



NEUBERGER BERMAN

Fixed Income Investment Outlook 1Q20

Stable Growth, Policy in Transition

With a stable economy likely to provide a positive environment for credit this year, shifts in monetary policy could contribute to more frequent volatility in fixed income markets, while political developments will be an ongoing risk. With this backdrop, Neuberger Berman's Global Fixed Income team sees particular opportunities in bank loans and CLOs, high yield emerging markets debt, European ultrashort cash and euro opportunistic approaches, and taxable and high yield municipals. More details are provided in the pages that follow.

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Investment Implications

In the following pages, we discuss where we believe investors can find value in the European and global fixed income markets given an outlook for 2020 that favors a muted growth picture and less active monetary policy intervention than in 2019. We have identified the following pockets of opportunity:

Interest rates: In our base case, we believe that both the Federal Reserve and ECB will keep policy rates unchanged over the next 12 months, although risks to higher yields are relatively higher in Europe. Given this view, we anticipate rates to be largely range-bound over the near term and—with less central bank influence on the front end—the yield curve to steepen. As a result, we think investors should lean toward a steepening bias in their portfolios and also give preference to investment solutions with more flexibility in their interest-rate positioning.

Inflation-related securities: As global central banks transition their focus away from the policy-easing environment of 2019, we anticipate a greater emphasis on and commitment to achieving inflation targets over the next 12 months. In light of this—combined with muted 2019 performance—we believe inflation breakevens will remain relatively positive. Treasury Inflation-Protected Securities (TIPS)—particularly on the long-end of the curve—and European inflation-linked bonds appear attractive in light of inflation expectations and year-end valuations.

Floating-rate exposure: We continue to find value in floating-rate products like bank loans and collateralized loan obligations (CLOs). The transition in the path of monetary policy and waning investor demand over 2019 led to continued mispricing of spreads for these securities. While these sectors still face the headwind of a falling LIBOR rate in the future, year-end valuations and our outlook for central banks to transition to “on-hold” policies should be supportive of these securities in 2020.

High-quality U.S. high yield: We maintain a constructive view on U.S. credit broadly; however, given year-end spread levels, we anticipate outperformance of U.S. non-investment grade credit over 2020. Despite a more uncertain macro environment, non-investment grade credit fundamentals appear sustainable and default expectations remain low by historical standards. As we head into 2020, we believe investors should consider high-quality “core” non-investment grade credit allocations.

European credit (high yield and investment grade): Investors focused on European markets can still find value in euro high yield, where fundamentals remain solid and there is technical support coming from the ECB’s asset purchases, a muted M&A pipeline and improving credits. Corporate hybrid bonds also still offer a generous spread premium over senior bonds of the same non-financial issuers, resulting in a compelling opportunity. Combining opportunities in European fixed income markets in ultra-short term or absolute return-oriented bond portfolios is likely to garner increasing interest as investors seek positive yields in European high-quality fixed income.

Emerging markets debt: Signs of leading indicators turning a corner, together with a de-escalation in the U.S.-China trade war, should raise confidence and improve the outlook for emerging market assets in 2020. We expect EM growth to pick up and outpace developed markets over the next 12 months. Other cyclical indicators such as fiscal and current account balances remain well behaved while inflation is on a downward trajectory. Within the sector, stabilization could provide support for select high yield bonds, which are relatively inexpensive as compared to their investment grade counterparts.

Stable Growth, Policy in Transition

Over the coming year, we expect more of the same for economic growth, but a changing monetary backdrop. This implies a good fundamental environment for credit, but potentially more frequent and severe pockets of market volatility as the central bank policy function changes.

Stable Growth Environment

We anticipate no major changes—either to the upside or downside—in the global growth environment of 2020, but expect some modest shifts in relative performance.

In the U.S., our strong conviction is that growth will remain at 1.5% or above in 2020. Importantly, we expect re-accelerating growth in the U.S., particularly in the second half, as a combination of consumer spending, housing market gains, and external market improvements take hold.

It's useful to spend a moment reviewing U.S. economic performance in 2019. Compared to 2018, the past year saw a deceleration in growth toward 2%, driven by modest declines in both consumption and investment spending. The reasons for this slowdown were straightforward: The diminishing impact of tax cuts returned consumer spending to more typical levels, and overhang from trade policy and Brexit negatively impacted investment spending.

