NEUBERGER BERMAN

Fixed Income Investment Outlook 2Q 2023

A Sharp Turn

Aggressive monetary pressure finally saw meaningful impact in the first quarter, in the form of a bank liquidity crisis that required swift intervention by regulators to limit contagion. Markets reacted with volatility and, in anticipation of tighter financial conditions, came to reflect a potentially shorter route to the U.S. Federal Reserve's terminal rate. In the upcoming months, we expect inflation to continue its decline, but believe that, after a Fed pause, central banks will be slower to ease than many expect. In this environment, we favor a focus on credit with a quality bias to defend against economic weakness.

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A Sharp Turn

At the start of the year, we anticipated that the U.S. Federal Reserve would forge ahead with tightening until it had clear evidence of slowing inflation—or until higher rates caused something to "break." That breakage did in fact come in the form of the first quarter's severe banking issues, which prompted quick regulatory action and sharply reduced expectations for the Fed's terminal rate, causing Treasury rates to decline. Moving ahead, we believe tighter lending standards will help curb economic growth, limiting (but not ending) prospects for moderate tightening going forward, and fostering a balance for investors between an improving rate environment and a deteriorating economy.

Crisis and Policy Response

The collapse of Silicon Valley Bank in March was a "run on the bank" for the digital age, as leery depositors—by phone, computer and on foot—rapidly sought to pull their accounts. The trigger was not credit quality, but rather the bank's maturity mismatch between short-term deposits and long-term investments in Treasuries and mortgage-backed securities.

U.S. regulators' swift action to guarantee uninsured deposits at SVB and Signature Bank, and to create a new $25 billion Bank Term Funding Program, generally helped limit contagion, though not before the Swiss central bank chose to extend a massive loan to Credit Suisse and engineer its acquisition by UBS. Also assisting were 11 large U.S. banks, which pledged to deposit $30 billion into struggling First Republic Bank to reinforce depositor confidence. First Citizens Bank will now acquire SVB assets at a steep discount.

Speaking before Congress, Treasury Secretary Janet Yellen said that further deposit guarantees might be warranted for smaller banks if there were systematic danger, which to some suggested the possibility of universal deposit insurance down the road. Still, it appears that all this protection could come with heightened bank regulation, while many banks have reportedly tightened their lending standards.

Stabilizing, With Room for Error

For now, the crisis seems to have eased. Financial markets, which initially panicked amid fear of widespread bank failures, have generally managed to recover, though high yield spreads have widened as longer Treasury rates have declined. Still, the liquidity mismatch at SVB is likely common among many lenders, while many smaller institutions are losing depositors to larger counterparts. In addition, smaller banks tend to be heavily exposed to commercial real estate, which continues to suffer from post-COVID structural changes, higher interest rates and economic slowing.

All this complicates the task of the Fed, which now must deal with financial stability concerns along with its inflation goals. Unfortunately, price increases remain far above the 2% target, and depending on how banking weakness plays out, the central bank may be forced to maintain tight conditions for longer than many expect. That said, we do anticipate slowing inflation this quarter, with the Fed perhaps executing one more increase before taking a pause. From an investment perspective, we see markets as assuming too much in terms of monetary easing, which reduces potential opportunity in duration. In contrast, we see tactical potential in credit despite weakening fundamentals, with an up-in-quality emphasis within high yield and emerging markets debt.

