Relative Value & Tactical Asset Allocation

Q3 2024

INSURANCE INSIGHTS | MACRO STRATEGY

July 12, 2024

Key Takeaways

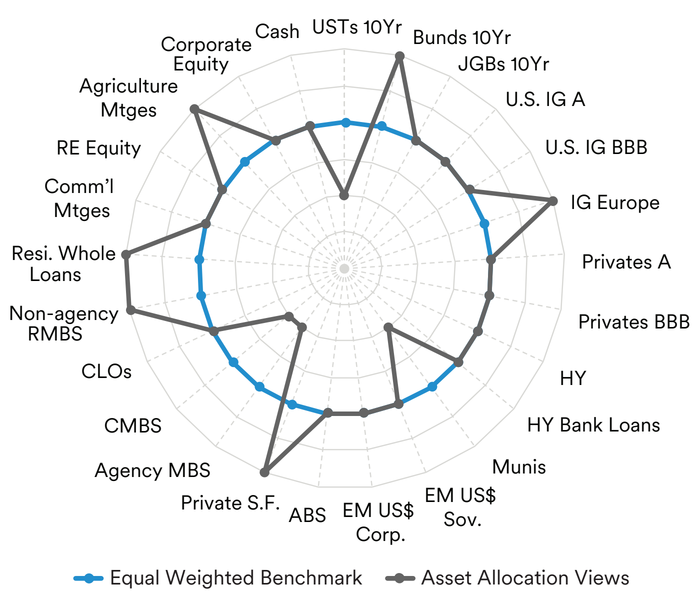
- We are not expecting a U.S. recession in 2024.
- We are looking for credit spreads to remain rangebound in the near future, and we prefer high carry while considering downside risks.
- Consumers and housing fundamentals continued to be solid, while CLOs fundamentals weakened further.
- Commercial real estate fundamentals are stable, but performance divergences are wide.
- We are neutral for both corporate equity and cash investments.

MetLife Investment Management

Global Growth Holds Steady with Economic Volatility Expected into 2025

Global manufacturing activities continued appear stable (see Figure 2), thanks to expansions in output, new orders, and employment. **U.S.**—We are expecting no recession in the United States in 2024 but look for growth to slow to 2% and inflation to remain near 3%. We are looking for a period of renewed economic volatility driven by a variety of domestic and global factors. **Europe**—The disinflation process has broadly persisted in the Euro area and the U.K., with growth momentum remaining positive. However, we are seeing increasing uncertainties in our growth outlook, due to regional conflicts, European elections, and volatile energy prices. **Asia**—Growth has held up well in the region and broadened out with stronger-than-expected global demand which is supporting export-oriented economies. Inflation has eased for most countries. **Latin America**—Disinflation is slowing down as goods inflation may have ended and services inflation remains sticky. Economic activity across the region was mixed.

Figure 1 | Tactical Asset Allocation Views



Note:

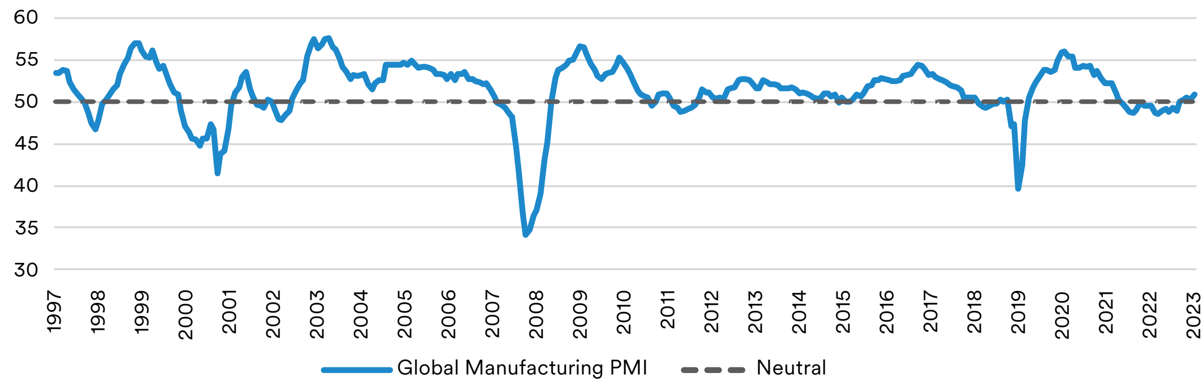
1. The asset class views in Figure 1 are based solely on our macroeconomic views, sector fundamentals, and market expectations by the authors, **which may be different from MetLife's Portfolio Managers' and sector strategists' views, which are included in this report.** For illustrative purposes only.
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: MetLife Investment Management (MIM). As of June 24, 2024

