

Relative Value & Tactical Asset Allocation

Q1 2024

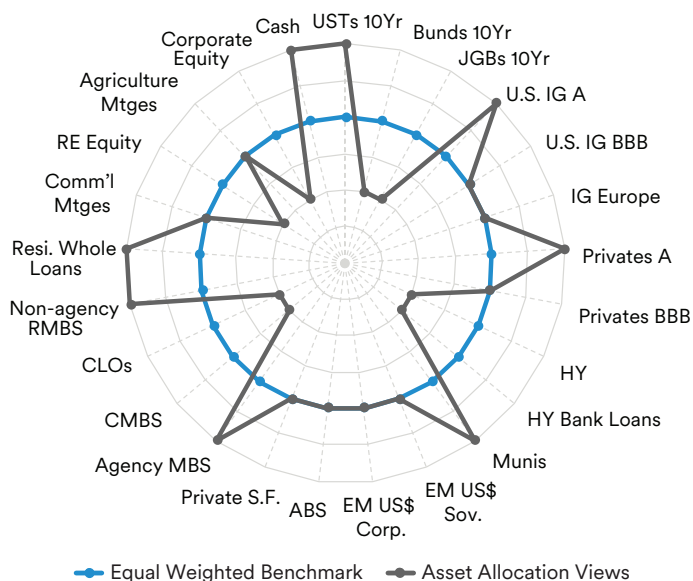
Key Takeaways

- We are expecting a recession with slower growth, lower inflation, and more supportive monetary policy in H1 2024.
- Government bonds are anticipating lower yields due to an easing of monetary policy.
- We are maintaining our “up-in-quality” strategy for Q1 2024.
- Current household balance sheets generally remain strong but with an expectation of weaker consumer fundamentals in 2024.
- We believe the office sector has yet to hit bottom, while the farm economy remains resilient.
- We continue to believe the future for fixed-income markets is brighter than equity markets.

Slower Growth, Lower Inflation and More Supportive Monetary Policy

The downturn in the global manufacturing sector persists, suggesting slower growth globally in the next three to six months (see Figure 2). **U.S.**—We continue to look for a U.S. recession, which we expect to be short-lived, to begin in 2024, with growth and the labor market to weaken further. We are anticipating a rate-cut cycle to start in H1 2024. **Europe**—Growth momentum is likely to remain feeble into 2024, with a disinflation trend well underway and a hope for monetary policy easing next year. **Asia**—Although the region's macro performance has held up relatively well, year to date, we are looking for more growth headwinds in 2024, including weaker external demands, and monetary policy to ease. **Latin America**—The region's central banks may continue or start cutting policy rates in 2024, with growth expected to converge to a modest 1% to 2% across the region.

Figure 1 | Tactical Asset Allocation Views



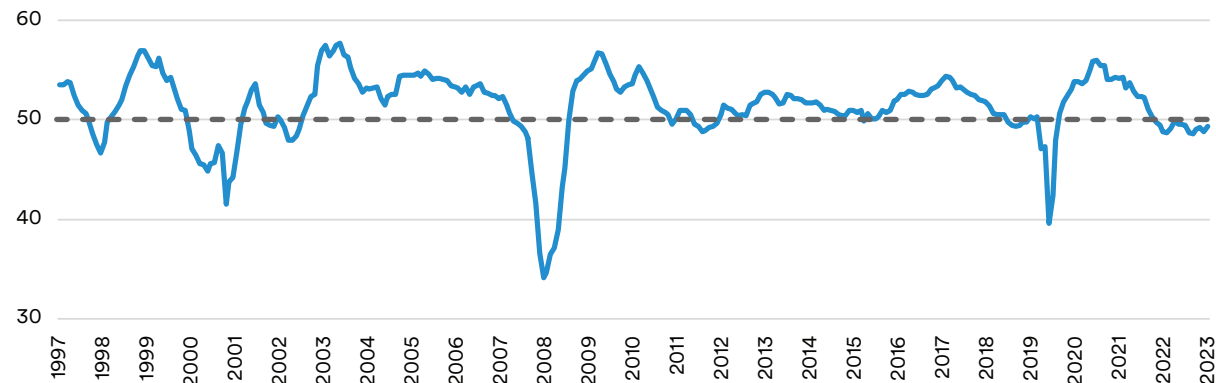
Note:

1. The asset class views in the chart above 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 December 21, 2023

More Supportive Monetary Policy May Mean Lower Yields

U.S. Treasury (UST)—Given our expectation of slowing inflation and economic growth, we look for the 10-year yield to move lower in the next quarter or two, especially if the Fed is pivoting to conduct rate cuts. **Japanese Government Bonds (JGBs)**—Our baseline for Negative Interest Rate Policy remains on hold in 2024, but we will continue to revisit depending on incoming data from Japan and globally. **Chinese Government Bonds (CGBs)**—The 10-year yield will likely remain rangebound due to ongoing cross currents between growth headwinds and expected policy supports. Easing growth and still-low inflation next year may pose downside risks to our 10-year yield forecast. **German Bunds**—We expect the 10-year yield to fall to around 2% by year-end 2024, due to the ECB's rate-cut cycle anticipated to begin around mid-2024. Valuations may also be supported by a tighter fiscal policy.