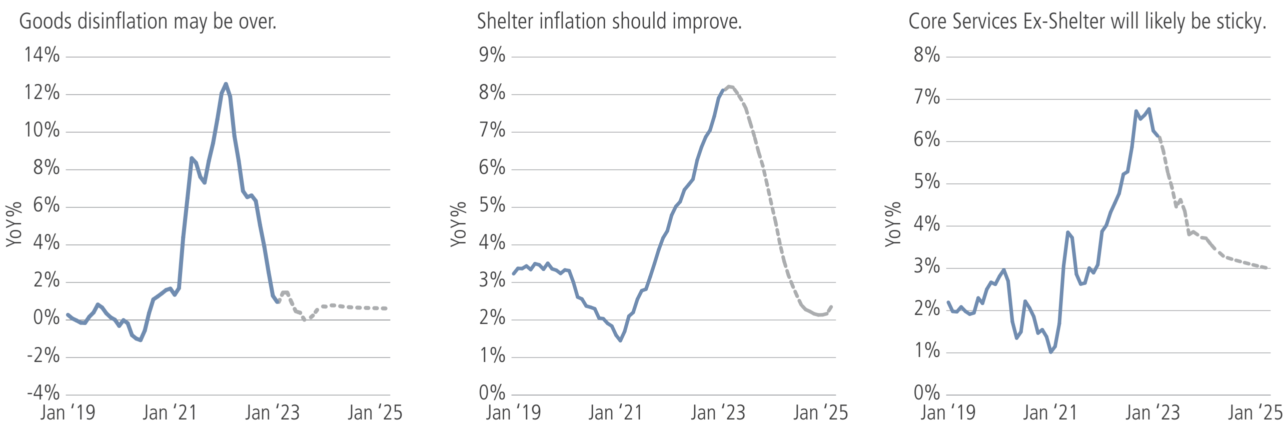
We provide details on our investment themes in the pages that follow.

1. Inflation Should Begin to Fall Globally

The level of inflation should continue to recede gradually, first in the U.S. and later in Europe. In the U.S., the severe decline of goods inflation is close to over; however, shelter costs may be near their peak, while non-shelter services are improving, but could remain sticky. Wage growth remains an issue as, despite layoff announcements (particularly in technology), open positions still far outstrip job seekers. Meanwhile, elevated inflation continues to motivate workers to pressure employers for more pay, whether in union negotiations or individual conversations throughout the country.

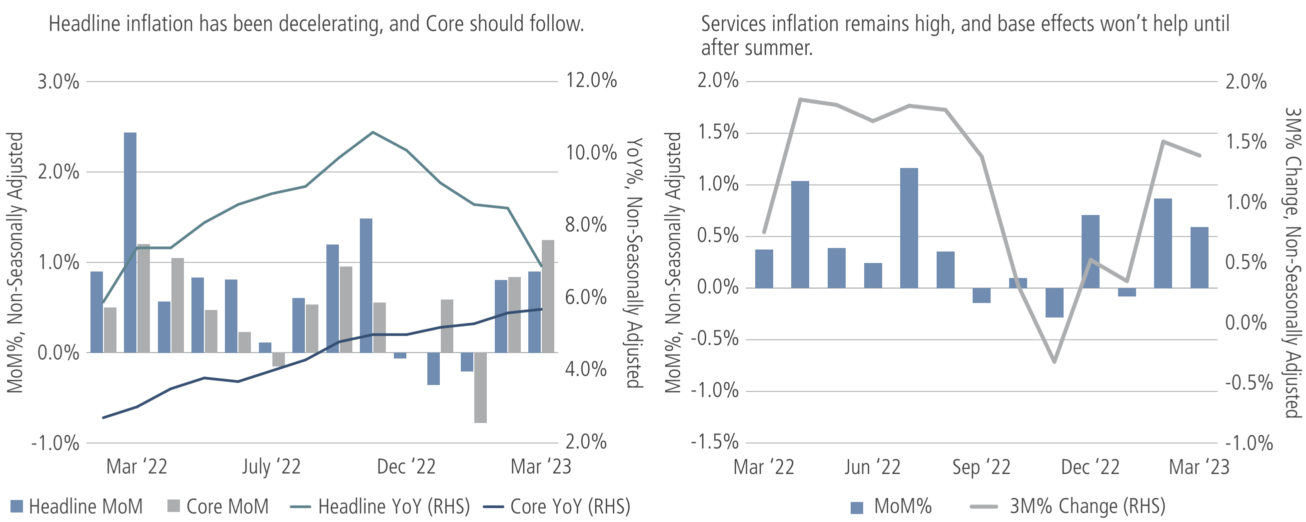
Across the Atlantic, impacts from the Ukraine invasion are starting to fall out of data series, which should push European inflation lower, starting with headline numbers and followed by core inflation. However, services inflation remains elevated and may be slow to moderate. All this means that the European Central Bank is more likely to go on hold than actually cut interest rates.

