TCW

INSIGHT

VIEWS FROM TCW'S FIXED INCOME INVESTMENT TEAM

The Great Rate Realignment

SECOND QUARTER 2024

Perfect Landing? The Cracks Appear

Another quarter is now in the books. A quarter that saw markets continue to embrace the "higher for longer" and "perfect landing" narratives, pricing in very gradual Fed cuts for 2024-2025. Credit markets remained resilient, and equities continued their ascent to the stratosphere.

However, some fragilities emerged, revealing a growing feeling that everything may not be all that well beneath the surface. Late-Q2 data suggested waning economic resilience, a trend we're closely monitoring. Consumer-facing companies showed troubling signs: Amazon cutting prices, Starbucks struggling with growth, and quick-service restaurants offering value meals, despite low unemployment. These trends may indicate shifting consumer behavior in the coming months.

Global rate markets also showed fragility as investors realized that political uncertainty and risk associated with major elections (Mexico, India, France, UK, U.S.) and fiscal consequences thereof might not be appropriately priced in – a pattern that will likely persist and continue to be a source of rate volatility as we approach key political events in the U.S. Risk markets revealed some weaknesses too, despite the apparent calm and resilience. The equity rally in the quarter was accompanied by narrowing breadth, and in credit markets, lower-quality credit (CCC-rated bonds) began underperforming – often an early stress indicator. This divergence might foreshadow broader market adjustments as we progress through Q3.

Despite the lingering "perfect landing" narrative, there's a growing sense that economic and market foundations are more fragile than valuations imply. Recognizing that the outlook remains complex, we at TCW believe that those signs of fragility should not be shrugged off. We think the second half of the year will likely confirm a deterioration of economic growth, resulting in more Fed cuts being priced in and higher credit volatility.

Hence, we are staying disciplined, trying to avoid parts of the credit market that are priced nearly to perfection, while overweighting securitized sectors, which we believe offer much more compelling relative value and will continue to generate alpha for our investors from bottom-up issue selection.

– Ruben Hovhannisyan, CFA

Mr. Hovhannisyan is a Generalist Portfolio Manager in the Fixed Income group, a team that oversees over $170 billion in fixed income assets including the flagship MetWest Total Return Bond Fund, one of the largest actively managed bond funds in the world.

Global Rates: Election Year Reshapes Fiscal, Monetary Dynamics

Not all Inflationary cycles are alike; each disinflationary cycle is bullish in its own way.

Slowing inflation is supporting fixed income markets, a crucial shift from the past two years. As for growth, despite a broadly better than expected first half of 2024, diverging trends are facilitating monetary policy easing cycles outside the U.S. Beyond growth and inflation, assessing the merits of duration increasingly depends on interrelated fiscal and political outcomes.

The 2024 consensus predicted decelerating growth leading to disinflation. However, Gross Domestic Product (GDP) expansion has proved resilient across developed economies, except New Zealand. Positive surprises have driven significant fluctuations in central bank rate-cutting expectations, especially in the U.S. Decelerating inflation has allowed central banks in Canada, the Eurozone, Sweden, and Switzerland to cautiously begin reducing rates.

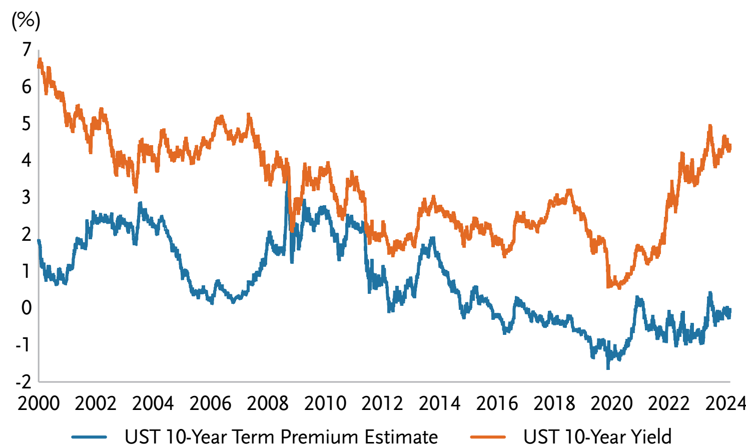
More recent global activity deceleration, evidenced by recent Purchasing Managers' Index (PMI) data, should bolster confidence that disinflation will persist through 2024's second half. Manufacturing activity across major economies (U.S., China, Eurozone) showed signs of recovery in the first quarter but has since stalled. This weakness may reflect an atypical post-COVID inventory cycle. Vigorous destocking suggests softening end-demand ahead.

Labor markets are expected to loosen further, particularly in Canada, the Eurozone, and the UK, with rising unemployment. This should enable the Bank of England to cut rates as soon as August. In the U.S., we anticipate the Beveridge curve to normalize, indicating fewer job openings and higher unemployment, potentially allowing the Federal Open Market Committee (FOMC) to initiate rate cuts by September.