We are Expecting a Flatter U.S. Treasury Yield Curve

U.S. Treasury (UST)—Over the next quarter or two, we expect lower front end yields and no change for the long end. **Japanese Government Bonds (JGBs)**—We have revised our year-end JGB 10Y forecast to 1% from 0.8%, reflecting our upward revision in core CPI and rising expectations for another hike from the BoJ. **Chinese Government Bonds (CGBs)**—We may see some modest upward pressure on 10Y CGBs in the near term, with more duration supply from both special Chinese government bonds and local government bonds. **German Bunds**—We are seeing some potential for bunds to rally, particularly at the short end, as the ECB has begun its rate cut cycle this year.

Figure 2 | Global Manufacturing PMI



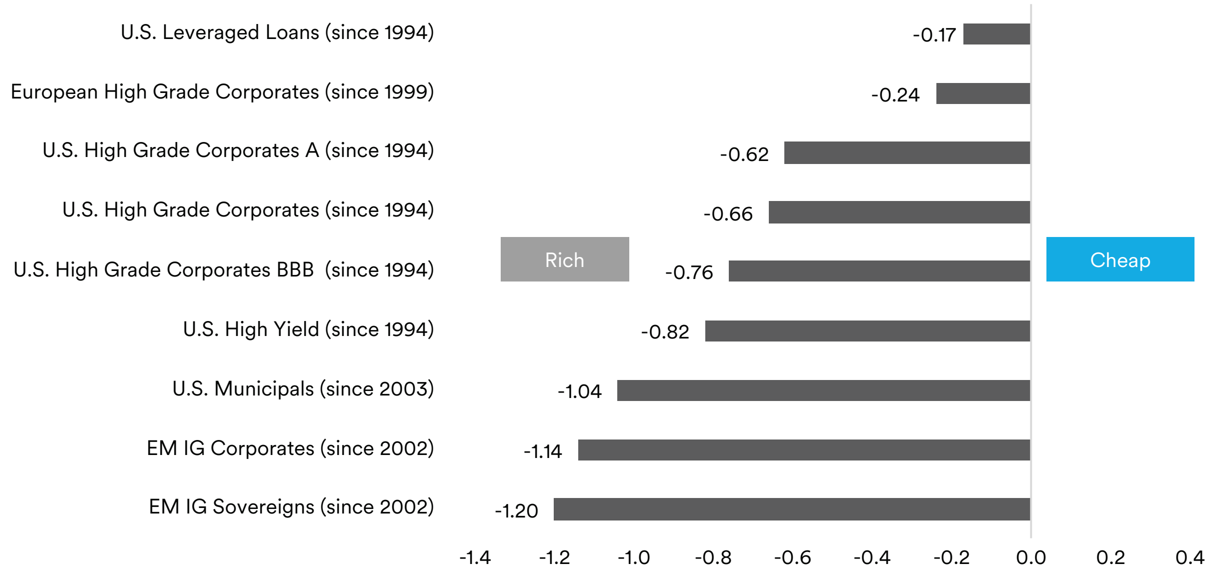
Note: PMI above 50 indicates expansion.
Source: JPMorgan, MetLife Investment Management (MIM). As of May 31, 2024.

Credit Spreads are Expected to Remain Rangebound

Credit spreads tightened further from a quarter ago, making valuations more challenging (see Figure 3). Although corporate earnings surprised to the upside, earnings growth disproportionally came from mega-cap technology companies. We believe the current expectation of EPS growth is too optimistic, given a smaller number of policy rate cuts from the Federal Reserve than MIM had initially anticipated. During the first quarter, credit fundamentals stabilized across the U.S., Europe, and emerging markets. Looking forward, we continue to look for credit metrics to stay at healthy levels. We are anticipating most credit spreads to be rangebound in the near term. Our approach has switched to risk-on from risk-off, and we prefer high carry while considering downside risks.