U.S. INFLATION DECLINES IN STAGES



Source: Neuberger Berman calculations and forecasts, Bloomberg. Actual data as of February 2023.

IN EUROPE, INFLATION BASE EFFECTS COULD LEAD TO A PAUSE—BUT CUTS MAY WAIT



Source: Bloomberg, as of March 2023.

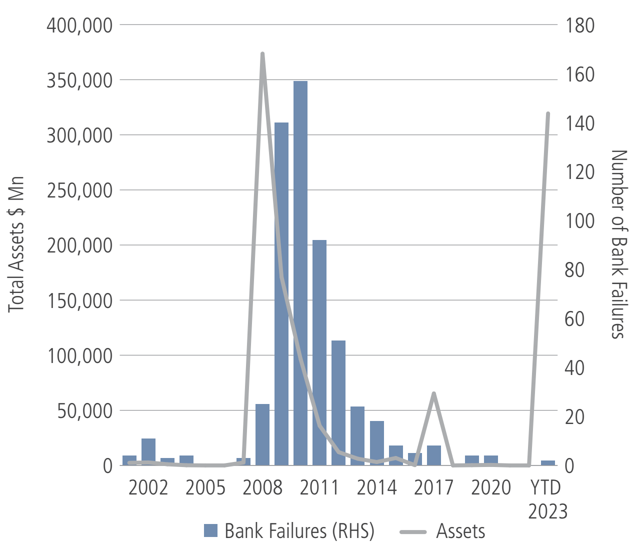
2. With Banking Conditions Uncertain, Credit Conditions Should Tighten

Despite aggressive regulatory steps, the banking outlook remains uncertain. As noted, many banks appear to suffer from the same maturity mismatch as SVB, carrying significant mark-to-market losses on their balance sheets. Meanwhile, smaller U.S. banks, which number in the thousands, are heavily exposed to commercial real estate—potentially an issue should the economy's slowdown worsen. The extent of deposit withdrawals and the level of bank loan book credit quality will be important issues. Meanwhile, bank rescues have thus far been isolated, but could be hugely expensive if extended to a wider array of institutions, potentially limiting the Fed's range of action. The banking situation bears close scrutiny as we move forward.

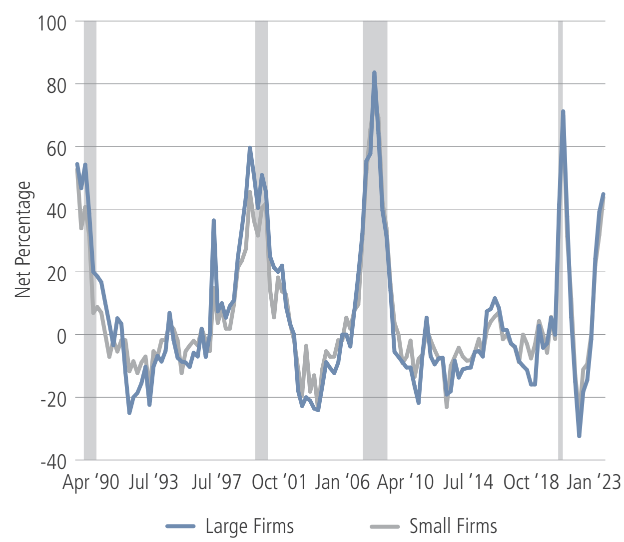
Even with a stable banking picture, bank credit conditions, which were already tightening (see display), are likely to constrict even more, given more intense regulatory oversight and greater attention to risk. Already the equivalent of a couple 25-basis-point rate hikes, this should assist with the slowing that the Fed has worked to engineer—which is a key reason for market repricing and why we feel that any further policy rate increases are likely to be limited.

U.S. CREDIT STANDARDS COULD GET TIGHTER

Assets of failed banks have surged.



The Senior Loan Officer Opinion Survey shows tightening standards.