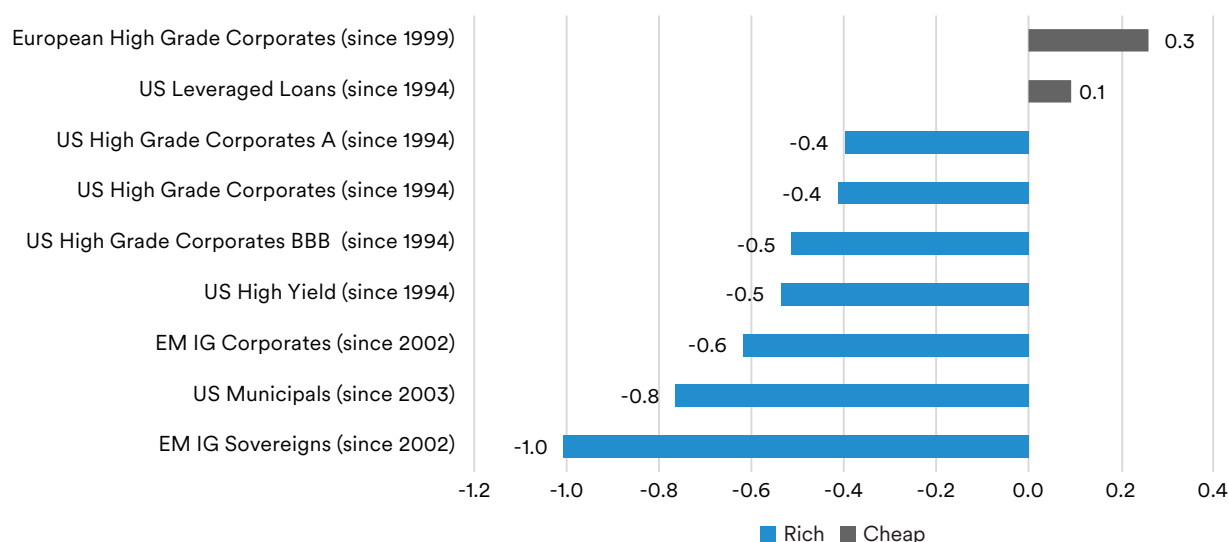
Figure 2 | Global Manufacturing PMI

Note: 50 indicates a neutral level. Below 50 indicates a contraction.

Source: JPMorgan, MetLife Investment Management (MIM). As of November 30, 2023.

“Up-in-Quality” Still Reverberates Within Corporate Credits

After weakening for three consecutive quarters, credit fundamentals appear to have stabilized and remain resilient across U.S., European and emerging markets, with corporate profits rebounding. Option-adjusted spreads (OAS) tightened to new year-to-date levels in most credit sectors, according to Bloomberg, thanks to stronger-than-expected Q3 earnings. However, we continue to believe the market is overly optimistic about the soft-landing scenario, and valuations remain rich (see Figure 3). We believe there is limited room for further spread compression. Given the lagged impacts of monetary policy and still-elevated recession risk in 2024, we continue to recommend an “up-in-quality” bias for the next quarter or two. **U.S. Investment Grade (IG)**—Credit fundamentals remained resilient with some mixed messages about both operating performance and credit metrics. Demand from investors chasing all-in yields was strong in the past quarter, further supporting U.S. IG bonds. Although spreads are generally near their year-to-date tights, we find all-in yields attractive on a historical basis.

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

Note: As of 11/30/2023. 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 November 30, 2023.