U.S. Investment Grade (IG)—Fundamentals deteriorated mildly in 1Q24 but remained mostly resilient. Valuations seemed rich at the index level. We continue to believe that spreads do not appropriately reflect market risks. Despite tight spreads, we do find that all-in yields remain attractive on a historical basis.

Figure 3 | Long-term OAS Z-Score Suggests Valuations Remain Rich in All Sectors



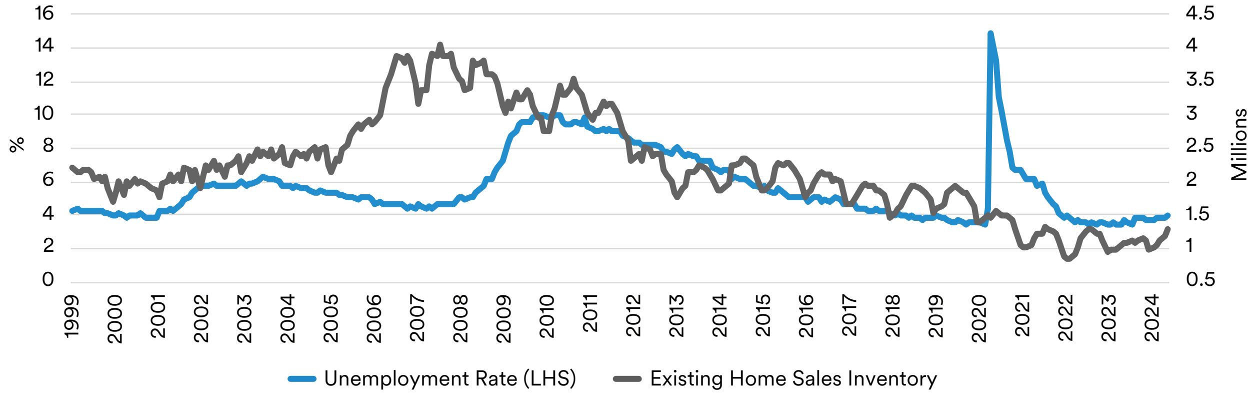
Note: Z-score is a metrics used to show how high or low the value relative to the average value using standard deviation as a unit. A Z-score of one indicates that the current value is one standard deviation higher than the average value.
Source: Bloomberg, J.P. Morgan, Barclays, Credit Suisse, MIM. As of 5/31/2024.

European IG—Spreads continued to tighten in line with U.S. markets. Fundamentals overall remained stable. European IG has been supported by a strong technical backdrop even as supply has risen to record levels. According to JP Morgan[1], it has been a record start to the year for retail fund inflows as well. The technicals are expected to strengthen further in 2H24 due to a slowdown in the pace of supply growth. **High Yield (HY)**—Credit fundamentals, like U.S. IG, weakened slightly but remained mostly stable. Moody's expects the U.S. issuer-weighted default rate to exhibit a downward trend, ending the year at 4%, from almost 6% in April[2]. The primary market has remained resilient with very strong issuance. HY mutual funds have been reporting significant inflows starting early this year, according to the Investment Company Institute. **Leveraged Loans**—We maintain our preference for an up-in-quality approach within bank loans as an offset against the potential for slowing economic growth. The relatively high interest returns are expected to continue playing a greater role in boosting total returns for this asset class. **Municipals**—The S&P Municipal Bond Index generated a return of -0.24% in May or a year-to-date return of -1.4%, due to a mass of issuance in April and May with historically tight valuations. Fund flows remained mixed. Although municipals fundamentals remained stable in 1Q24, we are seeing potential risks in the sector, as we are expecting economic growth to slow. **Emerging Markets (EM)**—EM sovereign fundamentals have largely stabilized from the growth and inflation shocks since 2020, with most EM countries running at or above potential. Fundamentals of EM corporates remained healthy, and we think that metrics may moderate while staying resilient in the near term. We are seeing EM opportunities at both the sovereign and corporate levels, which may lead to a better flow picture in 2024.

