September 30, 2022

INSURANCE INSIGHTS | MACRO STRATEGY

Relative Value & Tactical Asset Allocation

4Q 2022

Key Takeaways

- The key economic and market themes remain downbeat. We continue to prefer up-in-quality credits and underweight risky assets.
- Global economic growth could continue to slow over the next several months.
- U.S. 10-year yield and inflation are likely to have peaked, which could result in a fully inverted yield curve. A short, sharp recession is likely in the mid-to-late next year.
- Unsustainable home price and rent increases relative to income, higher mortgage rates, and extreme low affordability suggest a housing slowdown.
- The credit cycle is aging fast given tightening lending standards, slowing profit growth, and margin pressures. Credit spreads are trending wider.
- Private asset spreads have moderated a bit in the last quarter but remain rich relative to public assets in general.

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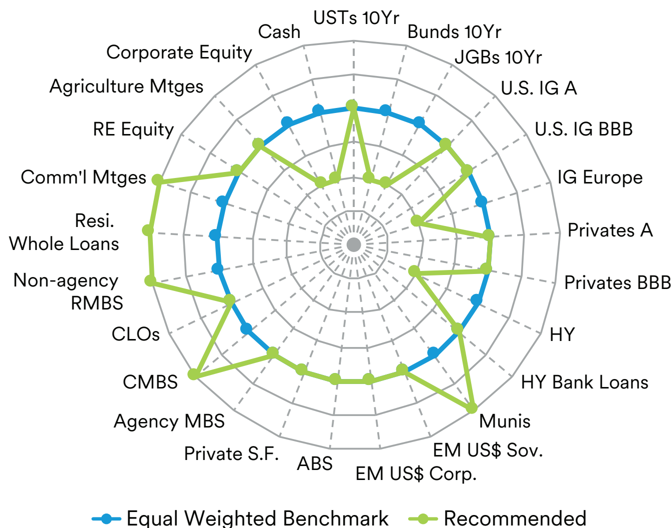
Slower Global Economic Growth Continues

The OECD Composite Leading Indicators Index (Figure 2) shows that the slowdown of the global economy continues. Most central banks continue tightening policy to fight rising inflation. **U.S. —** A recession in 2023 remains our base call. A slowdown in hiring over the next six months would seem to be a reasonable forecast. 2022 should have seen the peak in long-term yields for this cycle. **Europe —** The outlook for the remainder of the year and into early 2023 has weakened materially as negative spillovers from Russia's invasion of Ukraine continue to accumulate, and uncertainty over the region's energy supplies linger. **Asia —** Recent data point to a still-decent regional growth backdrop and tailwinds as economies emerged from COVID-19 restrictions earlier this year. However, we are seeing emerging weakness in the more export-oriented economies given the softer outlook for demand in developed markets. **Latin America —** Economic activity surprised in 1H22, but deceleration is expected for 2H22 and 2023. Commodity prices moderated lately due to concerns about global growth, negatively affecting LatAm currencies.

Figure 1 | Tactical Asset Allocation Recommendation



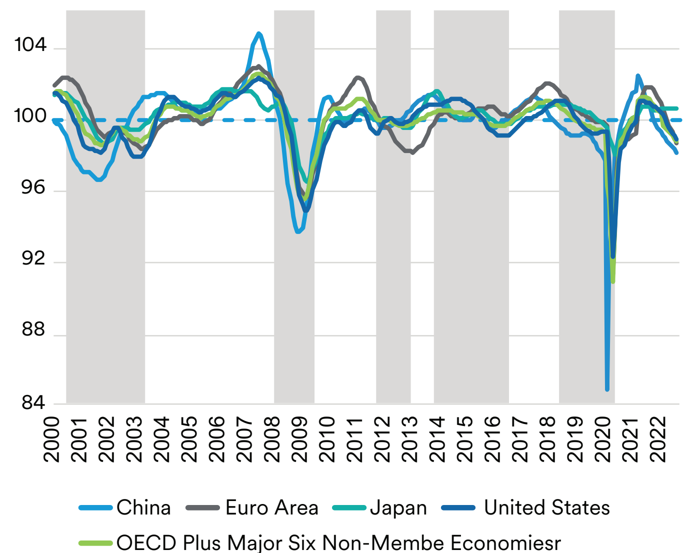
Note:

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.

More Hawkish Fed, Inverted U.S. Yield Curve Likely

U.S. Treasury — We expect the Fed to continue hiking the Fed Funds Rate to 4.25% by year-end 2022. Based on our GDP and inflation forecast for 2022, we expect the 10-year yield to have peaked and to fall to around 3.25% by the year-end. **JGBs —** Despite moves higher in USDJPY, the JGB market remains relatively calm, moderating over the course of this year. Our baseline remains for no change in the BoJ's ultra-accommodative monetary policy settings this year, given still-below target core CPI, growing headwinds to the export complex as external demand wanes, and a persistent negative output gap. These factors should keep JGB 10-year yields within the target band. **Bunds —** We continue to expect further upward pressure on 10-year bund yields over the next three to six months, reflecting the government's higher net financing needs as it continues to roll out fiscal support packages and the likely pending announcement of the ECB's quantitative tightening (QT) plans, which would underweight core sovereign holdings in favor of peripherals in the ECB's balance sheet operations.

