to recommend "up-in-quality." **U.S. Investment Grade (IG) –** Credit fundamentals weakened marginally in the first quarter as credit metrics deteriorated. The outlook remains neutral on the prospect of further slowing in profits and margin pressures. While overall EBITDA margins are slightly off cycle highs, ex-energy EBITDA margins have already peaked. Overall leverage ratio has only ticked up in 1Q23, but the coverage ratio has deteriorated as interest expenses have risen significantly. IG yields remain near the highest levels since 2009.

Figure 3 | U.S. Sell 2 Year & Buy 10 Year Bond Yield Spread



Note: Shaded areas denote recessions.
Source: Federal Reserve, Bloomberg, MIM

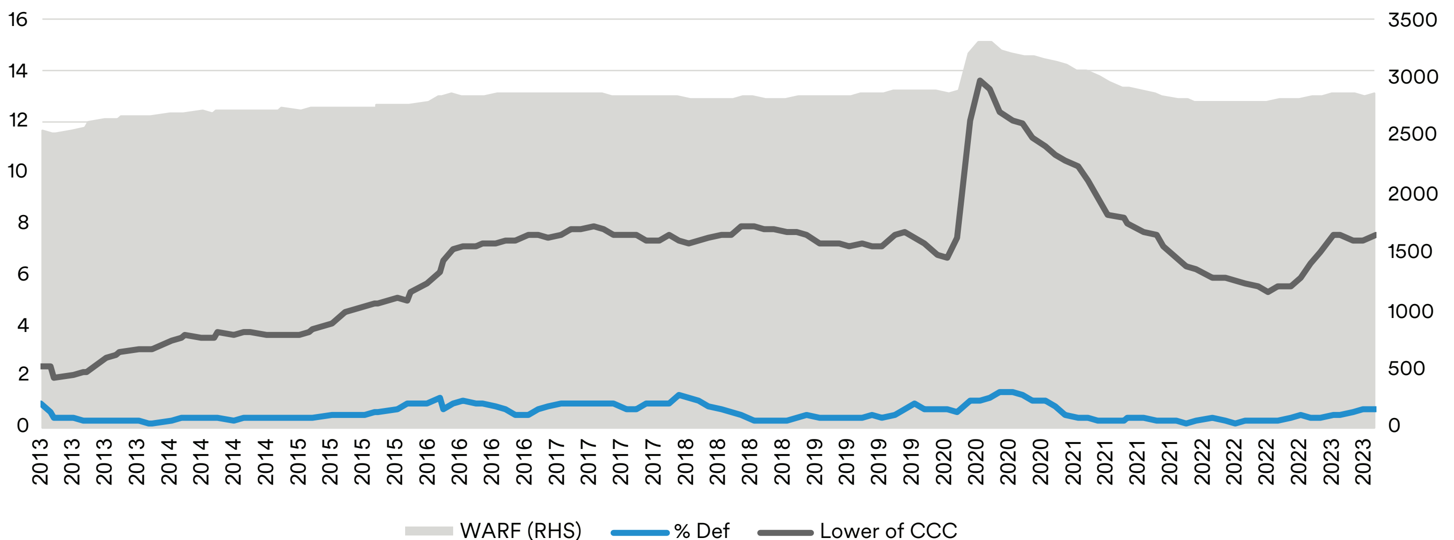
European IG – Credit fundamentals started to show signs of weakening in 1Q23 as the leverage ratio ticked up for the first time since the pandemic. Despite the announced OPEC cuts, oil prices are materially below the 2Q22 levels. EBITDA growth and margins are anticipated to continue trending down in the coming quarters. Although the ECB slowed down its pace of rate hikes, we are concerned that the eurozone growth may be below potential due to numerous headwinds. Nevertheless, the ECB is expected to conduct further rate hikes. **High Yield –** Credit fundamentals showed early signs of weakening. While the leverage ratio improved marginally in the first quarter, the coverage ratio ticked lower as interest expense outpaced EBITDA growth. According to JP Morgan, defaults picked up in 2022 and continued into 2023 but remain benign. Moody's expects the U.S. default rate to rise to 5.6% by May 2024 from only 3.1% in May 2023. The bond recovery rate dropped below its five-year average. **Leveraged Loans –** Due to the prevalence of loan-only capital structures, recovery rates are meaningfully lower than historical averages. Although recovery rates for first-lien loans remain above their five-year average in May 2023, according to Moody's, recovery rates for loan-only issuers over the past 12 months are significantly lower than those for cross issuers. Downgrades outnumbered upgrades in May, indicating that the rating migration has been negative for 13 months. Spreads appear attractive, but we are concerned about higher defaults with lower recovery rates and heightened downgrade risk for leveraged loans in 2023. **Municipals –** Outlooks for general obligation (GO) and revenue bonds remain sound despite a challenging macro outlook. For GOs, total state and local government tax revenue declined 2.3% year-over-year in 4Q22, according to the Treasury Department. This is a sharp contrast to the gains seen in 2H22. Coincident indexes improved in 1Q23. Budget reserves for FY2023 remain strong despite slowing revenue growth. For revenue bonds, air traffic has recovered from the 2020 lows, and toll road revenues have largely recovered to pre-pandemic levels. In the healthcare sector, the Omicron surge had a more severe financial impact on not-for-profit hospitals due to the nursing shortage. Recovery in EBITDA margins is expected to occur slowly in 2023-24, due to improving