Consumers and Housing Fundamentals Continued to be Solid

Residential Credit—Despite challenges including constrained builder confidence, stressed affordability, and regional climate risk, housing fundamentals remained robust. While limited inventory and a strong labor market have been a tailwind for home prices (see Figure 4), we are seeing some signs of normalization regionally in the sunbelt states. **Asset-backed Securities (ABS)**—Investor demand remains strong for the sector, supported by an inverted yield curve and its shorter duration profile. Delinquency rates across both auto loans and credit cards continued to trend upward. Looking forward, we think inflation, elevated debt levels and tightening bank standards are likely to remain headwinds for consumers. **Collateralized Loan Obligations (CLOs)**—Fundamentals have weakened further, with downgrades outpacing upgrades, and recovery rates are under pressure. Spreads are well supported, driven by investors' preference for floating rate securities into higher interest rates. We are looking for defaults to rise to a range of 3.5% to 5.0% by the end of 2024.

Figure 4 | Unemployment and Housing Inventory Remained Low



Source: Bureau of Labor Statistics, National Association of Realtors, MIM. As of 5/31/2024.

Commercial Mortgage-backed Securities (CMBS)—The delinquency rates for all CMBS loans continued to trend higher at 5.07% in April, according to CREFC[3]. Commercial real estate prices steadied over the past quarter but remained under pressure, with the NCREIF All Property Index down 7.2% yoy in 1Q24. **Agency MBS**—The sector has benefited recently from a modest drop in volatility and pockets of demand coming from the bank community. Current coupon spreads are trading at the tighter end of the year-to-date range. **Private Structured Credit (PSC)**—Appetite for esoteric ABS is particularly strong due to the potential for spread pick up relative to traditional ABS. While headwinds including higher debt costs and inflation continue to put stress on the weakest borrower segment, low recession probability and resilience of the labor market remain supportive for the sector.

CRE Fundamentals Decelerated but Mostly Remained Stable

Commercial real estate (CRE) fundamentals are stable, but performance divergences are wide depending on market and property type. **Office**—The sector continued to remain challenged, but early positive indicators have emerged like improving office sublease vacancy. We are looking for office vacancy to rise further in 2024, before beginning to decline next year. **Multifamily**—Despite high mortgage rates, demands for apartment buildings remained strong. Although the sector has rebounded from the lows it experienced last year, vacancy rates are at a 10-year high, and rent growth is slowing down across the country, according to the National Association of Realtors[4]. **Industrial**—Demands for industrial spaces decelerated, with net absorption dropping to the lowest levels in over a decade. Markets with physical or legislative barriers to new construction like Miami and Baltimore are better positioned. **Retail**—Vacancies, except for the still-recovering mall subsector, are at the lowest level on record. The outlook for retail income growth remains healthy particularly for high-quality centers. **Hotel**—Hotel demand is healthy, but expense growth remains a challenge. Expense growth significantly outstripped revenue growth in 2023. While expense growth has begun to moderate, we think it may not be fully back in line with revenue growth until 2025 or 2026.

