

Relative Value & Tactical Asset Allocation

Q1 2023

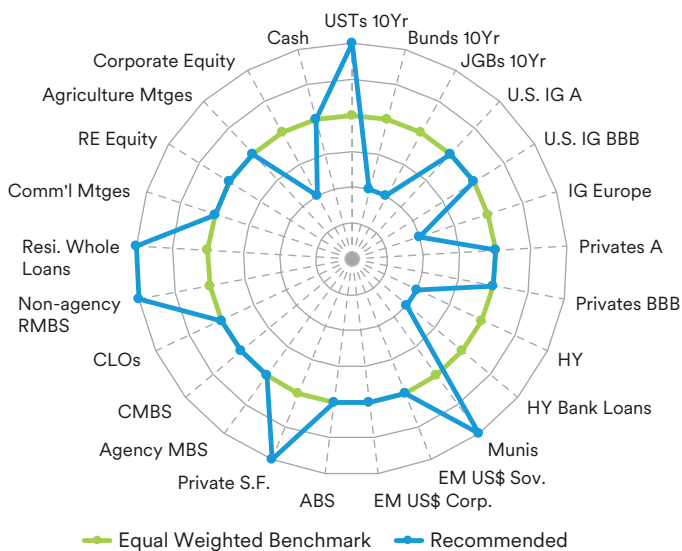
Key Takeaways

- U.S. recession risk in 2023 has increased; we expect inflation to peak, the Fed to pivot, and the yield curve to remain inverted.
- We maintain our risk-off view for asset allocation, prefer up-in-quality credits, and underweight risky assets. Cash may outperform equity in the next couple of quarters.
- Long-duration and safe-haven assets, e.g., Treasuries and munis, are preferred, considering our view on recession risk and the potential for lower yields.
- The stage of the current credit cycle may turn in 1H 2023.
- The housing slowdown has started, but healthy consumer balance sheets, constrained housing supply, and strong demand should limit this risk.
- The outlook for commercial real estate has softened somewhat. The agricultural credit cycle has peaked, but we do not expect an uptick in losses.

Rising Recession Risk in 2023

Leading economic indicators continue to signal a further softening of global economic growth. Tighter central bank policies may push the economy into a recession. **U.S.** — A recession in 2023 is our base case (Figure 2), although there is significant uncertainty regarding the depth and duration of any downturn. **Europe** — The expectation is that the euro area economy will slow further and may have entered a recession in Q4 2022, as the region absorbs a large, energy-price driven, and negative trade shock following Russia’s invasion of Ukraine. Lingering high rates of inflation and the expected weakening of labor markets are expected to curb real household spending power in 2023. **Asia** — We stick to our baseline view for growth to slow in 2023, but still outperform most other regions globally as inflation pressures steadily ease over the course of the year. **Latin America** — Activity is expected to decelerate in 2023, driven by tight monetary policies and commodity-price moderation.

Figure 1 | Tactical Asset Allocation Recommendation

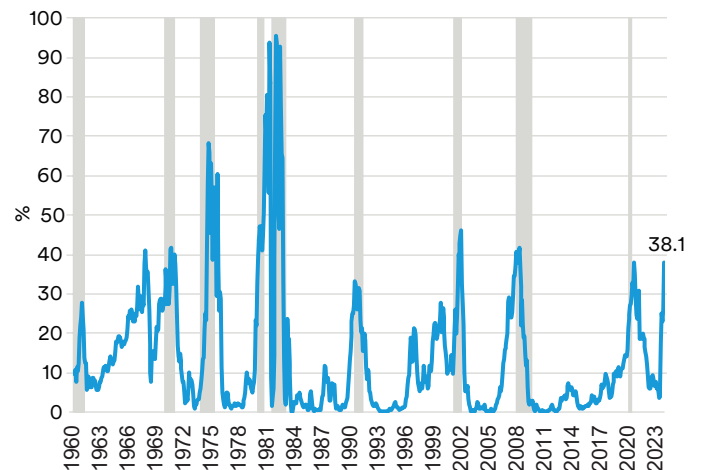


- Note:**
1. The recommendations in the chart above are solely based on our macroeconomic views, sector fundamentals, and market expectations by the authors, **which may be different from MetLife’s and Portfolio Managers’ views.**
 2. The recommendations are not associated with any MetLife’s or Clients’ 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.