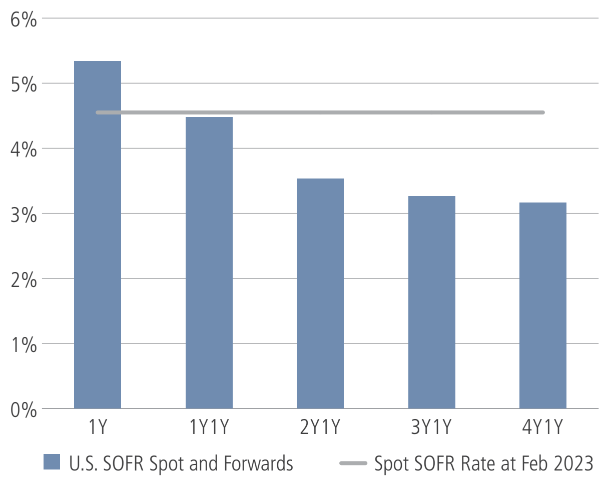
Source: FDIC, Federal Reserve, as of 1Q 2023.

3. Rates Now Price Significant Policy Easing

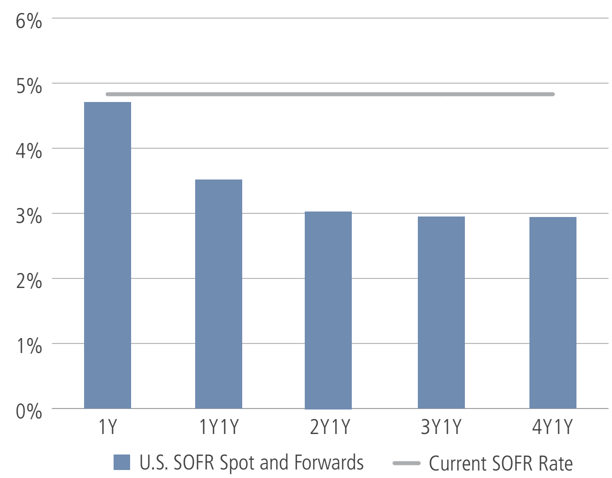
Declining inflation and central banks' move to a "hold" should have some positive tailwinds for markets or, at a minimum, contribute to stability. Given current reduced market expectations for tight policy, we see less tactical value in government bonds than earlier in the year, with duration holding reduced appeal. Yields are likely to remain higher than what markets are used to. Moreover, within our current expected range of 3 – 4%, the 10-year Treasury yield sits fairly close to its lower bound, making it less attractive than it was a few months ago and potentially vulnerable to a pull-back if the central bank fails to ease as much as anticipated. As shown, five-year rates have now repriced from positive to negative carry, and so would require quick, or fairly deep, cuts to reverse the situation.

FIVE-YEAR RATES: PRICED NOT TO CARRY

At the end of February, five-year swaps were less reliant on cuts and provided positive carry for the first year



A month later, five-year swaps had negative carry at inception.



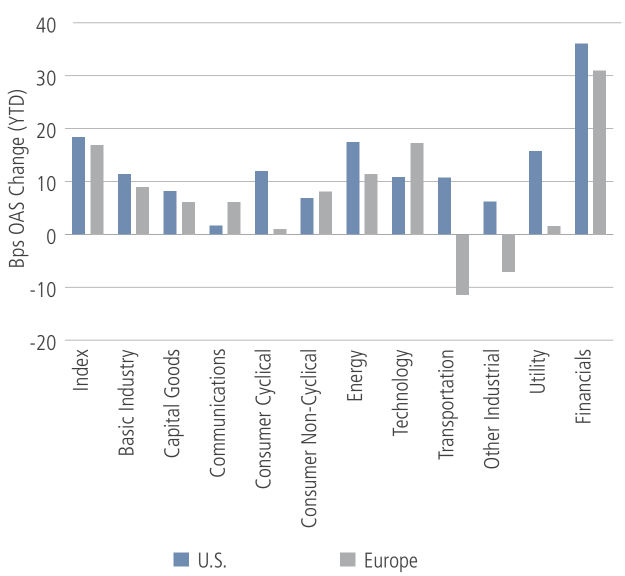
Source: Bloomberg, as of March 29, 2023.