Looking forward, we think the stage is set for improvement in U.S. GDP over the course of the full year. The consumer remains a key support for the U.S. economy, with continued tight labor markets supporting wage growth. As is well known, manufacturing and capital spending rates remain subdued, but after weakness in 2019, the potential for modest upside in this category is finally plausible in 2020. And as indicated in the chart at right, the renewed strength of the housing market, bolstered by low rates and more appealing valuations, is an underappreciated factor in current economic stability.

U.S. GROWTH AND ITS COMPONENTS

Category	Y/Y % CONTRIB. TO CHANGE, SA		
	Q3 2019	Q3 2018	Diff
TOTAL	+ 2.08%	+ 3.13%	- 1.05%
PCE	+ 1.74%	+ 2.39%	- 0.65%
Goods	+ 1.07%	+ 1.08%	- 0.01%
Durable Goods	+ 0.52%	+ 0.58%	- 0.07%
Nondurable Goods	+ 0.57%	+ 0.52%	+ 0.05%
Services	+ 0.77%	+ 1.36%	- 0.59%
Household Consumption	+ 0.80%	+ 1.24%	- 0.44%
Gross Private Domestic Investment	+ 0.10%	+ 0.98%	- 0.88%
Fixed Investment	+ 0.15%	+ 0.89%	- 0.74%
Nonresidential	+ 0.19%	+ 0.98%	- 0.78%
Structures	- 0.20%	+ 0.19%	- 0.39%
Equipment	+ 0.07%	+ 0.43%	- 0.36%
Intellectual Property Products	+ 0.39%	+ 0.36%	+ 0.03%
Residential	- 0.03%	- 0.03%	+ 0.00%
Change in Private Inventories	- 0.03%	- 0.04%	+ 0.01%
Net Exports	- 0.14%	- 0.71%	+ 0.57%
Exports	+ 0.02%	+ 0.33%	- 0.31%
Imports	+ 0.16%	+ 1.05%	- 0.89%
Government	+ 0.38%	+ 0.39%	- 0.00%
Govt. Expenditures	+ 0.25%	+ 0.29%	- 0.03%
Govt. Investment	+ 0.13%	+ 0.10%	+ 0.03%
Federal	+ 0.25%	+ 0.24%	+ 0.01%
State and Local	+ 0.14%	+ 0.16%	- 0.02%

Source: BIS.

U.S. HOME SALES RECOVERY

Three-Month Average, SAAR (YoY%)



Source: Bloomberg, Neuberger Berman.

Similar consumer/manufacturing patterns exist in Europe, but greater leverage to world trade and exposure to China and Brexit issues have further weighed on growth. Germany, with its dependence on exports, has in particular seen a sharp downturn in its industrial production, corresponding to lower global demand.

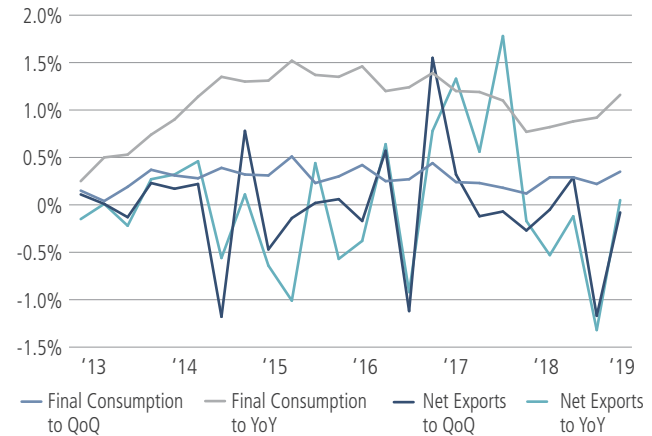
That said, it appears that growth in Europe is currently bottoming, and we anticipate some cyclical improvement this year. Indeed, pessimism is so strong that it implies a quick, significant cut in inventories, which could set the table for future investments to address challenges like pollution regulation on cars. Aside from automobiles, most euro zone sectors have stabilized since the summer; and except for Germany and Italy, most countries experienced growth last year that was faster than or in line with potential.

Without any scheduled national elections, uncertainty will be less of an issue in 2020, although the U.K. must still negotiate the conditions of its withdrawal from the EU by December. We anticipate resilience in domestic activity, supported by consumption and real estate activity due to very low interest rates and wage increases. Years of job creation have led to labor shortages in Northern Europe and, more recently, in France, supporting higher salary increases than in the U.S.

