April 4, 2024

INSURANCE INSIGHTS | MACRO STRATEGY

Relative Value & Tactical Asset Allocation

Q2 2024

Key Takeaways

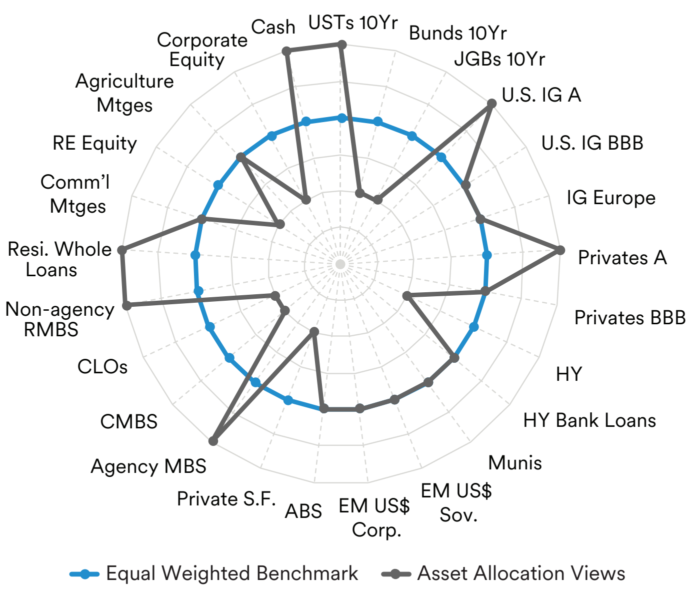
- We continue to expect the United States to enter a modest recession in 2024.
- We find valuations for UST, Bunds, and JGBs attractive relative to CGBs.
- Credit cycle remains in a late stage with fundamentals resilient across US, European, and emerging markets.
- Fundamentals of consumers and housing remain strong.
- Commercial real estate fundamentals are generally stable outside the office sector, while the farm economy is expected to stabilize in 2024.
- We continue to remain underweight corporate equity and overweight cash investments from a relative value perspective.

MetLife Investment Management

Global Economy is Weighed Down by Geopolitical Crises and Policy Uncertainties

Major economies are looking for their GDP to run below long-term trend (see Figure 2), with China continuing to slow gradually despite economic re-opening and policy stimulus. **U.S.—**We continue to expect the United States to enter a recession in 2024, which may be similar to pre-Great Financial Crisis recessions, i.e. not particularly sharp or long. **Europe—**Overall growth momentum in the euro area and U.K. remains weak, with inflation moderating due to declines in energy costs. We anticipate the ECB and BoE to begin a cautious rate-cut cycle in 2H24. **Asia—**The growth backdrop remains stable due to a stronger-than-expected external demand. With disinflation persisting, central banks are in no rush for rate cuts. **Latin America—**We are looking for growth to converge to a modest 1% to 2% this year across the region, with central banks continuing or starting rate cuts.

Figure 1 | Tactical Asset Allocation Views



Note:

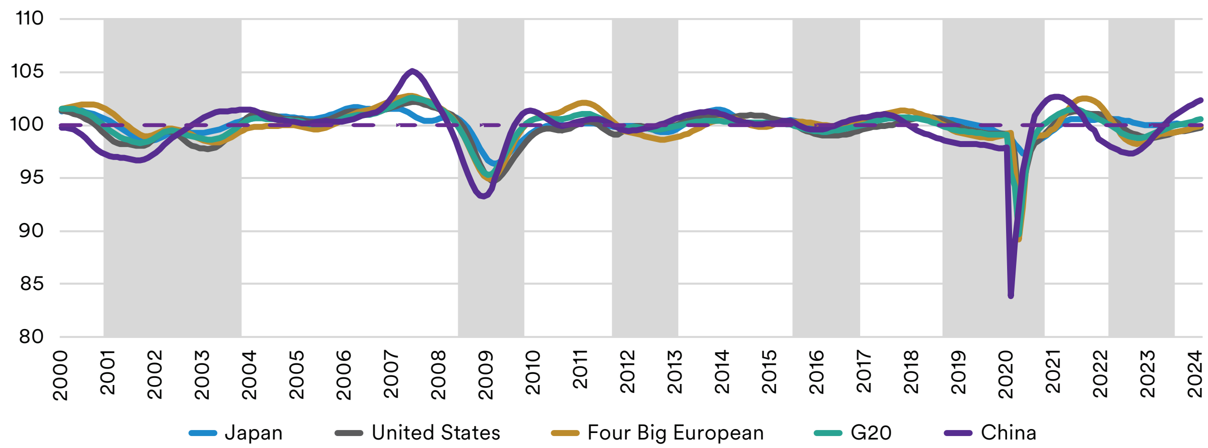
1. The asset class views in Figure 1 are based solely on our macroeconomic views, sector fundamentals, and market expectations by the authors, **which may be different from MetLife's Portfolio Managers' and sector strategists' views, which are included in this report.** For illustrative purposes only.
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 March 21, 2024