4. Credit Spreads Have Widened, Creating Tactical Opportunities

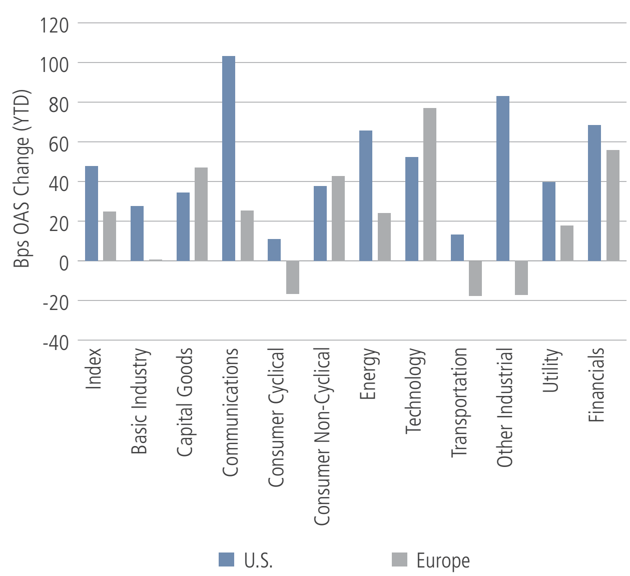
Although medium to long rates have declined, credit spreads have actually widened out of concern around economic slowing and vulnerability to higher debt costs. As such, we see more attractive relative valuations across the fixed income universe. With an environment that no longer "lifts all boats," dispersion among issuers tied to management strength, balance sheets and strategic position will likely surface more readily, while the rate of defaults could increase. Importantly, both risks and opportunities are likely to become more idiosyncratic—specifically tied to the issuers involved—which means that credit research and security selection will become particularly important. Especially within the non-investment grade space, we believe that a focus on quality issuance can help investors ride through a difficult period.

IMPROVED SPREAD ENVIRONMENT

Investment grade spreads have broadly widened, led by Financials, Energy and Technology.



High yield spreads have been more idiosyncratic.



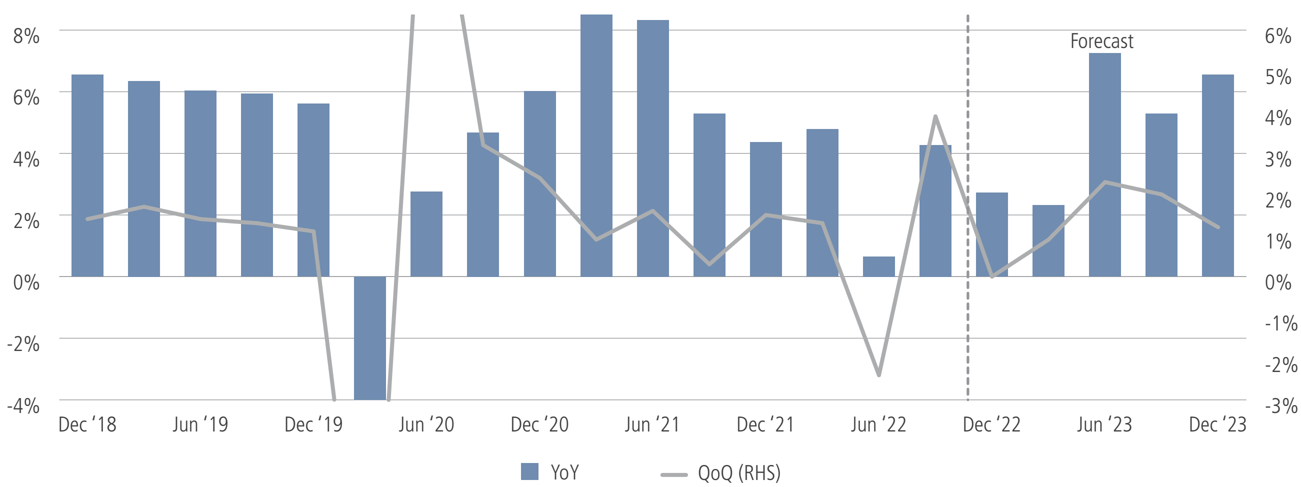
Source: Bloomberg. As of March 24, 2023.