Figure 2 | OECD Composite Leading Indicators

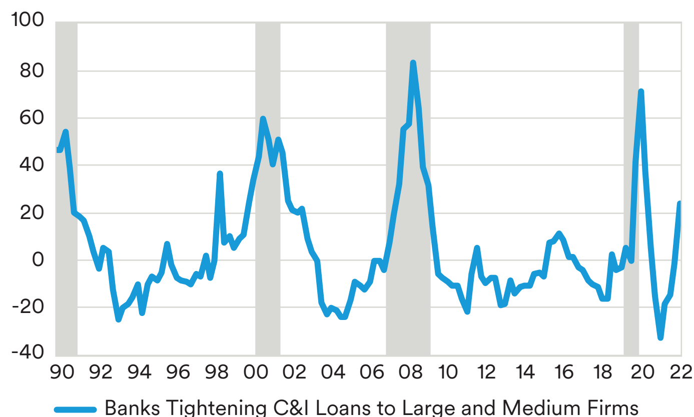


Note: Shaded areas denote economic slowdown defined by OECD.
Source: OECD, MetLife Investment Management (MIM)

Corporate Credit Spreads May Continue to Widen

The slowdown in corporate earnings continued in 2Q22. This credit cycle is aging very fast; we changed our credit cycle view to the "overheat" stage from the "expansion" stage on increasingly restrictive Fed policy, curve inversion, and tightening lending standards (Figure 3). We believe that the credit cycle is likely to turn in 1H2023. While valuations improved across credit markets, as spreads are near their historic averages, we do not believe that credit markets have priced in sufficient downside risk. At current spread levels, both U.S. IG and HY markets are pricing in only ~10% recession risk. Looking forward, we expect spreads will trend wider on heightened recession risk in 2023. As a result, we recommend "up in quality" for the remainder of 2022. **U.S. Investment Grade (IG) —** Although credit fundamentals improved further in 2Q22, the outlook remains neutral on slowing profit growth and margin pressures. Both revenue and EBITDA continued to improve during the quarter while total debt remained stable. Spreads are near fair value, but IG yields rose to the highest levels since 2009.

Figure 3 | Banks Tightening C&L Loans to Large and Medium Firms



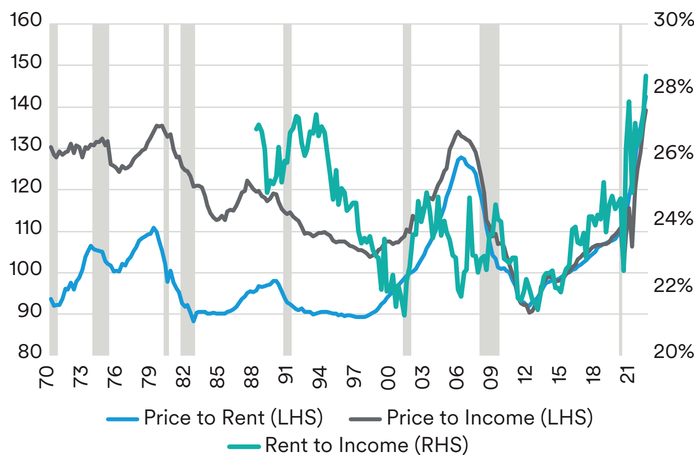
Source: Federal Reserve Board, Bloomberg, MIM

European IG — Fundamentals continued to improve in 2Q22. 2Q22 earnings surprised on the upside: 74% of Euro Stoxx 600 companies reported a positive top-line surprise, and 52% a positive earnings surprise, based on Bloomberg data as of September 14th. EBITDA growth and margins remained at record highs driven by the energy sector. We think that margins, ex-energy, have peaked, and for the next 12-18 months, it is likely to be a question of how well corporates can protect against declines. **High Yield —** Defaults remained benign in 2022, but year-to-date total defaults/distressed exchanges already exceeded last year's full-year total. Although default rates are expected to remain benign (1.4% - 2.5%, according to Moody's) for the rest of 2022, we expect them to rise to 4.3% by mid-2023. **Leveraged Loans —** The momentum of positive rating actions has stalled as downgrades outnumbered upgrades again in August, the fourth consecutive time since November 2020. Technicals weakened as we have seen fund outflows for four consecutive months, although year to date, the leveraged loans market still attracted strong inflows. CLO formation also slowed recently. Year-to-date CLO new issuance dropped ~20% YoY to $90bn (data source: Credit Suisse), but is still in line with pre-COVID-19 years. Year to date, the leveraged loan market has been the best performer in credit markets due to sharply rising rates. Spreads are near fair value and are cheap relative to the high yield bond market. **Municipals —** Both general obligation and revenue bond outlooks remain neutral. Valuations are near fair value, and we believe the taxable municipals market will be more resilient in a challenging macro environment. As a result, we remain overweight on taxable municipals. **Emerging market (EM) IG —** During 2Q22, EM growth slowed as a result of China's zero-COVID-19 policy, the Ukraine war, soaring inflation, and the tightening in global financial conditions. EM central banks started tightening earlier than developed market central banks, and many are nearing the likely peak of their hiking cycles. China has begun to ease policy to counter its slowdown and labor market disruption.