The Valuations for UST, Bunds, and JGBs Seem Attractive Relative to CGBs

U.S. Treasury (UST)—We look for the yield curve to shift downward and remain inverted, given our expectation of a mild recession around mid-2024. The 10-year yield may be lower in the next several months. **Japanese Government Bonds (JGBs)—**The BoJ ended its policy framework of Quantitative and Qualitative Monetary Easing with Yield Curve Control. The BoJ is anticipated to reduce its JGB buying gradually in accordance with market conditions. **Chinese Government Bonds (CGBs)—**The 10-year CGB valuation remains rich. As the PBoC maintains its accommodative stance, we expect CGB rates to hover around current levels. **German Bunds—**Bunds are supported by strong demand for high quality, euro-denominated sovereign paper in a much larger common currency area. Net financing needs are expected to keep overall bund supply at relatively elevated levels in coming years.

Figure 2 | OECD Composite Leading Indicators

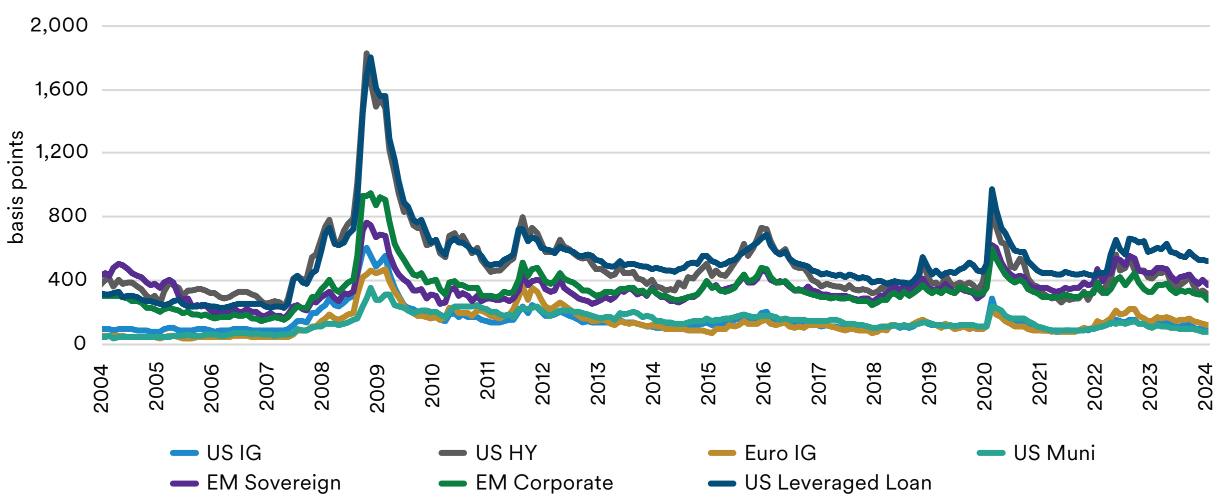


Note: Four Big European Countries include U.K., Germany, France, and Italy. Shaded areas signify contractions where G20 value is below 100.
Source: OECD, MIM. As of February 29, 2024.

Current Credit Cycle Remains in Late Stage

Credit fundamentals remained resilient across U.S., European, and emerging markets as corporate profits improved during Q4 2023. We believe current credit metrics are at healthy levels, and they are likely to improve further in 1H24. Default and rating migration outlooks both improved for 2024. Thanks to stronger-than-expected earnings, robust technicals, and stable macroeconomic fundamentals in 1Q24, credit spreads tightened further (see Figure 3). We believe there is very limited room for further tightening. Given our recession expectation, we remain constructive on credit markets for the next quarter or two. **U.S. Investment Grade (IG)—**Credit fundamentals remained stable in the past quarter, with slight improvement in leverage ratios as well as a drop in the coverage ratio due to elevated interest costs. We continue to believe that spreads do not appropriately reflect market risks. Therefore, we are positioned relatively conservative, favoring higher quality.

