October 5, 2023

INSURANCE INSIGHTS | MACRO STRATEGY

Relative Value & Tactical Asset Allocation

Q4 2023

Key Takeaways

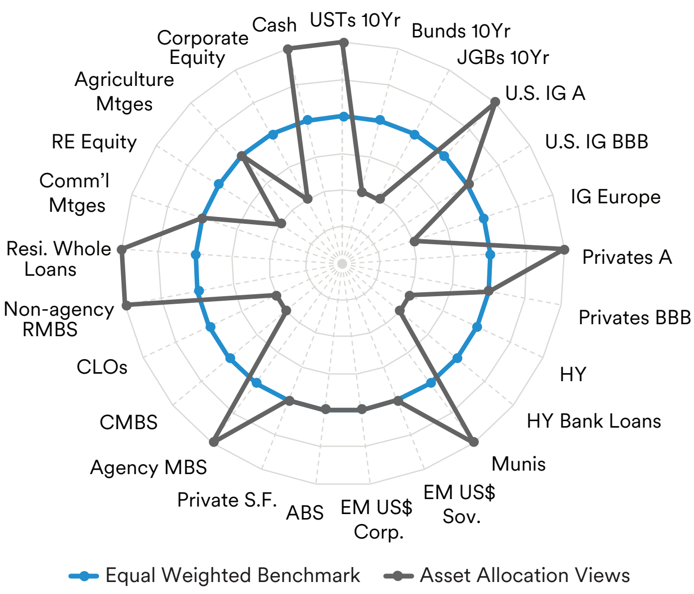
- Divergence in global monetary policy has become more obvious, with emerging economies cutting interest rates.
- Global economic growth is expected to slow further, putting downward pressure on global government bond yields.
- Valuation risks across credit markets remain high, with credit fundamentals mostly weakening.
- While home prices have held up, changing bank capital regulations and student loan payments may impact the current market dynamics.
- Agriculture fundamentals remain healthy, while office continues to be the most concerning sector.
- We believe that current equity valuations are too high, while cash investments remain attractive.

MetLife Investment Management

Global Economy to Slow Further

Divergence in global monetary policy has become more obvious, with emerging economies cutting interest rates (see Figure 2). **U.S.—**We look for a U.S. recession to begin in 2024. 2023 is expected to continue to show mixed growth messages as consumer spending is anticipated to continue offsetting weakness in the manufacturing sector. **Europe—**Growth continues to weaken due to China's slower-than-expected growth, energy, the lagged impacts of policy tightening, and waning fiscal support. **Asia—**The lagged effects of tighter monetary policy have begun to emerge against a backdrop of slowing global growth, but Asia is expected to be a global growth outperformer this year. **Latin America—**The region's economic activity surprised to the upside in 1H23 in Mexico and Brazil, but the growth, like other regions, is expected to decelerate.

Figure 1 | Tactical Asset Allocation Views



Note:

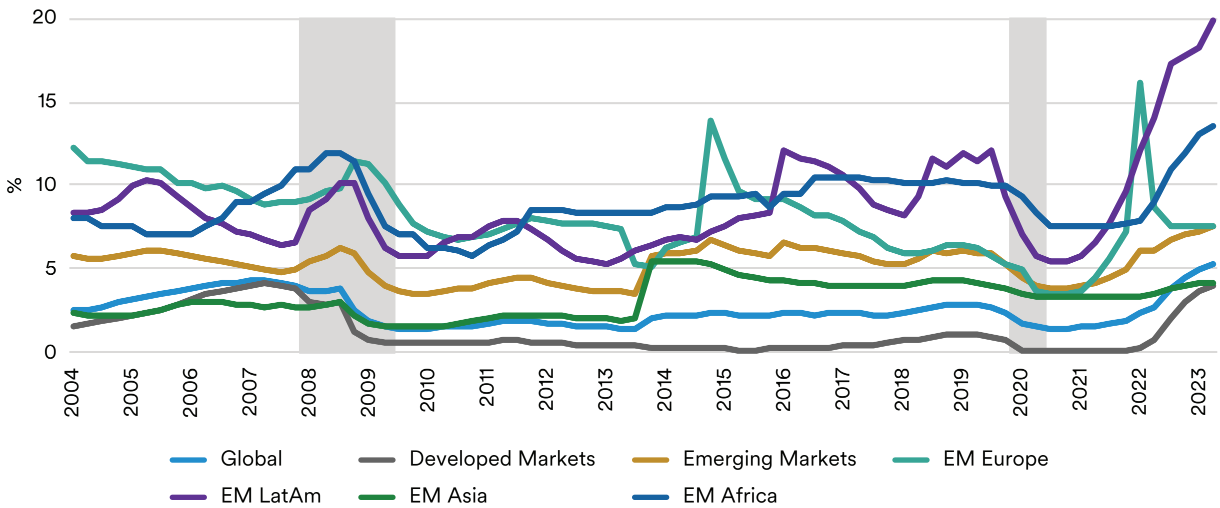
1. The asset class views in the chart above are based solely on our macroeconomic views, sector fundamentals, and market expectations by the authors, **which may be different from MetLife's, Portfolio Managers' and sector strategists' views, which are included in this report.** For illustrative purposes 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.