Housing Slowdown Has Emerged

Increases in home prices and rents have outpaced the increases in incomes over the last couple of years (Figure 4), which is not sustainable. **Residential Credit —** The long-awaited housing slowdown has emerged quickly. Mortgage rate increases, along with home price appreciation, have led to a sharp drop in affordability. The primary risk to the housing market is job loss translating into delinquencies, but we feel elevated foreclosures remain a low risk. Borrowers will not voluntary walk away from homes just due to softening prices in our view.

Figure 4 | Housing Ratios



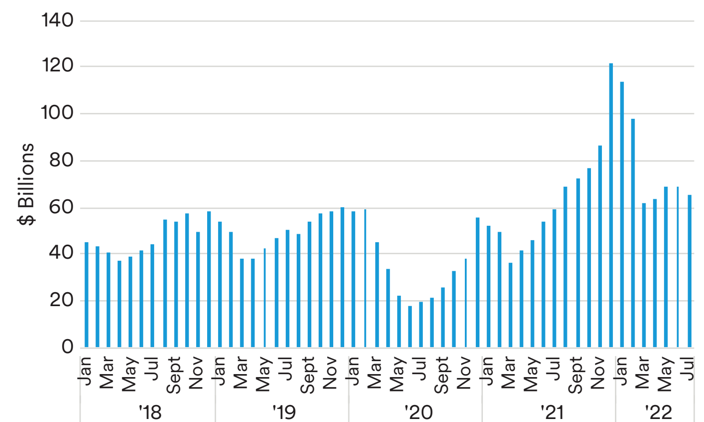
Source: National Assoc. of Realtors, MIM

Asset-backed securities (ABS) — COVID-19-driven excess savings continue to allow the consumer to weather inflation, as well as to support higher spending trends, but weaker borrower segments are starting to struggle. Credit card balances are noticeably higher and close to pre-COVID-19 peaks. Delinquencies are increasing in autos, with non-prime delinquencies escalating quickly. Credit card delinquencies have also begun trending higher. **CLO —** We feel the CLO market should transition to fundamental performance as the era of prolonged and low defaults is in the past. Spreads have already reacted and are pricing in historically wide levels. Deals continue to migrate to static or short tenor as the issuance market is challenged due to the cost of funds. **CMBS —** A cooling in commercial valuations has begun. With a continued contraction in the lending environment and elevated rates, we expect issuance to slow. Conduit issuance could fall to an 11-year low. **Agency MBS —** Housing turnover and prepays are a focus for investors. With high mortgage rates, the incentive to refinance is low. Agency MBS risk measures have converged as incentives have eroded. Weighted average life across coupons only vary by 1.5 years. (8.7-10.5 WAL). Fed portfolio sale narratives change weekly, and Fed coupon consolidation efforts have not begun. **Private Structured Credit —** Over the past several months, deal pricing in private structured credit has re-established a healthy spread pickup to public markets. Deal flow has also accelerated into Q4 across various sectors. Opportunities in consumer credit have also increased and have become more attractive from a risk-reward perspective as pricing moves wider.

Lower Transaction Volume for Commercial Real Estate

We believe real estate fundamentals remain on solid footing for most property types. Labor market growth and stable consumer spending trends have supported demand, while continued supply-chain disruptions, inflation, and higher interest rates have kept supply growth low. As a result, vacancy rates are near historically low levels, and rents continue to increase. Through the first half of the year, equity transaction volume (Figure 5) was on track to eclipse even the elevated level of activity exhibited in 2021. However, the higher interest-rate environment and uncertain macroeconomic outlook have rapidly cooled transaction markets, and activity in July was nearly 20% below the 2021 level. We expect a relatively modest level of equity transaction activity for the duration of the year.

Figure 5 | Historical REE Transaction Volume



Source: Real Capital Analytics. 3-month training average.

Agriculture Loan Spreads Likely to Remain Compressed

The U.S. farm economy continues to benefit from strong incomes and profitability. The USDA projects Net Farm Income will increase 5% year-over-year in 2022 to a record $148 billion. Rising farm incomes are largely attributable to strong global demand for U.S. agricultural products. MIM's 12-month rolling average agricultural spread was 21% lower, as of August compared to last year. There is no publicly available market spread data for agricultural mortgages. However, Federal Reserve data indicate spreads have likely compressed given an increase in benchmark interest rates.

Bearish Sentiment for Public Equity Markets Continues

We continue to underweight equity (i.e., underweight risky assets in general), given the hawkish Fed, slowing global economic growth, and downward pressure on profit margins. Technically speaking, we believe that we are in a bear market, given that both the medium- and long-term trends are downward. A short-term bounce higher is possible, as the market sentiment and market breadth have reached extremes. However, with the rising recession risk and soft earnings outlook, we maintain our risk-off call on equity.

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