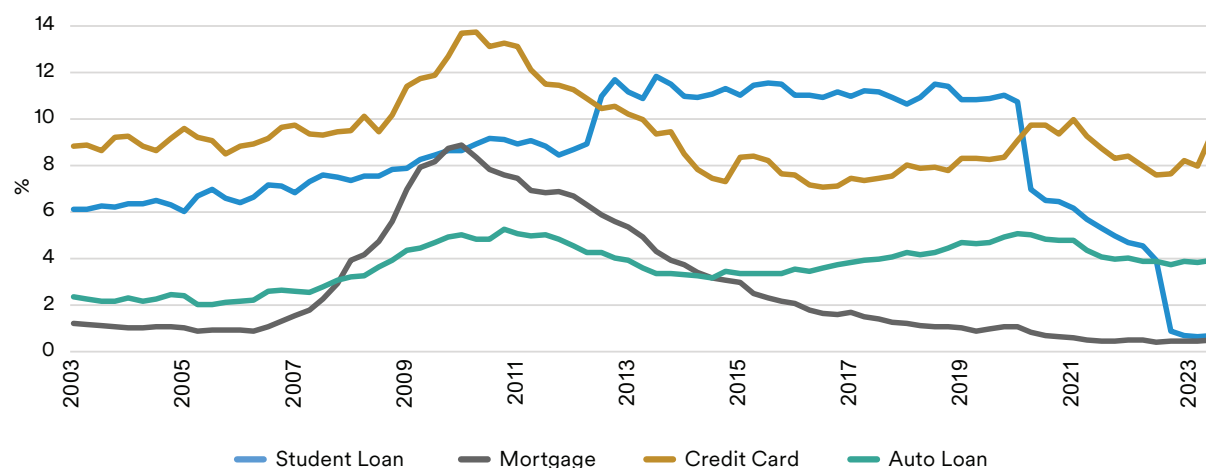
European IG—Our credit outlook for 2024 is constructive. Fundamentals saw a slight deterioration mainly in the Chemicals and Consumer Discretionary sectors, but demand for European IG remained strong. Spreads have tightened driven by decent corporate performance in Q3. We view current valuations as fair, and we believe it will be difficult for spreads to narrow much further.

High Yield (HY)—Credit fundamentals stabilized in Q3 2023 and remained strong relative to historical levels. The default outlook has improved for 2024, as issuers pushed out their maturity wall, based on Moody's default report. While spreads remain tight, the HY market looks attractive from a yield perspective. **Leveraged Loans**—Our strategy is to maintain an “up-in-quality” bias to offset any potential impacts of macro risks (e.g., slowing growth) and continued credit deterioration. We expect the start of policy easing next year to be supportive of loan issuers' credit fundamentals. **Municipals**—Credit fundamentals remained stable in Q3 2023. Looking forward, we are seeing some sources of potential volatility in 2024, including the election and a debate over the 2017 Tax Cuts and Jobs Act. Although current spreads are tight, they can be attractive for investors who are looking for tax-adjusted yields. With relatively long duration, municipal bonds can potentially reduce reinvestment risk, while also benefiting from potential rate cuts in 2024.

Emerging Markets (EM)—EM sovereign fundamentals have largely stabilized from COVID-19-driven growth and inflation shocks. Most countries are seeing their growth running at- or above-potential, while those that are more exposed to China are seeing a drag. We believe that there are roughly one-third of EM countries that are facing some downgrade risk, due to rising debt dynamics that require fiscal adjustment. For EM corporates, fundamentals remained healthy. Balance sheets remained strong with active liability management that has reduced concerns over refinancing risks. Looking forward, we believe that credit metrics may moderate further.

Household Balance Sheets Generally Remain Strong

Residential Credit—Despite the surge in mortgage rates seen in 2023, the U.S. housing market remained resilient, with home prices rebounding over the past few months, thanks to a strong labor market and limited housing supply. Borrower fundamentals continued to be robust, with mortgage delinquencies staying near historical lows (see Figure 4). We continue to look for supply to remain under pressure as homebuilders have been conservative due to elevated costs and mortgage rates. **Asset-backed Securities (ABS)**—Excess savings and a strong labor market have supported consumers well throughout this year, but we are expecting some headwinds in 2024. Generally, household balance sheets are strong (see Figure 4), with credit card and auto loan delinquencies close to their long-term averages. However, younger borrowers need to be watched, as student loan payments restart (with high interest rates)—we are anticipating an uptick in student loan delinquencies. **Collateralized Loan Obligations (CLOs)**—Fundamentals trend weaker, in line with market expectations, as bank loan borrowers struggle with high borrowing costs. The Kanari database indicated that market value of CCC within CLO portfolios increased to above 10%. A recent JP Morgan report also indicated that recovery rates are historically low. We expect loan-only issuers to remain weak.

