WHAT OUR MANAGERS THINK…

Q1 2023

WESTERN ASSET

Is the Fed now behind the *disinflation* curve?

- Last year many feared the Fed was behind the inflation curve, as it responded slowly to above-target inflation. The Fed may once again be behind, but now in the opposite direction.
- The market currently anticipates rate cuts on the horizon. The Fed continues to assert that further rate hikes will be appropriate.
- We think market pricing has correctly anticipated two points: Interest rates are unlikely to remain at these elevated levels for that long, and the risks are increasingly tilted toward lower rather than higher yields.
- We expect developed market (DM) government bond yields to stabilize as we move through the first half of 2023. We think month-to-month inflation will be in the Fed's target range before the middle of 2023.
- Investment grade spreads are currently just fair in our view, given potential forthcoming economic weakness and the strong financial condition investment-grade companies held coming into this turn. We continue to favor banking, energy, and select reopening industries.
- In Europe, yields at multi-year highs look attractive. In particular we like the 3- to 5-year part of the market for total return potential.
- For agency mortgage-backed securities (MBS), the fundamental picture has greatly improved as spreads widened in 2022 and now look attractive historically; prepayment risk has subsided to low levels. We are constructive on 30- and 20-year subsectors vs. 15-year MBS.
- High-yield credit spreads are relatively attractive, in our view. Yields are providing ample cushion for higher defaults—which are likely to be below historical averages given the higher credit quality of the market on average.
- We also believe bank loan spreads are relatively attractive. Yields are providing ample cushion for gradually higher defaults.
- In emerging markets (EM), we like local currency bonds; Asian currencies should benefit from the end of China's zero-COVID policies. EM corporates have strong balance sheets with lower leverage than their DM peers. Risks primarily come from sovereign developments.

FRANKLIN TEMPLETON FIXED INCOME

Markets too sanguine on inflation outlook

- Still too optimistic, investors are seemingly convinced that the battle against inflation has already been won.
- There are some reasons to be optimistic. Inflation has declined.
  - The Employment Cost Index has come down from very high levels.
  - Housing inflation should slow as well, once new and lower rental contracts start feeding into the index.
  - Some delayed impact of the Fed's rate hikes still needs to be felt.
- However, there are important reasons to fear that the path ahead will be a lot more challenging.
- At January end, financial conditions were back at early-April 2022 levels, and that was before the Fed press conference-ignited rally.
- The loosening in financial conditions has offset all of the Fed's rate-hiking effort. Financial conditions have loosened so much that it's as if the Fed's rate hikes never happened.
- The labor market remains exceptionally tight. The December Job Openings and Labor Turnover Survey (JOLTS) numbers show the ratio of vacancies to unemployed is almost back to its high of two openings for every job seeker. [1]
- Various measures of wage growth are still running in the range of 4%-6%, which might make it a lot harder to push inflation below 4%-5%—considering also that workers have already surrendered a lot of purchasing power.

CLEARBRIDGE INVESTMENTS

US recession risks elevated; the case for dividends

- With the U.S. economy slow dancing toward a potential recession, we believe the first half of 2023 will prove choppy for equity markets as incoming data fails to reveal a clear trend for growth and earnings.
- Countertrend rallies are not uncommon during extended bear markets, and we continue to believe a durable bottom has not yet formed.
- The lagged effects of Fed tightening could continue to weigh on an already slowing growth backdrop in 2023.
- The 10Y-3M yield curve is now deeply inverted, suggesting elevated recessionary risk in 2023. This portion of the yield curve has correctly predicted the last eight recessions with no false positives.
- The narrow path for a soft landing relies on a slackening labor market, slowing wage gains and a substantial reduction in inflation.
- While negative returns in 2022 were primarily driven by multiple contraction, downside to earnings expectations appears to be the primary risk in the coming year.
- In these turbulent and uncertain times, we believe dividend growers are particularly attractive.
- Many of the forces that buoyed companies with growing dividends in 2022 remain intact for 2023.
  - Dividend payers tend to stay afloat in choppy waters as their current income gives investors something to hold onto.
  - Dividend growers can thrive in an inflationary environment because, unlike bonds, which have fixed coupons, rising dividends can help offset inflation and protect purchasing power.
  - Payout ratios, broadly speaking, are conservative; companies have cushion to continue raising dividends despite slowing or even negative earnings growth.
- Despite growth valuations falling by twice as much as value in 2022, the relative value of value remains well above historic averages and remained in the cheapest decile.
- There is a long way to go in favor of value in the current market cycle.