We favor the front end of yield curves, with attractive anticipated returns in Germany, New Zealand, the UK, and the U.S. As the perceived soft-landing transitions to a more pronounced slowdown, our opportunity set should extend further along the curve.

Fiscal policy and elections will shape economic landscapes. Fiscal expansionism has replaced the 2010s' austerity, with half the world's population in countries holding national elections this year. Fiscal policy will likely remain central to political debates, particularly in France and the U.S. Investors will weigh rising term premia against increased fixed income demand during the economic deceleration. Absent much weaker growth, declining inflation and narrower deficits will be crucial in preventing fiscal policy from driving significantly higher yields.

U.S. Term Premium Is Drifting Higher



Source: Bloomberg, TCW

– Nick Verdi

Mr. Verdi is a Global Rates and FX Strategist in the Fixed Income group, where he leverages his analysis to generate recommendations for the Global Rates portfolio management team.

Credit: Decoding LMEs: Strategies for a Shifting Debt Market

The term "liability management exercise" (LME) refers to a range of transactions undertaken by companies to manage their capital structures by exploiting debt document flexibility. Typical objectives include capturing debt discount, providing incremental liquidity, extending maturities, and obtaining covenant relief. These actions often negatively impact some or all existing creditors, benefiting other stakeholders.

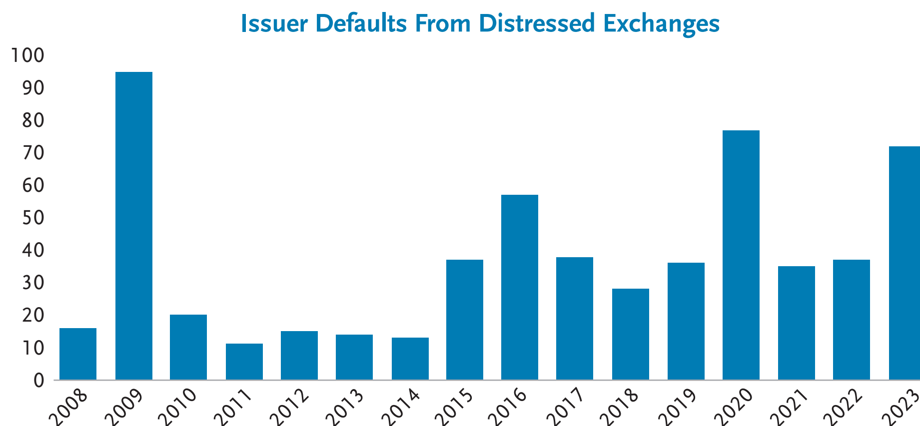
While flexible covenant packages are not new, there has been a significant rise in both the frequency and aggressiveness of LMEs. Additionally, LME activity has expanded from predominantly "sponsor vs. creditor" conflicts to "creditor vs. creditor" conflicts. Many recent LMEs have resulted in markedly different outcomes for investors holding the same credit instrument.

We won't opine on the appropriateness of recent LMEs. As investors, we must view the world as it is, not as we wish it to be. Instead, we explain how we strive to protect our portfolios from the risks of these transactions.

1. **Develop distinct investment theses for the "left side" and "right side" of the balance sheet**
   First, we conduct detailed fundamental ("left side") underwriting of the business to determine the value of the assets. Next, we analyze the covenants of each debt instrument in detail to understand specific permitted LME permutations. We then evaluate the motivations of other stakeholders to identify how they can leverage LMEs to their benefit. Finally, we assess situational dynamics to determine the feasibility and likelihood of specific LME paths ("right side") and run discrete security valuation analyses to determine the fair value of debt instruments across a variety of fundamental business and LME scenarios.
2. **Maintain relationships with advisors and investors**
   LMEs are not the result of business performance akin to quarterly earnings. They are devised in boardrooms with the advice of legal and restructuring experts, often in conjunction with certain existing lenders or third-party capital providers. Therefore, it is critical to maintain dialogue with these influential players to both understand the evolving LME "technology" and develop the pattern recognition required to effectively manage LME risks.
3. **Engage in proactive, solution-focused dialogue with companies.**
   We believe a full-cycle partnership with our borrowers leads to strong long-term investment performance. Terrific investments are often created when we support good businesses going through bad times. We aim to provide tailored capital solutions to businesses facing complex circumstances while achieving appropriate risk-adjusted returns for our investors.

For better or worse, liability management is here to stay. While our core investment philosophy has remained unchanged since our founding, we have continuously evolved our process to protect our investors from these emergent risks.

Issuer Defaults From Distressed Exchanges



Source: S&P Global Ratings Credit Research & Insights; Data through December 31, 2023

– Steven J. Purdy

Mr. Purdy is a Specialist Portfolio Manager, Co-Head of Global Credit, and Head of Credit Research. He oversees the firm's proprietary credit research process within the corporate investment grade, high yield, and leveraged loan markets.