productivity, cost reductions, and higher revenues. **Emerging Market (EM) IG –** After a strong rebound in 1Q23, we expect EM growth to moderate to below trend in 2H23. In China, the recovery is uneven as service sector activity continues to outperform, while the manufacturing sector has slowed significantly. China's central bank unexpectedly cut its short-term policy rate, and officials are considering a broad package of stimulus to support the property sector and domestic demand. For EM corporates, the outlook remains neutral as quarterly revenues and EBITDA declined slightly. EBITDA margins contracted but are still near the cycle peak. We expect margins to remain healthy, although there is the possibility of compression due to higher cost pressures. The leverage ratio continued to pick up as LTM EBITDA deteriorated marginally, even as debt levels were stable.

Housing Fundamentals Remain Resilient

Although lending conditions are tightening, weaker performance has been contained and within long-term expectations. **Residential Credit –** Thanks to low transactions and high mortgage rates that discourage existing borrowers (who have locked in at a lower rate) from swapping their houses, housing supply has been persistently tight, helping to limit downside to prices. A recent JP Morgan analysis pointed out that "60% of builders raised prices in May, 34% held prices flat, and just 6% lowered prices." **Asset-backed Securities (ABS) –** The still-robust labor market and healthy consumer balance sheets have been underpinning consumer spending. As the economy slips into a mild recession, a pullback in consumer health is widely expected, but it has not materialized in any significant manner and has been slow in progression. Currently, we are seeing that only the weakest consumers — those with low savings and high borrowing rates — are showing stress, and that stress is confined to certain sectors. The Federal Reserve's delinquency rate on all consumer loans rose to 2.23% in Q1, though this is still lower than the pre-pandemic level of 2.31%. **Collateralized Loan Obligations (CLO) –** As we endure an elevated downgrade environment, we have noticed that the share of CCC within CLO portfolios has grown, and defaults are trending higher (see figure 4). Deal weighted-average risk factors, or WARFs, are increasing slowly. Issuance has begun to slow after a brisk Q1. Recovery rates have been under pressure lately and have fallen to multi-year lows according to JP Morgan. In our view, it is expected that 40% of CLOs will be out of reinvest by year-end, which may reduce the flexibility of CLO managers to manage their pools.

Figure 4 | CLO Universe Metrics



Source: Kanari, MIM

Commercial Mortgage-backed Securities (CMBS) – Fundamentals continue to face several challenges: tighter lending standards, higher refinancing costs, elevated volatility in the capital markets, and valuations under pressure. Elevated office vacancy across the U.S. is leading to growing delinquencies in office collateral. With weak demand for office space, we may see the effects of lower tenant demand on the sector, when leases on office properties begin to roll. Rating agencies are expected to become more active with downgrades and negative watches in the near future. **Agency MBS –** With attractive valuations, a diminishing negative convexity effect, and the potential decline of interest rate volatility, money managers are increasingly overweight on Agency MBS. However, bank liquidations and a weak outlook for bank demand may pressure the sector. We noticed that mortgage originations have normalized this spring, as positive seasonals offset higher mortgage rates. Refinancing activity remains minimal as the majority of the asset universe is out of the money. **Private Structured Credit –** With high rates, inflation pressures, and potential weakness in employment, we expect delinquencies and defaults to rise in the coming months., This is especially true for asset classes exposed to non-prime borrowers. The private ABS pipeline has slowed as market volatility increased. Credit stress and rising recession risk put pressure on spreads. We expect esoteric ABS spreads to remain under pressure in Q3 and may see potential spread widening.