Figure 3 | Spreads Continued Tightening



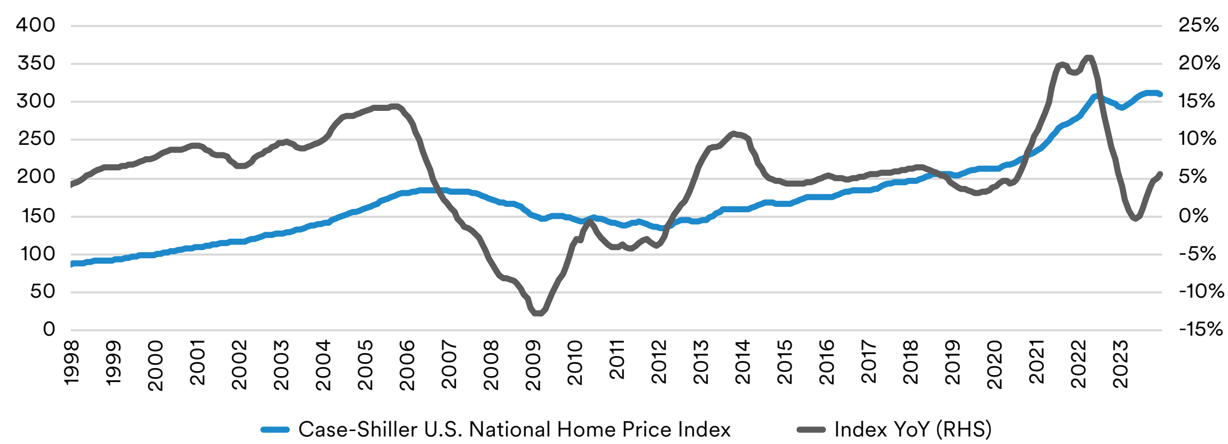
Source: Bloomberg, J.P. Morgan, Barclays, Credit Suisse, MIM. As of February 29, 2024.

European IG—We have seen a slight deterioration in overall metrics in the past quarter as well as a mild weakening in corporate health. However, overall fundamentals stayed healthy. Spreads have been decreasing since mid-October 2023 despite record issuance in January and February. As timing for rate cuts has been pushed out, elevating government yields, we continue to find all-in bond yields attractive. **High Yield (HY)—**Credit fundamentals remained stable with some mixed messages about both operating performance and credit metrics. Although spreads have continued to narrow in 2024, we still believe the HY market looks attractive from a yield perspective. **Leveraged Loans—**We continue to be constructive on the outlook for the leverage loan market, given a backdrop of slowing economic growth and a steadily increasing default rate. The relatively elevated yields are expected to continue playing a greater role in boosting total returns for this asset class. **Municipals—**During 4Q23, the fundamentals of municipals remained strong, and we look for credit quality to remain stable, thanks to the healthy "rainy day" fund balances. Due to the extremely tight spread levels, it's not surprising to see a few issuers exercising Extraordinary Redemption Provisions (ERP). We continue to find all-in yields attractive on an historical basis. **Emerging Markets (EM)—**EM sovereign fundamentals continued to be stable in the past quarter. Aggressive central bank hiking has dragged down inflation, and some have begun to ease policy. The ratings trajectory is balanced, with roughly one-third of EM countries facing some downgrade risks. For EM corporates, fundamentals stayed healthy as of last quarter. Liability management has pushed out the maturity wall, especially for higher quality issuers. We are anticipating credit metrics to be resilient in the next quarter.

Consumers Continue to Surprise to the Upside

Residential Credit—Overall housing credit fundamentals remained strong, with some signs of normalization. Limited housing inventory and a strong labor market continued to be a tailwind for home prices (see Figure 4). **Asset-backed Securities (ABS)—**Consumers continue to surprise to the upside, supported by low unemployment. Bank underwriting standards tightened further, and we think the trend is likely to persist this year as economic weakness sets in. While delinquency rates remain in an upward trend across most sub-sectors, the gap between prime and non-prime borrowers widened. **Collateralized Loan Obligations (CLOs)—**We think the brisk pace of issuance is likely to moderate as warehouses take time to ramp back up. Fundamentals remained as weak as the last quarter, and we expect fundamentals to weaken further with the CCC share of CLO portfolios expected to trend higher.

Figure 4 | Further Appreciations are Expected in 2024



Note: YoY means year over year change.
Source: S&P CoreLogic Case Shiller, MIM. As of December 31, 2023.

Commercial Mortgage-backed Securities (CMBS)—Commercial real estate remains under pressure with the NCREIF All Property Index down 7.9% yoy in 4Q23, mainly driven by the office sector which posted a 17.6% decline. The delinquency rate for all CMBS loans stands at 4.66% in January compared to 2.94% a year ago, according to CREFC. **Agency MBS—**Elevated rate volatility, Fed balance sheet run-off and a lack of bank demand may continue to be a headwind for the sector in the short term. However, with current coupon spreads remaining wide to longer-run averages, we continue to find Agency MBS attractive. **Private Structured Credit (PSC)—**Thanks to tactical positioning that aimed at locking in higher yields in advance of anticipated Fed rate cuts, demand for PSC has been robust in 1Q24. Valuations are under pressure. We think we may experience pressure on origination volume due to tighter pricing and credit considerations.