5. Emerging Markets: Local Currency and Quality Stand Out

Recent developed-market monetary tightening and dollar strength have proved headwinds for emerging markets debt, but we see scope for strength, particularly in local-currency markets. Rate increases in the developing world largely predated the current Fed campaign and limit further interest rate risk moving forward. Importantly, China's growth prospects have been improving, with our outlook for 2023 GDP increasing to 5.3% from 4.2% previously, and compared to the country's 5% growth target (see display). This should help lift economies across Asia, supporting their exchange rates and overall credit fundamentals. We remain cautious on the high yield sector given elevated risks. However, assuming the U.S. avoids severe recession, we like higher-quality local currency debt. In our view, favorable yields make emerging markets debt an appealing alternative on a total return basis for investors seeking to trim their equity exposure.

CHINA GROWTH BENEFITS FROM REOPENING, REGULATORY SUPPORT

% GDP Growth (Year-Over-Year and Quarter-Over-Quarter)



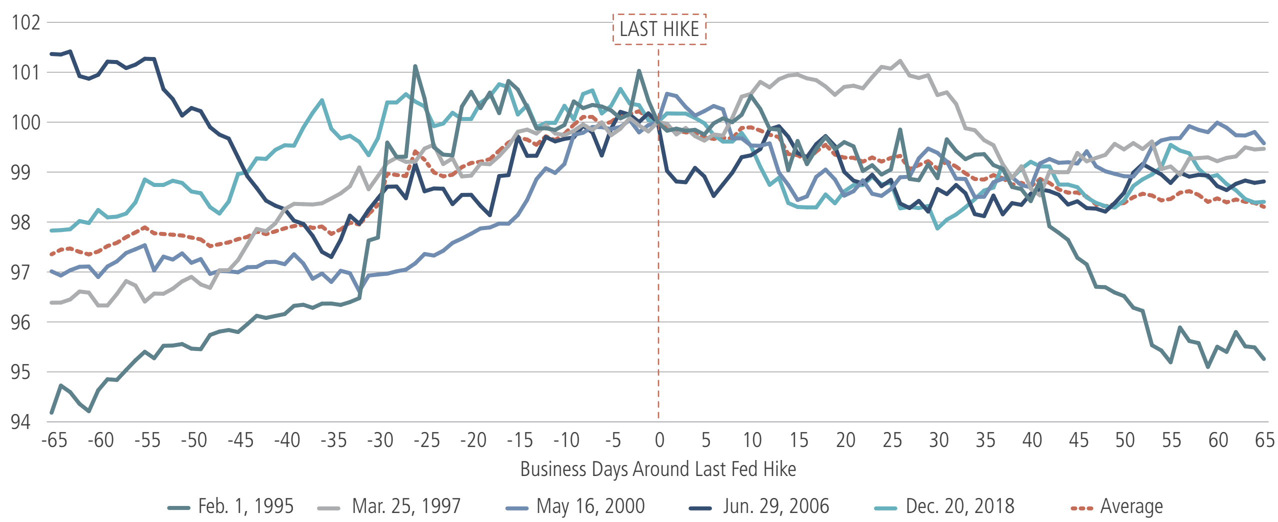
Source: CEIC; Neuberger Berman, as of March 6, 2023.

6. The Dollar Could Soften From Here

Two key factors drove U.S. dollar strength in 2022: the Fed's move ahead of other developed-market central banks to raise interest rates and the energy crisis, which pressured net energy-importing countries. Both of those situations have since changed dramatically. U.S. terminal rate expectations have dropped more than European counterparts, while oil prices have dropped from their highs and natural gas shortages in Europe have proven less dire than anticipated. Assuming markets avoid further "accidents" like the banking crisis, and as long as European growth holds up, we believe that the U.S. dollar could move lower from here.

FINAL FED HIKE HAS OFTEN PRECEDED DOLLAR WEAKNESS

U.S. dollar price before and after the last Fed interest rate hike in a cycle.



Source: Bloomberg, Neuberger Berman calculations, as of March 30, 2023. U.S. Fed Trade-Weighted Nominal Broad Dollar Index.