MARTIN CURRIE

EM equities poised to spring to life in 2023

- Emerging markets equities look well placed to us in 2023.
- We believe China is now in an interesting place, in sharp contrast to many developed markets, with easing policy and the potential for a significant economic rebound as Covid restrictions finally ease.
- Due to positive impacts from structural factors and policies, Brazil and India appear favorable.
  - Brazil was one of the earliest markets to hike rates, and its monetary policy is set to ease over the coming year.
  - India continues to deliver the strongest growth amongst the large economies, fueled by strong domestic demand.
- However, not all is rosy in emerging markets.
- We see some earnings pressure from technology-focused stocks in countries like Korea and Taiwan. Technology supply chains are entering a period of de-stocking, but we believe much of that has already been discounted into their share prices.
- Inflation remains relatively benign in emerging markets, which gives central banks more optionality. Monetary policy is likely to be divergent across regions, and emerging markets economies have the opportunity to decouple from G7.

Key Themes

THEME	RATIONALE
INCOME RETURNS TO FIXED INCOME	Yields on investment grade and high yield bonds more than doubled in 2022.[2] Long-term valuations appear to be fairly reflecting the pace of rate hikes already discounted. Solid corporate earnings continue to provide support for corporate investment grade bonds, and lower rated bonds and loans. The yield curve inversion suggests at some point there will be a recession, but that date seemingly continues to get pushed out.
MUNI RECOVERY POWER	Only six times in 42 years have munis delivered negative calendar-year returns.[3] In each instance, they rebounded with robust returns the following year. States and many muni credits go into this period of slower or negative growth with very strong balance sheets and reserve funds.
FLEXIBLITY AND BALANCE: KEYS TO FISCAL FITNESS?	Flexible funds managing allocations across asset classes and sectors may be able to nimbly move to take advantage of income opportunities generated by market volatility.
DIVIDENDS: INDICATORS OF POTENTIAL SUCCESS IN DIFFICULT MARKETS	In a challenging market like that spurred by the Fed rate hiking cycle, dividend growers have outperformed the broader S&P 500 Index before, during and after the rate hikes.[4] In all markets, dividends can be a great indicator of potential success. Stocks of companies that initiated or grew their dividends outperformed, in aggregate, those that didn't over the last 30 years.[5] Likewise, they had a lower standard deviation of return.
INTERNATIONAL OPPORTUNITIES	Years of underperformance by international equities relative to the S&P 500 ended in 2022. Emerging markets may be in position to join them this year. Many EM countries' credit tightening preceded that of the US and developed markets, and they are now in position to potentially lead the easing of credit going forward. The removal of COVID restrictions in China should be a boon for other Asian economies as well, with a normalization of trade and tourism.
ALWAYS BE PREPARED	The start of 2023 showed the benefit of diversification, as anticipation is a powerful force.

1. Source: Bureau of Labor Statistics. Data as of December 31, 2022.
2. Source: Bloomberg, 12/31/2022. Represented by the yield to worst of the Bloomberg US Corporate High Yield Bond Index and the Bloomberg US Corporate Investment Grade Bond Index .
3. Source: Bloomberg, 12/31/2022. Bloomberg Municipal Bond Index Total Return Index Value Unhedged USD.
4. Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, FRB. S&P 500 Index screened each month end, no dividend cuts in the past five years, latest one-year dividend per share growth and current dividend yield greater than the S&P 500 Index.
5. Source: © 2022 Ned Davis Research Group, Inc. All stocks were categorized by the following methodology for the 12-month period ended 12/31/2022: Dividend Growers and Initiators represents all dividend-paying stocks in the S&P 500 Index that raised their existing dividend or initiated a new dividend. Risk is measured by the standard deviation of monthly total returns.

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