Inflation Peaking, Central Banks Pivoting, and Lower Yields Are Expected

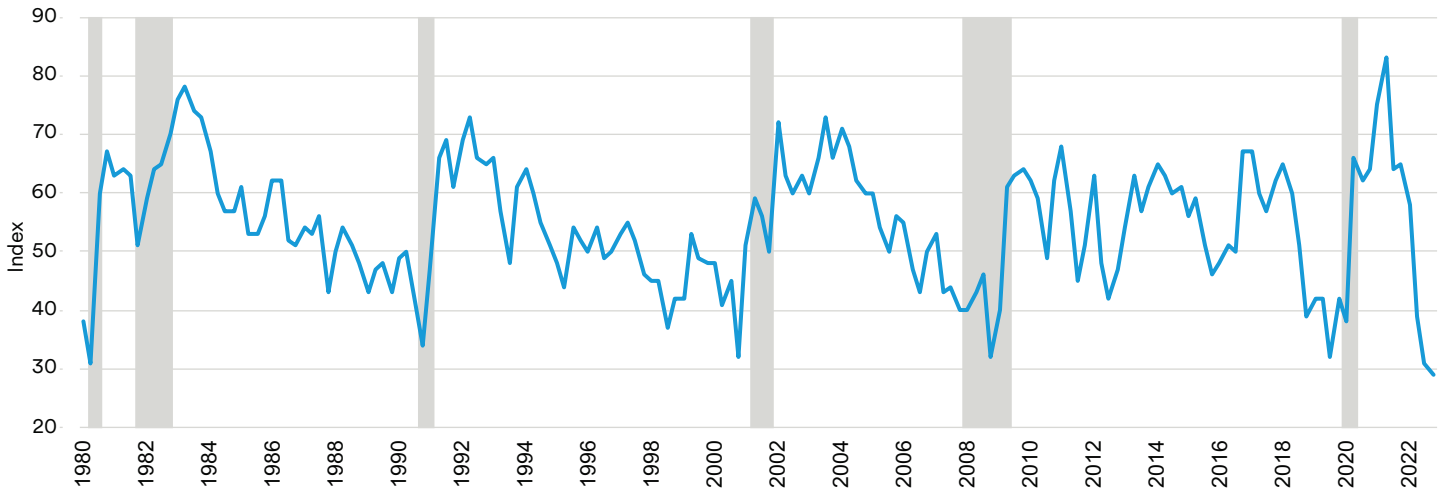
U.S. Treasury — We expect the Fed to end their hiking cycle by mid-2023, given our outlook for slowing economic growth and rising recession risk. **JGBs** — Despite moves higher in USD/JPY, the JGB market remains relatively calm, moderating over the course of 2022. The recent tweak in Yield Curve Control (YCC), i.e., allowing 10-year yields to rise to 0.5%, has caused the Yen to strengthen. It also increased speculation that BoJ may allow yields to rise further. **CGBs** — CGB 10-year yields reached a 12-month high of 2.92% at the end of November, as Beijing shifted its stance on Zero Covid policy (ZCP). An easing bias will persist, as evidenced by support measures for the property sector and the policy change on ZCP. **Bunds** — 2022 was a pivotal year for euro government bond markets, marking as it did the end of the ECB’s net QE asset purchases in June, followed by the July start of its first interest-rate hiking cycle in over 11 years. 2023 will be another pivotal year for the region’s fixed-income markets, with the ECB expected to begin a QT program.