Source: MIM

Slower Growth May Mean Lower Yields

U.S. Treasury (UST)—The 10-year yield is expected to move lower over the next several months; we look for the yield curve to shift downward and remain inverted. **Japanese Government Bonds (JGBs)—**A growth slowdown in Japan's export markets and our expectation for the Federal Reserve (Fed) to cut interest rates next year may put more downward pressure on global government bond yields, helping the BoJ to reduce its JGB purchases. **Chinese Government Bonds (CGBs)—**Local government special bond issuance seems unlikely to cheapen CGBs due to ample liquidity. If Beijing undertakes a debt swap program in 4Q23, we believe it is unlikely to have a material impact on CGB yields. **German Bunds—**Bunds remain fundamentally supported by strong demands for high-quality euro sovereign papers.

Figure 2 | GDP-Weighted Policy Rates

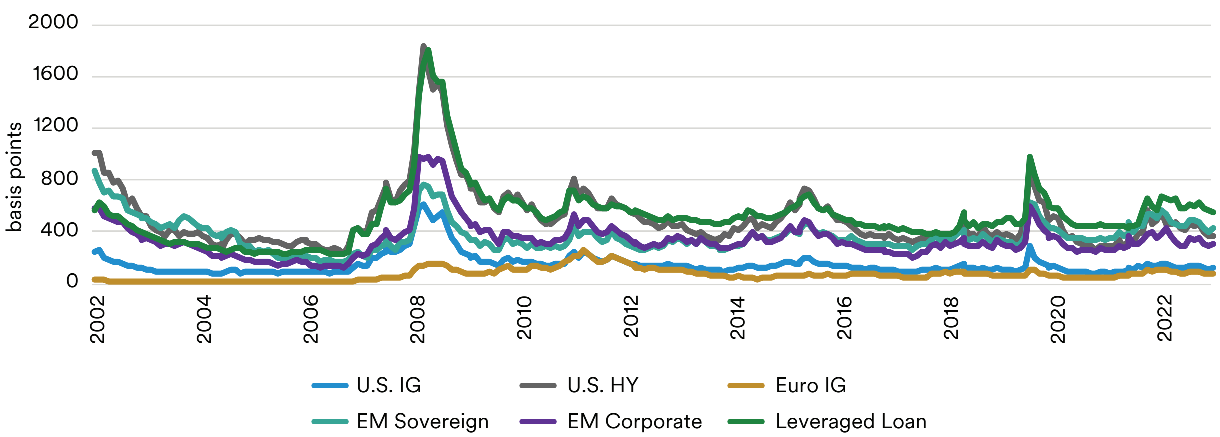


Note: Shaded areas denote recessions. EM means emerging markets.
Source: Haver, MIM

Valuation Risks Across Credit Markets Remain High

The credit market recovered further during the summer as spreads tightened (see Figure 3) with low-quality corporate bonds outperforming. Corporate earnings were resilient and beat expectations. With headline inflation continuing to improve, the soft-landing narrative became louder. However, we believe the market is overly optimistic about the soft-landing scenario, and valuation risks across credit markets remain high. Historically speaking, when the Fed is done tightening, rates have usually peaked. Therefore, we believe it is now better to take duration rather than credit risk, and we continue to recommend "up-in-quality" for the remainder of 2023. **U.S. Investment Grade (IG)—**Credit fundamentals continued deteriorating moderately. After the banking issue earlier in 2023, confidence about the U.S. banking system gradually recovered. We think overall IG spreads are fairly valued. With IG yields climbing to the highest levels since 2009, we believe the current yield levels are attractive.