All told, we anticipate a steady euro zone economy in 2020, with growth that is higher than the consensus of 1.0 – 1.2%.

EUROPE'S TWO-SPEED ECONOMY

Euro Zone GDP Consumption - Private (HH & Gov't) vs. External



Source: Bloomberg.

In China, where the government has been executing an array of stimulus measures, we expect stable conditions and annual growth of 5.8%. Japan will likely remain a laggard: The consumption tax may contribute to relative weakness, although recent stimulus and the Tokyo Olympics could provide some offset. Overall, we anticipate a roughly flat growth rate of 0.1%.

Finally, emerging markets should offer stronger growth relative to developed markets, as the lingering effects of tighter U.S. monetary policy and trade policies continue to fade. Our expectation is for GDP of 3.2% ex-China this year versus around 2.8% in 2019. An important component to this outlook relates to emerging market central bank policy. In 2019, at least 15 major emerging market central banks eased policy, some quite significantly (e.g., Turkey's 1,000 bps in rate cuts). With its inevitable lag, we expect the residual impact of this 2019 easing to support growth in 2020.

In addition, problems in vulnerable emerging markets (Lebanon and Argentina) are generally idiosyncratic; although demonstrations in Latin America reflected strains from a decade of low growth, generally constructive responses from governments suggest that the issues can be managed. Given varied fundamentals across the emerging world, investors are increasingly apt to isolate such events rather than see them as evidence of contagion.

In recent months, we have continued to see a dichotomy between healthy "hard" data and weak "soft" survey (i.e., confidence) data, perhaps reflecting the noise associated with trade and general political conflict. With U.S.-China trade tensions and Brexit concerns stabilizing or resolved (at least in the short term), we expect the coming quarter to bring a resolution of this difference between hard and soft data. While actual production and consumption data may firm up, it's equally likely

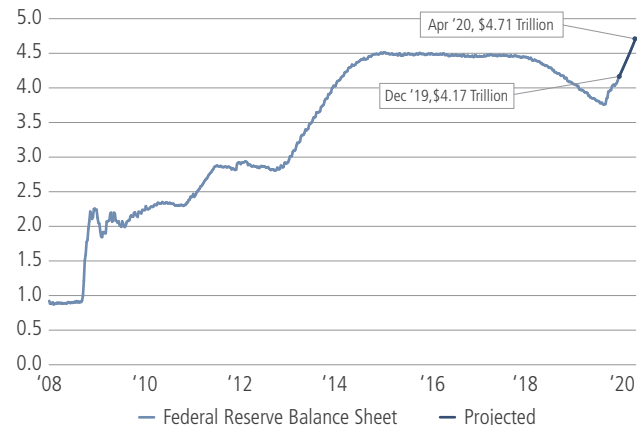
that soft data measures such as PMIs and confidence indices begin rising, reflecting the stabilization of these political issues.

Transitioning Central Bank Policy

While the growth outlook for 2020 will, for the most part, look like a continuation of 2019 trends, we expect this year to bring a transition for central banks. Globally, policy easing should generally pause after a year in which the Federal Reserve, ECB and PBOC all cut rates and restarted quantitative easing, and, as noted earlier, 15 major emerging markets countries eased rates. The Fed is likely to take an asymmetric stance on interest rates, leaning toward cuts if the need arises, while ECB policy should remain unchanged this year.

It's important to note that, even as central bank policy rate moves become less of a factor in 2020, changes to central bank balance sheets will continue to be impactful. For example, the Fed's balance sheet will continue to expand this year as a result of policy changes enacted in 2019 (see display). Rate moves might be less common, but monetary accommodation isn't going away.

FEDERAL RESERVE BALANCE SHEET (\$ TRILLIONS)



Source: Bloomberg, Neuberger Berman.

More structurally, changes to both the Fed and ECB policy frameworks could happen in 2020: The Fed is moving toward a more inflation-centric approach, while the ECB's new president has requested a strategic policy review, as a third of its members are skeptical as to the usefulness of negative rates in supporting inflation. We expect the ECB's analysis and discussions to contribute to periodic volatility in European markets.

For emerging market central banks, the transition in policy will likely be more subtle as central banks migrate from easing campaigns to on-hold policies.