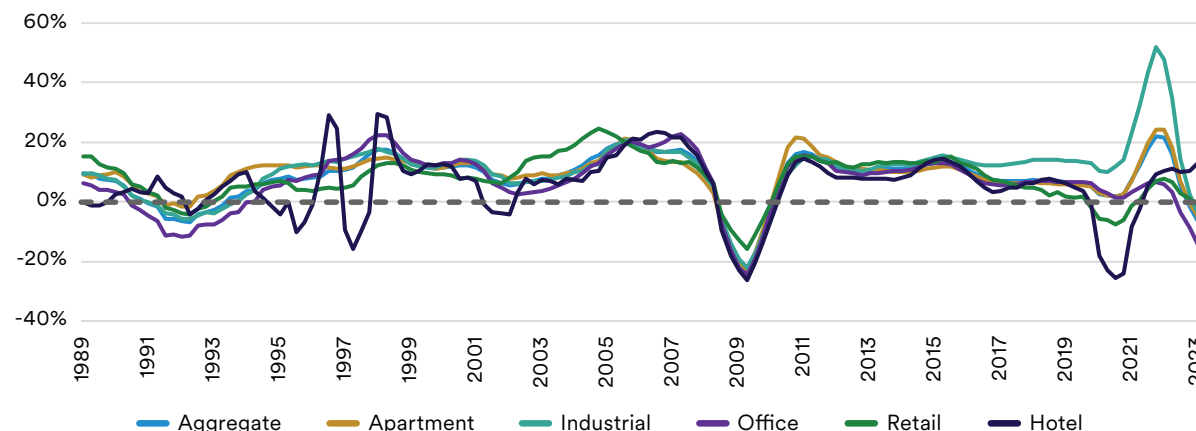
Figure 4 | 90+ Days Delinquencies

Source: Bloomberg, Federal Reserve, MIM. As of September 30, 2023.

Commercial Mortgage-backed Securities (CMBS)—Commercial real estate fundamentals continued to face challenges, especially the office sector. The CRE Financial Council indicated that delinquencies and specially serviced loans continued to trend higher, reflecting greater risk in the asset class. We look for CMBS issuance to increase 25% next year from 2023 levels, but to remain well below the annual run rates seen prior to 2020. **Agency MBS**—Money managers continued to increase their allocation to Agency MBS in the past quarter, despite limited demand from banks. Current coupon spreads remained significantly wide to longer-run averages, which we find attractive. Prepayments are low and anticipated to decline further during the winter months, while mortgage originations continue to be muted. **Private Structured Credit (PSC)**—We expect consumer credit performance to remain under pressure in 2024, with an expectation of higher unemployment moderated partially by tight lending standards and still-strong household balance sheets. We look for deal flows to remain healthy going into the start of Q1 2024. Given some uncertainties in inflation, monetary policy and the labor market, our credit outlook remains constructive for 2024.

CRE Fundamentals Stable, but Office Remains Challenged

Similar to broader inflation trends, real estate fundamentals have cooled from historically elevated demand in 2021 and 2022. Still, vacancy rates that remain near historical averages for most property types are continuing to generate stable rent growth. In the apartment sector, pockets of oversupply in several sunbelt markets like Nashville and Phoenix could cause rents to remain flat or even fall modestly in 2024, but Coastal, Mid-Atlantic, and Midwestern markets are generally better positioned. Retail, industrial and hotel sectors are benefiting from healthy demand, and, in the case of retail, a dearth in new construction. The office sector is challenged, and we expect another year of deteriorating vacancy in 2024. The NCREIF office property index in September 2023 generated a total return of -17% over the past year (see Figure 5). Overall pricing has improved relative to the 2022 peak, as evidenced by values in the NCREIF property index which have declined 11% through 3Q 2023. Transaction volume is muted and will likely remain low next year.

Figure 5 | NCREIF Indices (year over year)

Source: National Council of Real Estate Investment Fiduciaries (NCREIF), MIM. As of September 30, 2023.

The Farm Economy Remains Robust

2023 Net Farm Income (NFI) estimates by the United States Department of Agriculture (USDA) showed a decline of 17% from a year ago, due to an 8% year-over-year contraction in agricultural exports (e.g., corn, livestock, poultry, dairy, tree nut). Unfavorable weather conditions during growing seasons resulted in harvests wrapping up slightly behind the 2022 pace. Despite the elevated interest rate environment and the modest downtrend in NFI, 2023 will likely mark the third consecutive year of high farm incomes. We believe the farm economy is in a good shape. In 2023, farmland values remained strong on a year-over-year basis, which created steady capital flows to the sector. Delinquencies in agricultural mortgages dropped to all-time lows in 2023, according to Ag Finance Databook. Heading into 2024, we are looking for crop prices to stay in a moderate territory.

Valuation Risk Seems High in Equity, While Cash Looks Attractive

Given our recession call and “up-in-quality” strategy for H1 2024, we are expecting a more challenging macro backdrop for equity markets next year. We believe that consensus estimates of earnings per share for 2024 are overly optimistic, as equities are currently expensive, volatility is at its historical low, and geopolitical risks are likely to remain elevated—meaning that the uptrend in equity valuations may not be sustainable. Since the risk of a recession remains high, we believe the future for fixed-income markets is brighter for the next quarter or two, and cash investments remain attractive in the near term (3-month U.S. Treasury bills are at a multi-decade high, according to the U.S. Federal Reserve). Hence, we continue to remain underweight corporate equity and overweight cash investments from a tactical asset allocation perspective.

Authors

JUN JIANG

Director, Global Economic & Market Strategy

JASON CHEN

Associate Director, Global Economic & Market Strategy

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