Figure 3 | Spreads Narrowed from Three Months Ago



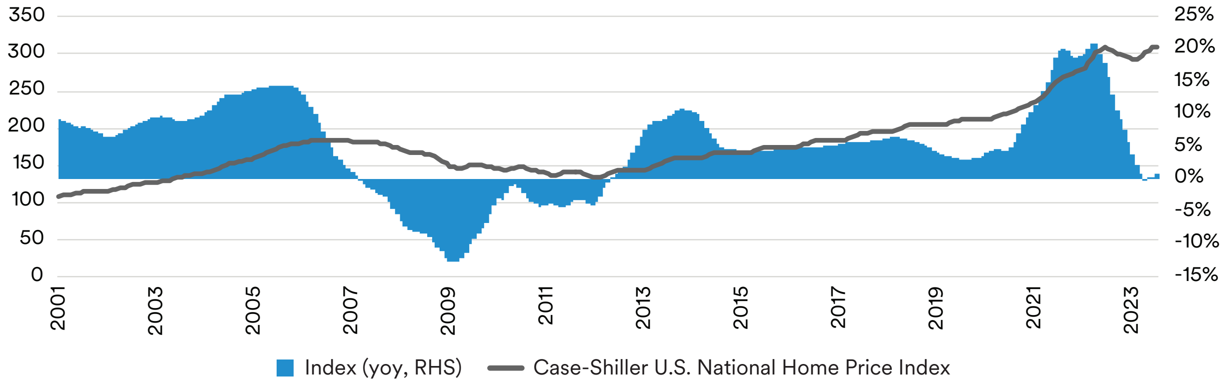
Source: Bloomberg, J.P. Morgan, MIM

European IG—Fundamentals weakened moderately in the second quarter of 2023. Although earnings were better than anticipated, downside risks remained. The energy sector, a strong performer from last year, reversed to be an underperformer in 2Q23. We look for European IG's fundamentals to continue to weaken in the coming quarters. **High Yield (HY)—**Like other asset classes, HY's fundamentals deteriorated further in 2Q23, with bond recovery declining to near its five-year low. Moody's expects the U.S. speculative-grade default rate to rise to 5.6% in January 2024 and then ease to 4.6% by August 2024. **Leveraged Loans—**Recovery rates remain persistently lower than historical averages. Moody's rating migration outlook remained negative, with the one-year forward downgrade probability for single-B issuers still elevated. **Municipals—**Credit fundamentals were stable for both general obligations (GOs) and revenue bonds in 2Q23. For GOs, total state and local government tax revenue declined 8.9% in real terms year over year (yoy) in 1Q23, according to Urban Institute's State Tax and Economic Review, while property tax revenues expanded by 0.4% yoy. We expect state budgets to increase 2.5% next year. For revenue bonds, the healthcare sector's operating cash flow margins recovered in 2Q23, based on MIM's internal data, but are still below the pre-pandemic level. **Emerging Market (EM) IG**—Despite the growth slowdown during 2Q23, we look for EM growth to rebound in 2H23 and Asia to outperform EMEA and LatAm. In China, the macro backdrop continued to fade amid a broad-based slowdown in its domestic demand and a faint property sector. For EM corporates, fundamentals also weakened moderately. We look for the leverage ratio to trend higher as EBITDA may remain pressured. EM banks' loan growth slowed due to elevated interest rates, and we expect savings to increase and borrowing to decrease in the short term.

RMBS Are Preferred Over CMBS

Residential Credit—Mortgage rates continued to stay very elevated, keeping affordability measures very weak. However, we think the U.S. housing market has already hit its bottom and is recovering (see Figure 4), due to limited supply and a lack of transactions. Looking forward, changing bank capital regulations may lead banks to hold more agency MBS and less loans in the long term. **Asset-backed Securities (ABS)—**Consumers have managed to continue spending excess savings. We see consumers with low FICO scores and young borrowers are falling behind in payments at a faster rate than other cohorts. Student loan payments are expected to begin shortly, adding more stress to consumers who are not making payments for three years. **Collateralized Loan Obligations (CLOs)—**Fundamentals within the bank loan market have not improved, with higher weighted-average risk factors (WARFs) and elevated shares of CCC within CLO portfolios. We have noticed that a resurgence in refinancing and reset transactions has begun. Recovery rates continue to be very low and are anticipated to remain below long-term averages for some time.