Implications for Rates and Credit Markets

Interest Rates: Options markets currently imply a low-volatility 2020, with U.S. interest rates in a 44–55 basis-point range and a range-bound environment for developed market rates generally. Risks to higher yields in the developed markets are liable to come from Europe, not the U.S.: We expect the Bund 10-year yield to rise modestly and remain in positive territory. With central banks on hold, rates at the front end of the yield curve are likely to be “pinned”; we expect yield curves to steepen as growth picks up and central banks effectively accommodate rising growth rates. Following muted performance last year, we believe inflation breakevens should remain relatively positive.

Credit Markets: A backdrop of reasonable growth, range-bound interest rates and easy monetary policy should create a strong environment for credit markets. As a result, we would not underestimate the potential for credit spreads to continue tightening in 2020. However, we believe that bifurcation within markets will remain a dominant theme, favoring an emphasis on quality in investment grade and high yield. Idiosyncratic risk is liable to rise across credit markets. And return expectations should be more muted given the exceptional returns generated across fixed income in 2019.

Implications for Fixed Income Asset Classes

After last year's aggressive easing, a commensurate move away from flat-to-negative yield curves, and the narrowing of credit spreads, we believe that total returns will likely be harder to come by this year in fixed income. This is especially true given the strong performance of virtually all fixed income sectors in December, which likely moved some 2020 performance into 2019. But while returns may be more muted this year, the themes that drive performance will likely remain similar, and center on:

- Low/negative yields in many non-U.S. developed markets generally favor a focus on high-quality U.S. assets. Leverage among investment-grade companies is elevated, but has stabilized below recent peak levels as management teams with larger BBB-rated structures are seeking to deleverage and improve credit ratings; this suggests the potential for some further spread compression for investment-grade corporates. Treasury Inflation-Protected Securities appear attractive in light of inflation expectations.
- Given current monetary support, we believe that the U.S. high yield sector is likely to see more muted defaults this year than currently reflected in pricing. Although the credit quality of the bank loan sector has generally declined, we believe that select opportunities in floating-rate securities (bank loans, CLOs) are available based on appealing valuations. Default patterns in the energy sector will likely require investor focus next year. After capital injections and balance sheet restructuring following the energy crisis of 2016, high yield energy issuers generally have less flexibility going into 2020.

- Tax-exempt municipal yields are historically tight. However, absent dramatic policy shifts affecting their tax-sensitive investor base, municipals are unlikely to widen in the near term; within the municipal market, high yield bonds and taxable municipal bonds appear to offer good relative value.
- Investors focused on European markets can still find value in euro high yield, where fundamentals remain solid and there is technical support coming from the ECB's asset purchases, a muted M&A pipeline and improving credits. The "peripheral" convergence trade worked very well again in 2019 and should be limited this year to long maturities. European ultrashort cash and euro opportunistic approaches are likely to garner increasing interest as investors seek positive yields in European high-quality fixed income.
- Although emphasizing quality credits, we believe that stabilization in emerging markets could prove supportive for the segment's high yield bonds, which are now relatively inexpensive compared to investment grade counterparts. Local emerging market investments also appear compelling on both an absolute and relative basis, including because of FX valuations.

VALUE IN EMERGING MARKETS HIGH YIELD

Spread Difference: EMBI GD HY (ex. Argentina and Venezuela)



Source: JP Morgan, Bloomberg.

Ongoing Issues

A handful of key issues could affect our outlook and the course of the fixed income markets this year.

Trade and Politics

It's no secret that one reason for relatively weak global growth in 2019 was weakness in capital spending. We don't see that structurally changing given the upcoming election in the U.S. and uncertainty about a whole host of U.S. tax, trade and spending policies. Likewise,

the changes in the Chinese economy and structural challenges to the auto industry should keep European investment spending relatively sluggish. With these overhangs, we see little scope for accelerating global growth, which, in turn, should reinforce trends in interest rates and credit markets.

On trade, it appears that we will see a de-escalation of tensions in 2020. The scope of that trend is quite unclear and likely prone to short-term reversals, but we do expect that 2020 brings both reduced policy actions on trade and softer rhetoric. A primary relative beneficiary of such a reduction in tensions should be emerging markets, particularly local markets that could benefit from growing momentum toward a weaker U.S. dollar this year, reversing stronger conditions that prevailed with heightened trade tensions.