Figure 2 | U.S. Yield Curve Recession Probability Model



Source: Federal Reserve Bank of New York, MetLife Investment Management (MIM)

Figure 3 | CEO Confidence Index

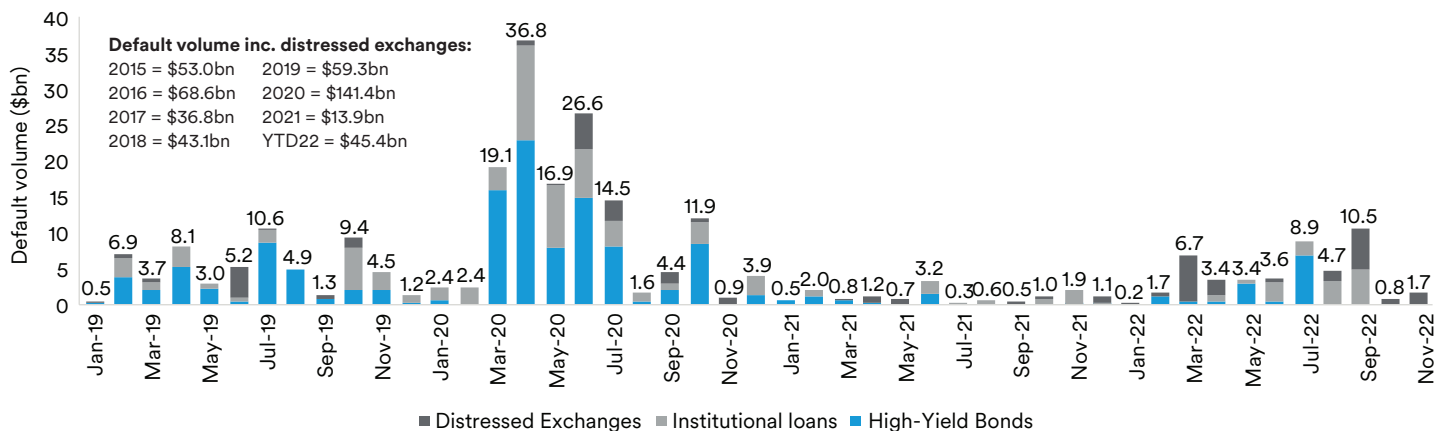


Source: Bloomberg, MIM

The Credit Cycle May Turn in 1H 2023

The credit market suffered historic losses in 2022 as rates rose significantly, and spreads widened. This credit cycle is aging very fast; although we are still in “overheat” stage, we may already be on the brink of a “downcycle” stage. We believe that the credit cycle could turn in 1H 2023. However, we don’t think credit markets have priced in sufficient downside risk just yet. Across credit markets, valuations are still near their historic averages and priced like mid-cycle. At the current spread levels, both U.S. IG and HY markets seem to be pricing in less than a 10% recession risk. Looking forward, we expect spreads will trend wider on heightened recession risk in 2023. However, for 1Q 2023, we believe that there is a chance of a relief rally as the Fed’s hiking cycle comes to an end. That could be an opportunity to “sell into strength” and upgrade portfolio quality. As a result, we continue to recommend “up in quality” as we head into 2023. **U.S. Investment Grade (IG)** — The outlook remains neutral on slowing profit growth and margin pressures. While EBITDA margins remain at cycle highs, ex-energy EBITDA margins have already peaked. Overall leverage ratio improved further in 3Q22, but the ex-energy leverage ratio started to rise marginally. IG yields rose to the highest levels since 2009, and we believe current yield levels are attractive.