Enduring Trends and Challenges Continue to Hover Over the CRE Market

Real estate fundamentals are generally stable outside the office sector, and vacancies are near historical long-term averages across the commercial real estate (CRE) market. **Office**—We are expecting a continued deterioration in the sector's fundamentals during 2024, due to high interest rates, economic uncertainty, and hybrid work. We are looking for the vacancy rate to advance further. **Multifamily**—Outside of sunbelt markets, the multifamily sector looks solid, and we expect positive national rent growth in 2024. Markets like Nashville and Austin may see vacancies exceed their historical averages. **Industrial**—The sector is experiencing a slowdown, with an uptick in the vacancy rate, which is still well below the historical average. Despite the slowdown, the sector is expected to continue generating healthy rent growth. **Retail**—Vacancy rates are at a historical low, which is beginning to generate decent rent growth for the sector. Although retail space rents remain higher than last year, the pace of growth has moderated. **Hotel**—The sector's occupancy has not fully recovered to the pre-pandemic level, according to the National Association of Realtors, despite gains in average daily rates and revenue per available room.

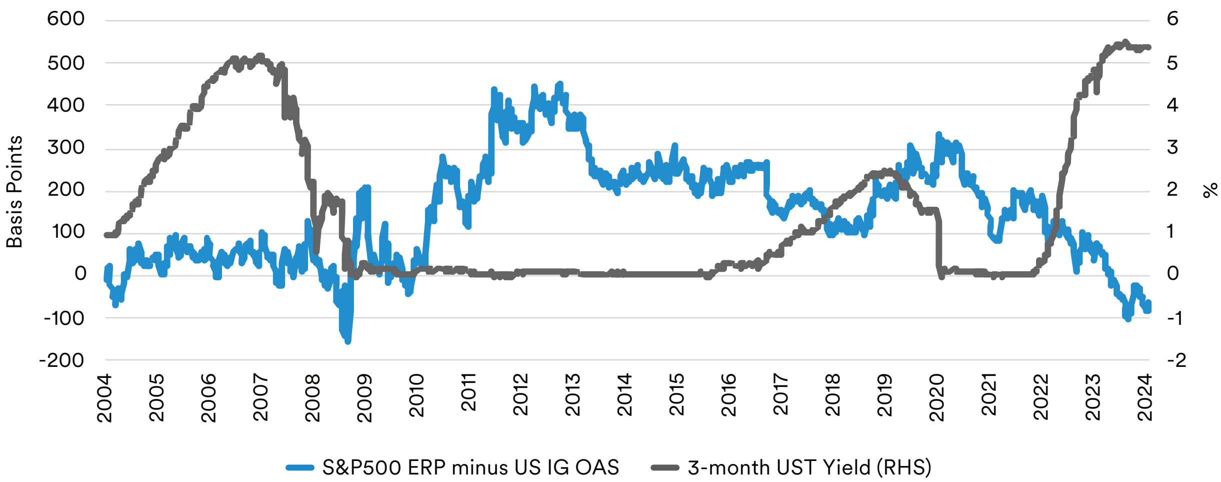
The Net Farm Income is Expected to Return to the 10-year Average

The United States Department of Agriculture (USDA) predicts a 26% year-over-year decline in net farm income (NFI) for 2024, as commodity prices moderate. Input costs are forecasted to broadly decrease, while interest expense is projected to remain flat. Producers' balance sheets continue to be strong amid steady farmland values and consecutive years of high farm incomes. A reduction in supplies from South America may favor appetite for US crops. Overall, we anticipate farm sector profitability to stabilize above the long-term average in 2024. Valuations remain neutral with agricultural mortgage spreads near historical averages. Delinquency rates stay historically low. We expect origination to rebound slightly in 2024.

We Remain Underweight Corporate Equity and Overweight Cash Investments

The S&P500 equity risk premium (ERP) has been running below the U.S. IG spread since July 2023 (see Figure 5), indicative of elevated equity valuations. Given our recession call, we continue to believe the future for fixed-income markets is brighter in the next quarter or two. We continue to remain underweight corporate equity from a relative value perspective. Thanks to a patient Fed, the yield on 3-month U.S. Treasury bills remains at a multi-decade high. Even if the Fed does cut rates in the near term, we expect cash investments to remain attractive on a historical basis.

Figure 5 | ERP Has been Running Below IG Credit Spreads



Note: ERP is calculated as LTM earnings yield minus 10-year UST yield.
Source: Bloomberg, S&P Global, Federal Reserve, MIM. As of March 22, 2024.

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