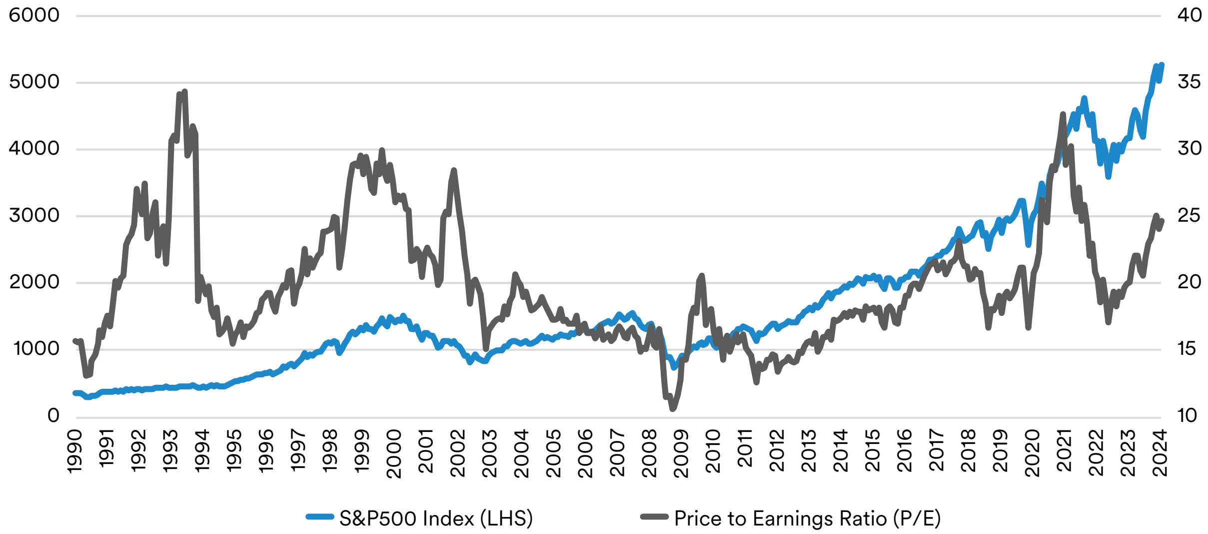
Agricultural Producers' Balance Sheets Continued to be Strong

After consecutive years of strong growth in farmland values and high farm incomes, producers' balance sheets remain strong. Increases in commodity prices between Feburary and May may have further improved net farm income. Overall, we continue to expect the sector's profitability to stabilize above the long-term average in 2024. Deal flow has slowed, and competition remains strong which may likely pressure spreads in 2024. Delinquency rates have increased in 1Q24 but are near historical lows. We think that origination will rebound towards the end of the year and continue to grow into 2025.

We are Neutral for Both Corporate Equity and Cash Investments

With more than 76% of US companies beating earnings estimates in 1Q24, the market is nearing all-time highs (see Figure 5). However, earnings growth was disproportionally from mega-cap technology companies. Even though we no longer expect a recession, we have seen a disconnect between the elevated valuation and the weakening economic fundamentals (e.g., rising jobless claims, rising unemployment). With rising political risks, we are taking a neutral position in corporate equity. With a low risk of recession and an expectation of fewer Fed rate cuts, cash and short-term fixed income investments become less attractive. However, given the risk-free nature and elevated yields of US Treasury bills, we remain neutral for this asset class in the near term.

Figure 5 | S&P500 Index Near All-time Highs with High Valuation



Note: P/E ratio is calculated as last price divided by trailing 12-month earnings per share.
Source: S&P Global, MIM. As of May 31, 2024.

Endnotes

1 Source: J.P. Morgan, European Credit Strategy 2024 Mid-Year Outlook, June 2024

2 Source: Moody's, Default Report, April 2024

3 Source: CREFC, Monthly CMBS Loan Performance Report, April 2024

4 Source: National Association of Realtors, Commercial Real Estate Market Insights Report, May 2024

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About MetLife Investment Management

MetLife Investment Management (MIM)[1] serves institutional investors around the world by combining a client-centric approach with deep and long-established asset class expertise. Focused on managing Public Fixed Income, Private Credit, and Real Estate assets, we aim to deliver strong, risk-adjusted returns by building sustainable, tailored portfolio solutions. We listen first, strategize second, and collaborate constantly to meet clients' long-term investment objectives. Leveraging the broader resources and 150-year history of MetLife provides us with deep expertise in skillfully navigating markets. We are institutional, but far from typical.

For more information, visit: investments.metlife.com

[1] As of March 31, 2023, subsidiaries of MetLife, Inc. that provide investment management services to MetLife's general account, separate accounts and/or unaffiliated/third party investors include Metropolitan Life Insurance Company, MetLife Investment Management, LLC, MetLife Investment Management Limited, MetLife Investments Limited, MetLife Investments Asia Limited, MetLife Latin America Asesorias e Inversiones Limitada, MetLife Asset Management Corp. (Japan), MIM I LLC, MetLife Investment Management Europe Limited and Affirmative Investment Management Partners Limited.

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