Shift in Monetary Focus

Slow-moving but important changes are occurring within the two major central banks: the Fed and the ECB. It's most apparent at the Fed, which is progressing toward a structural dovish shift. The Fed's concerns center on two issues: first, the apparent inability of monetary policy to even moderately raise realized inflation rates despite achieving trend growth; and second, the modest decline in inflation expectations that occurred over the past 12 months. For the Fed, maintaining stability or upward pressure on inflation rates at around 2% remains a key goal in order to build flexibility around future recessionary periods and avoid any deflationary bias.

What this could mean in practice for 2020 is a shift in policy framework. Likely around midyear, as part of an announced framework review, we expect the Fed to adopt some form of "inflation targeting," committing to higher realized inflation rates in stronger growth periods to offset lower inflation rates in weaker growth periods. Effectively, these changes would raise the bar for rate hikes and represent a major monetary policy development.

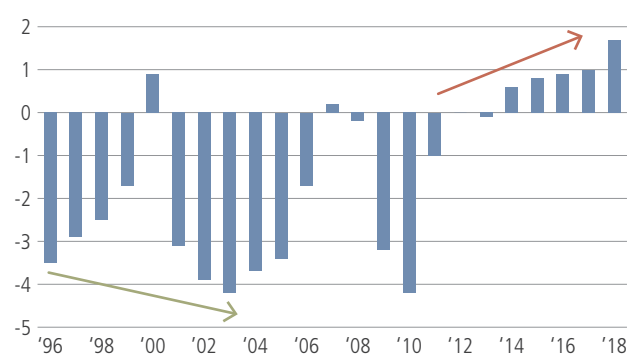
Changes in ECB policy are also coming. Its policy is more complicated, but new ECB President Christine Lagarde is conducting a wide-ranging assessment of various approaches, including a move to a symmetrical inflation target, shifts in communication policies, and cost-benefit analysis of negative rates and quantitative easing, as well as modeling climate change impacts. We would note that the Swedish Riksbank returned its policy rate to positive territory at the end of 2019, which may end up foreshadowing a broader shift among central banks currently utilizing negative rate policy.

Particularly in Europe, focus on fiscal policy will continue to intensify. There is room for stimulus in certain countries if there is political will. Most prominently, Germany has enjoyed positive fiscal balances even as GDP growth has slowed, and may come under increased pressure

from voters (not to mention Lagarde and the ECB) to take action. The recent election of two left-leaning politicians to lead the Social Democratic Party—junior partner in a coalition government led by Angela Merkel’s Christian Democratic Union—has the potential to shift dialogue on increased social spending. But a real economic boost is likely to be activated only in case of a recession.

ROOM TO MANEUVER

German Fiscal Balance as % of GDP



Source: Eurostat.

Region-wide, an array of reform ideas are being considered, although they vary in potential effectiveness and the timing of execution. For example, a proposed new “European Fund for Strategic Investments” (EFSI) would release as much as €650 billion over seven years for strategic infrastructure, education and research. Nearer-term, the EU could amend its Stability and Growth Pact to allow for more flexibility in member states’ budget deficit and national debt levels.

Of course, the new European Parliament and the new Commission team have to determine their objectives and agenda first, starting with tough and complicated negotiations on the terms of Brexit, to be reached before December 2020.

Geopolitics

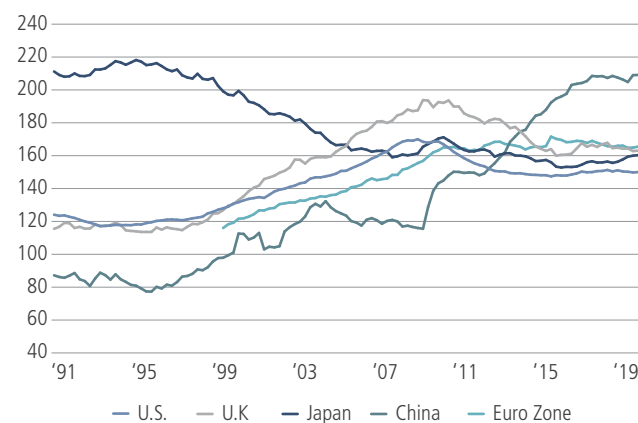
December 2019, and continuing into January 2020, saw a rapid escalation of tensions in the Middle East. The financial markets have generally been resistant to pricing large risk premiums due to geopolitical issues. However, with valuations less compelling than a year ago, we suspect that geopolitical issues could lead to more severe and longer-lasting impacts on markets in 2020.