Figure 4 | US Defaulted Bond/Loan Debt



Source: JPMorgan, MIM

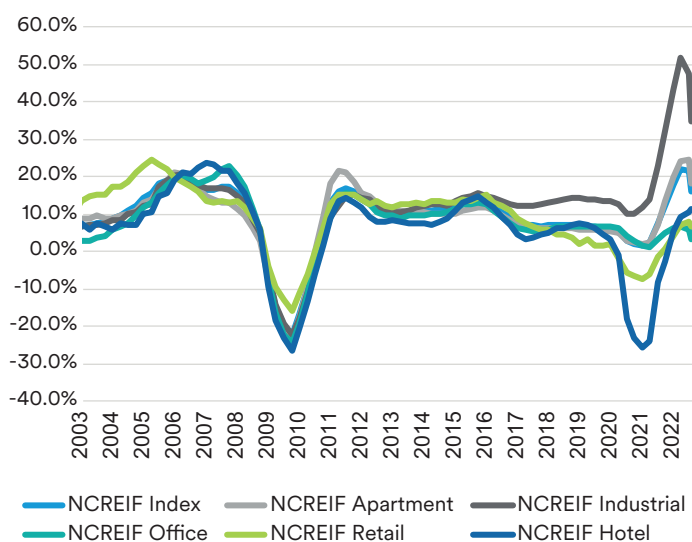
European IG — We maintain our view that margins, ex-energy, have peaked, and for the next 12-18 months, it is likely to be a question of how well corporates can protect against declines. Spreads still appear relatively cheap, but we are concerned about further widening on the ECB's aggressive rate hikes, the ongoing energy crisis, and the recession. As the result, we remain underweight in European IG. **High Yield** — Similar to the IG market (although overall EBITDA margins remain at cycle highs), ex-energy margins have already peaked. Defaults remained benign in 2022, but total defaults/distressed exchanges are already more than three times 2021's full year total. The default rate is expected to rise significantly in 2023. Moody's expects U.S. default will rise to 5.0% by October 2023 from only 1.5% in October 2022. The bond recovery rate remains around its five-year average. **Leveraged Loans** — Due to the prevalence of loan-only capital structures, recovery rates are meaningfully lower than historical averages. The recovery rate for first-lien loans fell to as low as 50% in August 2020, but since then it has improved to 65.7%. The ratings-migration trend has been negative as downgrades outnumbered upgrades again in November—the seventh consecutive month that has occurred. Spreads appear cheap, but we are concerned about higher defaults with lower recovery rates and heightened downgrade risk for leveraged loans in 2023 as the credit cycle turns. **Municipals** — Both general obligation (GO) and revenue bond outlooks remain neutral on a challenging macro outlook. For GOs, total state and local government tax revenue rose 7.0% YoY in 1Q22. We expect continued growth. For revenue bonds, in the health care sector, the Omicron surge this past winter had a more severe financial impact on not-for-profit (NFP) hospitals starting in 4Q21, and that continued into 2022. While EBITDA margins rebounded sequentially in 2Q22 and 3Q22, hospitals must improve productivity, cut costs, or increase revenue. Air traffic continues to recover from the 2020 lows. Toll road revenues have largely recovered to pre-pandemic levels. We believe the taxable municipals market will be relatively more resilient in a challenging macro environment. **Emerging market (EM) IG** — We expect EM growth to slow down further in 2023 from 2022 and remain well below its pre-pandemic trend. LatAm and EMEA growth will be negatively impacted by the lagged impact of monetary tightening and still high inflation. Asia will likely outperform, driven by China. In 2022, China was hit by Omicron surges along with significant weakening in the housing market. Although

significant uncertainty remains surrounding the ZCP, recent announcements to loosen ZCP suggest a modest rebound in 2023 as the economy gradually reopens. For EM corporates, we have changed our outlook to neutral from positive as revenues and EBITDA seem to have peaked in 3Q22, and while we expect margins to remain healthy, they are likely to compress on higher cost pressures.

Housing Slowdown Has Started

Home price declines are taking center stage with select regions officially showing declines. Almost 50% of states have shown recent declines. The widely followed S&P Case Shiller Index registered its first decline since 2018. **Residential Credit** — As Fed actions prompt higher mortgage rates, the market should cool. Seasonals and a “lock-in” effect could bring home sales to a standstill. While current affordability is down to 104.4, issue-date-adjusted affordability is still close to the long-run average at 157. The recent increase in mortgage rates has not resulted in greater payment for existing borrowers as ARM volumes have been low in recent years. While home prices can decline, consumer home equity has increased to \$29 trillion. This should be a significant dampener to distressed selling.