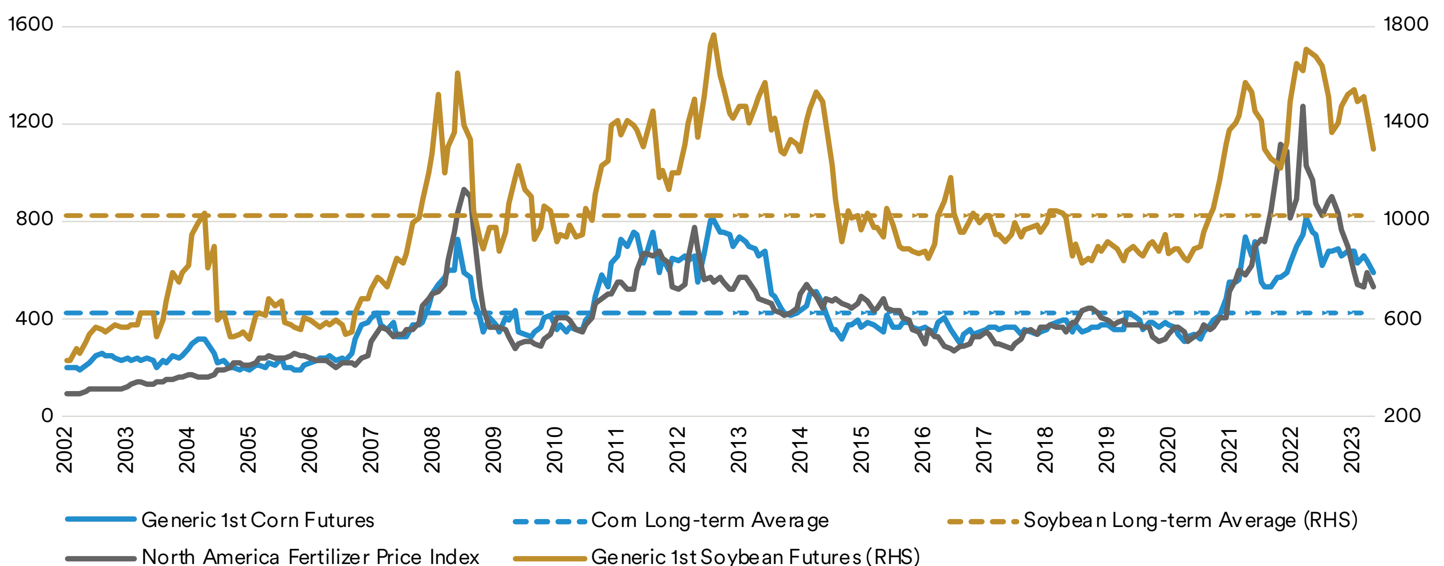
Office is the Most Stressed Sector

Despite economic headwinds, we think current commercial real estate fundamentals remain generally healthy. Most property types are well positioned, with vacancy rates at or below their historical averages. However, in our view, office is the most stressed sector.

Positive Drivers may Offset Recent Signs of Softening

Due to the ongoing Ukraine-Russia conflict, softening economic conditions, policy tightening, and a stronger U.S. dollar, U.S. agricultural exports are expected to decrease from last year's record high. Despite these headwinds, agricultural credit fundamentals remain robust, thanks to above-average commodity prices and moderating input costs, such as fertilizer (see figure 5). South American crop production has improved slightly compared to spring projections due to easing drought conditions. As a result, global corn and soybean production are expected to expand in 2023. However, tight stocks may keep crop prices above the 10-year average and support margins this year. We continue to believe farm sector financials remain healthy, with near-record farmland values, strong farm incomes, and historically low delinquency rates on agricultural mortgages.

Figure 5 | Commodity Prices and Fertilizer Price Index



Source: Chicago Board of Trade, Green Markets, Bloomberg, and MIM

Corporate Equity May Lose Steam While Cash Seems Attractive

Since the regional bank turmoil in the spring, equity markets have posted a surprisingly good performance so far this year, reflecting better-than-expected macro news flow. However, we believe that this is unlikely to be sustained due to the inversion of the yield curve, ongoing policy tightening, compressing margins, a slowdown in earnings, and elevated recession risks. We look for U.S. corporate equity to start to lose steam as the economy enters a recession around midyear. We remain underweight corporate equity from a relative value perspective. Cash seems relatively attractive, with U.S. three-month Treasury bills yielding above 5%, according to Bloomberg. As monetary policy will likely remain restrictive in the near future, cash may maintain its relative attractiveness.

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