China Growth

Of all the major economies, China has been particularly active in terms of fiscal policy, seeking to encourage consumption and infrastructure investing in the face of trade pressures. However, authorities are battling on two arguably conflicting fronts, seeking to stimulate

near-term activity while avoiding adding leverage to the system. As highlighted below, private sector leverage in China has grown significantly over the past 10 years, contributing to the government’s desire to seek measured slowing, not reacceleration, in growth rates.

PRIVATE SECTOR DEBT AS % OF GDP



Source: BIS.

A recent PMI print is a positive sign and, taken together with other data, informs our estimate of 5.8% growth this year. A stable Chinese economy should maintain existing support for exporters generally without being an engine for meaningful global acceleration.

Conclusion: Solvable and Unsolvable

After a year of full monetary support, fixed income investors move into 2020 with a more challenging environment from a valuation standpoint. That being said, an array of problems that have nagged at the macro picture seem apt for some resolution. Despite the noise around the U.S. and China, the two parties seem ready for at least a rudimentary deal and a move away from constant crisis. With the British Parliamentary election, orderly Brexit seems far more likely—perhaps not the best outcome for regional growth, but better than the uncertainty that has prevailed for more than three years. Fiscal easing, already in play in the U.S., has some chance of gaining momentum in Europe. And if economic trends do not go as smoothly as hoped, central banks still have meaningful capacity to right the ship. Perhaps the only “unsolvable” challenge at this stage is the U.S. election, and uncertainty over the country’s political direction and its implications for the global economic picture. That variable will simply take time to play out, potentially adding to market volatility until clearer outcomes become apparent.

Market Views

Next 12 Months

	UNDER --	-	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	Better U.S. growth prospects and an absence of new monetary stimulus suggest limited value at these levels.
United Kingdom	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	With diminished economic momentum, odds of interest rate cuts and QE have increased.
Germany	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
France	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Italy	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Spain	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Japan	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Canada	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	Potential for rate cuts; high-yielding cash rates.
New Zealand	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Australia	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	Rate cuts appear likely; Reserve Bank of Australia may also initiate QE.
U.S. TIPS	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	Particularly at the long end of the curve, TIPS appear attractive in light of inflation expectations and year-end valuations; breakevens moved wider in the fourth quarter.
INVESTMENT GRADE SECTOR						
U.S. Agencies	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.S. Agency MBS	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.S. CMBS	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
U.S. ABS	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.S. Mortgage Credit	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	Housing market is healthy; we see potential in relatively short bonds with solid structures, but valuations largely reflect fundamentals.
U.S. Credit	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Europe Credit	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	
U.K. Credit	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	
Hybrid Financial Capital	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	
Municipals	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	

	UNDER --	-	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
HIGH YIELD & EMERGING MARKETS						
U.S. Full-Market High Yield	○	○	○	●	○	
U.S. Short-Duration High Yield	○	○	○	●	○	
Pan-Euro High Yield	○	○	●	○	○	
Floating-Rate Loans	○	○	○	○	●	
U.S. CLO	○	○	○	●	○	
EM Hard-Currency Sovereigns	○	○	○	●	○	Stabilization of global manufacturing, adjustment of current account could prove supportive.
EM Hard-Currency Corporates	○	○	●	○	○	
EM Hard-Currency Short Duration	○	○	●	○	○	
EM Local-Currency Sovereigns	○	○	○	●	○	EM currencies could strengthen with pressure on U.S. dollar, relative growth potential, adjustments in value and current accounts.
CURRENCY*						
U.S. Dollar	○	○	●	○	○	
Euro	○	●	○	○	○	
Pound	○	○	●	○	○	Reduced Brexit uncertainty, in our view, is largely priced in, with tough negotiations on the horizon; central bank will likely remain on hold for now.
Yen	○	○	○	●	○	
Swiss Franc	○	●	○	○	○	
Australian Dollar	○	○	●	○	○	
Swedish Krona	○	○	●	○	○	
Norwegian Krone	○	○	○	●	○	
Canadian Dollar	○	●	○	○	○	
Mexican Peso	○	○	●	○	○	
Brazilian Real	○	○	○	○	●	
Chinese Yuan	○	○	●	○	○	
Russian Ruble	○	●	○	○	○	
Turkish Lira	○	●	○	○	○	

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*Currency views are based on spot rates, including carry.

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