Figure 4 | The U.S. Home Prices Have Held Up



Source: Bloomberg, S&P CoreLogic Case Shiller, MIM

Commercial Mortgage-backed Securities (CMBS)—Fundamentals continued to be challenged. Most indices of National Council of Real Estate Investment Fiduciaries (NCREIF) were showing steep declines, with the office sector down 15% yoy. With the lending environment still under stress, we are seeing significant consolidations in average number of loans in a deal. Due to higher delinquencies, appraisals are being released. We look for many key properties in large cities to be down significantly more than indices indicated. **Agency MBS—**Higher interest rates, elevated volatility and a lack of bank demand remain a headwind for Agency MBS. Prepayment activity is muted, while mortgage originations remain at low levels. FDIC bank liquidations of specified pools have been completed, which may improve the supply picture going forward. **Private Structured Credit—**Performance in the prime consumer segment remains healthy. Delinquencies and defaults in the subprime borrower cohort have largely stabilized at or slightly above long-run historical averages. However, we remain cautious of the subprime segment as its performance may deteriorate further if unemployment were to rise in a recession scenario.

Office Continues to be the Most Concerning Sector

Real estate values have been repriced throughout the year, due to the high interest rate environment and the macroeconomic outlook. Vacancies continue moderating but remain well below historical long-term averages across many property types. Office remains the most concerning sector with another period of negative net leased space. Overall fundamentals seem to remain healthy. Both debt originations and equity transaction volumes continued declining, and we expect the trend to persist for some time.

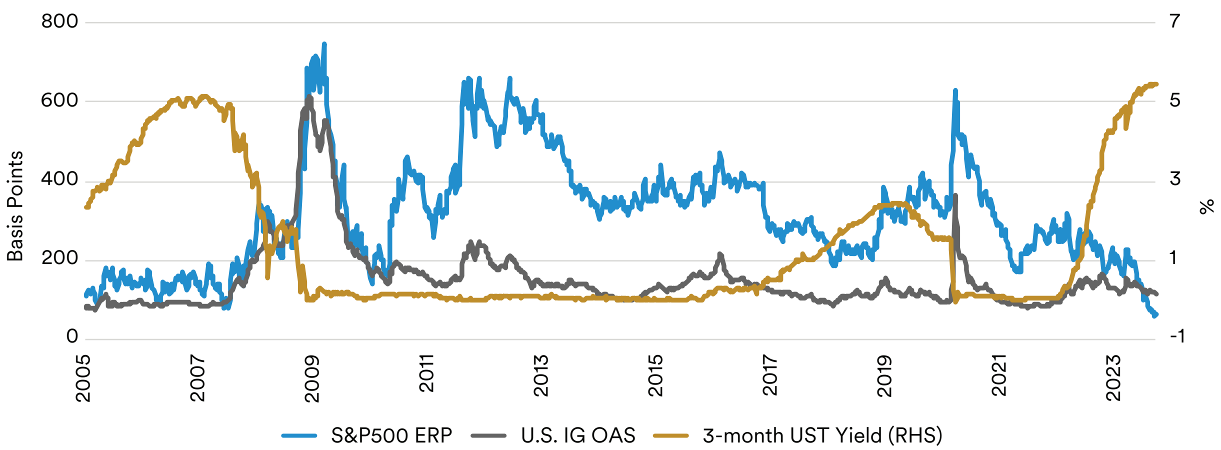
Agriculture Fundamentals Remain Healthy

Net farm income is projected to be lower due to moderating annual crop market prices but still remains 39% above the long-term average, according to the United States Department of Agriculture, thanks to declining input expenses (e.g., fertilizer, diesel). Agricultural mortgage borrowers' financial positions continue to remain healthy due to multiple years of robust farm incomes and strong growth in farmland values. We think that tight global stocks may help maintain annual crop prices above the 10-year average. The ongoing Russia-Ukraine War and the Black Sea Grain Initiative (BSGI) suspension are anticipated to disrupt grain export flows from the Black Sea, potentially creating trade opportunities for the U.S. grain exports. While the agricultural credit delinquencies remain low, the rising interest rate environment is taming the debt demand.

Corporate Equity May be Overvalued While Cash Seems Attractive

The S&P 500 equity risk premium (ERP) has been surprisingly below the U.S. IG option-adjusted spread (OAS) since late June this year (see Figure 5) and is at its lowest level in decades. This may suggest that stock investors have priced in an expectation that is even better than the soft-landing scenario. We believe that current equity valuations are too high, comparing to current macro fundamentals, which we think may not be sustainable. We continue to remain underweight corporate equity from a relative value perspective. Thanks to the high interest rate environment, the yield on 3-month U.S. Treasury bills is at a multi-decade high. As monetary policy will likely stay restrictive in the near future, we continue to consider cash investments relatively attractive.

Figure 5 | ERP Has Fallen Below IG Credit Spreads



Note: ERP is calculated as LTM earnings yield minus 10-year UST yield.
Source: Bloomberg, S&P Global, Federal Reserve, MIM

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