Figure 5 | NCREIF Indices



Source: NCREIF, MIM

Asset-backed securities (ABS) — The consumer is beginning to grow credit balances to support spending. The Federal Reserve consumer credit report shows that credit card balances are up to \$887 billion and are just below the high of year-end 2019. Lower FICO borrowers will continue to see increasing delinquencies and less access to credit as originators begin to pull back. **CLO** — CLO collateral pools are beginning to show weakness. The downgrade ratio (i.e., rolling three-months number of downgrades to number of upgrades) continues to deteriorate and is up to 2.24 as of November. Default rates, which lag, have begun to increase but are still low. Most default projections range from 3-5% for 2023. Deals continue to migrate to static or short tenor as the issuance market is challenged due to wide cost of funds. **CMBS** — Interest rates and the lending environment are finally leading to a decline in commercial valuations (Figure 5). Retail has staged a strong valuation recovery since the very weak 2019-2020 environment. Most loans have ample debt service coverage ratios (DSCR) given past low mortgage rates, but refinancing risk could be a concern as loans come due and are refinanced over the next several years. **Agency MBS** — Cheap MBS valuations have brought in a larger buyer base, leading most asset manager to move to neutral weight relative to the index. However, on a relative basis across all asset classes, Agency MBS looks attractive given its total yield, valuation, healthy consumer balance sheet, and stable housing market fundamentals. **Private Structured Credit** — We saw a healthy pipeline of transactions across a diverse range of asset sectors as public market execution became challenging, and issuers increasingly looked for private market solutions with certainty of execution. While spreads may remain volatile in the near term, valuations look attractive, with spreads near the widest level since COVID-19, coupled with all-in yields not seen since the financial crisis. We expect deal flow to remain robust and are currently seeing opportunities in alternatives, solar, energy, trade receivables, and residential credit.

The Outlook for Commercial Real Estate Has Softened Somewhat

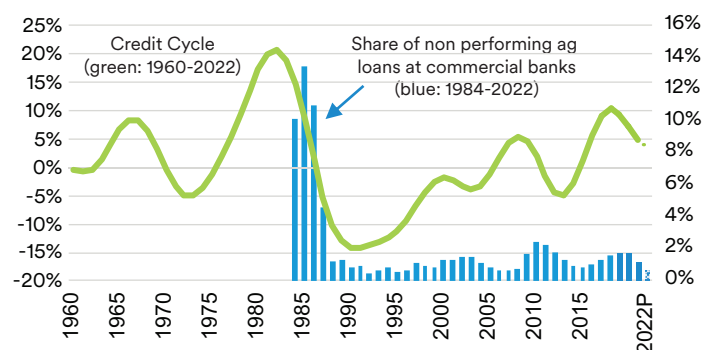
Real estate fundamentals remain mostly healthy. Inflation has run above expectations, which has generally benefited property income growth, and

vacancy rates remain near historical lows for most property types. Still, looming economic headwinds have tempered growth expectations. The outlook for the economy and commercial real estate performance has softened somewhat. Recent transactions and offerings suggest real estate equity pricing has improved, with discount rates up around 75 basis points, but not sufficient to match the move in Treasury rates. Transaction activity for both real estate debt and equity has slowed.

Agricultural Credit Cycle Peaked, But We Do Not Expect an Uptick in Losses

U.S. farm incomes are forecast to have reached record levels in 2022 due to strong commodity prices, although growth was muted somewhat by rising production costs. The agricultural credit cycle indicator peaked in 2018 and has been contracting. Agricultural loan losses at commercial banks (a proxy for the sector) tend to occur during contractions in the agricultural credit cycle (Figure 6). Strong farm incomes have led to a borrower contraction of short-term credit. Firm farmer repayment capacity has translated into a decline in non-performing loans in the cycle. Rising land values continue to add strength to sector balance sheets. Given these factors, we do not expect an uptick in losses.

Figure 6 | Agricultural Credit Cycle



The Agricultural Credit Cycle measures the deviation in the growth rate of leverage in the agricultural economy from the estimated Sources: MIM, Ag Finance Databook, Kuehne & Hubbs

Cash May Outperform Public Equities

Given our dim economic outlook, corporate profit margin pressures, and rising recession risk, equity may continue its current medium- to long-term downtrend. A market capitulation could provide an early signal for a market bottom and signal an end to the current downtrend. We continue to underweight equity (i.e., underweight risky assets in general). Cash (i.e., 3-month LIBOR), which currently offers 4.7% yield, may outperform risky assets if equity markets remain soft, and bond volatility continues.

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