Market Views
Next 12 Months

	UNDER −−	−	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
GOVERNMENT BOND MARKETS						
United States	○	●	← ○	○	○	Sharply lower market rates may reflect too much optimism on Fed policy.
United Kingdom	○	○ →	●	○	○	Gilts have failed to rally despite the prospect of a more moderate central bank stance amid uncertainty.
Germany	○	○ →	●	○	○	Leads the inflation correction due to the openness and efficiency of its economy.
France	●	← ○	○	○	○	The budget deficit should increase in the wake of rising rates and sluggish growth.
Italy	○	○ →	●	○	○	The new governing coalition maintains seriousness on fiscal policy from the previous Draghi government.
Spain	○	●	← ○	○	○	Yields offer only modest value despite slowing inflation and softening economy.
Japan	○	●	○	○	○	
Canada	○	○ →	●	○	○	Monetary tightening appears on pause, though labor conditions remain strong.
New Zealand	○	○	○ →	●	○	The central bank has delivered aggressively on expected terminal rates, and is likely to pause its hiking cycle.
Australia	○	●	← ○	○	○	Sharply lower market rates may reflect too much optimism on RBA rate cuts.
U.S. TIPS	○	○	○ →	●	○	Inflation will likely remain above recent norms, creating value in breakevens.
INVESTMENT GRADE SECTOR						
U.S. Agencies	○	○	●	○	○	
U.S. Agency MBS	○	○	○	○	●	
U.S. CMBS	○	○	○	●	○	
U.S. ABS	○	○	○	●	○	
U.S. Mortgage Credit	○	○	○	●	○	
U.S. Credit	○	○	○	●	○	
Europe Credit	○	○	○	●	○	
U.K. Credit	○	○	●	← ○	○	Economic stresses and higher taxes have dampened issuer fundamentals.
Hybrid Financial Capital	○	○	○	○ →	●	We favor select preferreds issued by U.S. money-center banks and AT1s from European "national champions."
Municipals	○	○	●	○	○	

Market Views (continued)

Next 12 Months

	UNDER −−	−	NEUTRAL ◇	+	OVER ++	CHANGE NOTES
HIGH YIELD & EMERGING MARKETS						
U.S. Full-Market High Yield	○	○	○ →	●	○	Wider spreads make for attractive relative yields, though economic stresses favor a quality bias.
U.S. Short-Duration High Yield	○	○	○	●	○	
Pan-Euro High Yield	○	○	○ →	●	○	Increased income generation offsets increased macro risk for quality issuance; conditions warrant an emphasis on quality.
Floating-Rate Loans	○	○	○ →	●	○	We see a more favorable risk-return balance with wider yields and floating-rate characteristics; a quality bias can help manage risk.
U.S. CLO	○	○	○	●	○	
EM Hard-Currency Sovereigns	○	○	○ →	●	○	EM growth prospects, valuations and various recovery stories in sovereign high yield names should provide a good basis for prospective returns.
EM Hard-Currency Corporates	○	○	●	○	○	
EM Hard-Currency Short Duration	○	○	○	●	○	
EM Local-Currency Sovereigns	○	○	○ →	●	○	EM and China growth prospects combined with a mature tightening cycle should provide support to EMFX and local bonds.
CURRENCY*						
U.S. Dollar	○	●	← ○	○	○	Likely Fed policy shift may augur a weaker dollar, along with energy trends and constructive EU data.
Euro	○	○	○ →	●	○	ECB tightening likely has further to go unless data deteriorates and inflation falls sharply from here.
Pound	○	●	○	○	○	
Yen	○	○	●	← ○	○	Recent performance strength drives our tactical move to neutral.
Swiss Franc	○	○	●	○	○	
Australian Dollar	○	○	●	○	○	
Swedish Krona	○	○	●	← ○	○	Domestic data has been weak, reducing the appeal of the currency.
Norwegian Krone	○	○	●	○	○	
Canadian Dollar	○	○	●	○	○	
Mexican Peso	○	○	○	●	○	
South African Rand	○	○	○	●	○	
Brazilian Real	○	○	●	○	○	
Chinese Yuan	○	○	●	○	○	

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

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