Emerging Markets: Strategy Shifts as High-Yield Rally Prompts IG Rotation

Emerging markets have been resilient in 2024, with high-yield sovereigns in Africa and Latin America leading the charge. Given the extent of the rally and the potential for election-related volatility, we have started to reduce select high yield exposure, rotating into investment grade.

Key highlights in the first half include:

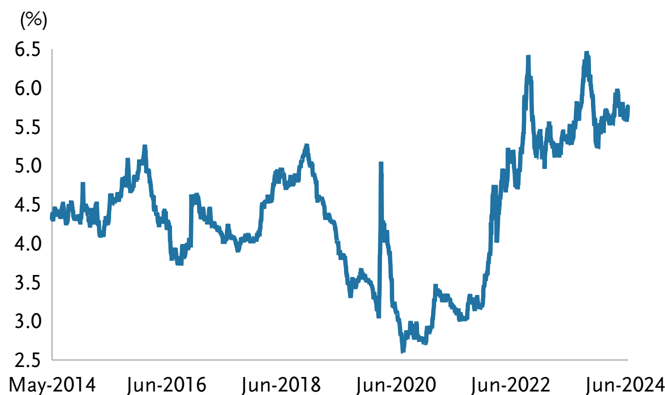
- Outperformance of EM dollar-denominated sovereigns (2.3%) versus EM local currency (-3.7%), as the latter has been impacted by dollar strength.
- Outperformance of EM high yield sovereigns, up 5.2%, with single Bs up 4.9% and distressed (C-rated) up 21.5%, compared to a return of -0.5% for EM investment grade sovereigns. This outperformance of high yield is largely a reflection of macro stability, fiscal consolidation, financial support from the IMF or FDI and/or progress on restructurings. More recently, however, investment grade assets have started to outperform high yield as U.S. rates have rallied.
- Regional outperformance of Africa (+6.3%) and Latin America (+2.4%). Notable countries outperforming the S&P 500's 14.5% return include Ecuador (+45.7%), Argentina (+30.9%), Zambia (+23.1%), Egypt (+20.4%), Ghana (+16.7%), and Bolivia (+16.3%).

In the near term, the market is likely to continue to be driven by expectations for U.S. monetary policy. Further election-related uncertainty is likely to increase market volatility into and following the November 5 U.S. election.

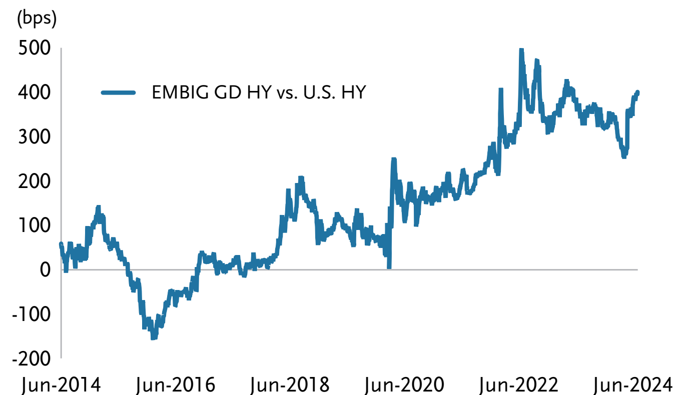
Looking ahead, global growth forecasts for 2024 appear largely in line with the 3.2% figure in 2023. Notably, the EM-DM economic growth differential is forecast to reach its widest level in almost a decade, as some large DM economies decelerate or struggle to recover. Further, more prudent macro policies have emerged, including conservative fiscal management, gradual subsidy reduction, and a growing commitment to monetary orthodoxy via inflation targeting. Consequently, we do not anticipate any sovereign defaults in 2024 or 2025. In fact, 73% of ratings actions in EM this year have been upgrades or moves to a positive outlook.

As for valuations, while credit spreads are at the tighter end of historical ranges, we are finding value in various segments of the market. For example, EM investment grade yields are in the 95th percentile relative to history over the past decade. Further, the approximate 400 bps spread differential between EM HY sovereigns (~730 bps) and U.S. HY (~340 bps) is in the 96th percentile over that same period.

EM Investment Grade Yields Are in the 94th Percentile Versus History



Spread Differential between EM HY Sovereigns and U.S. HY in the 96th Percentile



Source: JP Morgan; Data as of July 1, 2024

We are capitalizing on opportunities that span various themes including improving fiscal dynamics, demographic tailwinds, commodity demand and increased regionalization of trade. In our hard currency EM portfolios, we have reduced overweights to select frontier sovereigns where further appreciation will need to rely on external factors (a beta rally) and have started to increase investment grade sovereign exposure. In our local currency portfolios, we are emphasizing relative value trades and countries with idiosyncratic drivers (Egypt, Turkey, Nigeria) over exposures more dependent on U.S. rates policy or a general reduction in volatility.

– Anisha Goodly

Ms. Goodly is the Head of the Portfolio Specialist team for the TCW Emerging Markets Group, whose core activities include communicating investment strategies, performance and outlook, in addition to product marketing and business development. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals.

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