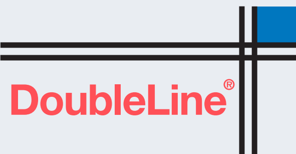


Fixed Income Asset Allocation Outlook 2024

Corey Clermont, CFP® & Sam Nussbaum, Product Specialists

Key Takeaways

- Investors enter 2024 with a fixed income market that has a similar setup to where we entered 2023: attractive all-in yield levels enabling the potential to generate positive returns across a variety of economic outcomes.
- The market might be disappointed that while 2024 marks the start of the Fed's easing cycle, cuts won't be delivered as fast or as forcefully as expected by year-end.
- Market expectations are optimistic for a variety of conditions to align in 2024, which taken together could neatly be characterized as a "soft landing," however, we are mindful of outcomes in which economic conditions deviate from expectations.

Defying deafening calls for recession at the start of the year, markets were buoyed by persistent growth and a strong consumer in 2023, a dynamic that delivered broadly positive returns for fixed income investors. The year was marked by the Federal Reserve hiking the target federal funds rate (FFR) to 5.5%, its highest level since 2007. However, perhaps the most surprising outcome of 2023 was that the 10-year U.S. Treasury yield closed unchanged year-over-year (YoY) at 3.88% after rising to nearly 5.0% and trading in a range of 168 basis points (bps). Risk-taking was generally rewarded, as floating-rate debt and below-investment-grade (below-IG) bonds outperformed traditional fixed-income sectors in 2023. *(Figure 1)*

2023 Fixed Income Performance | As of December 31, 2023

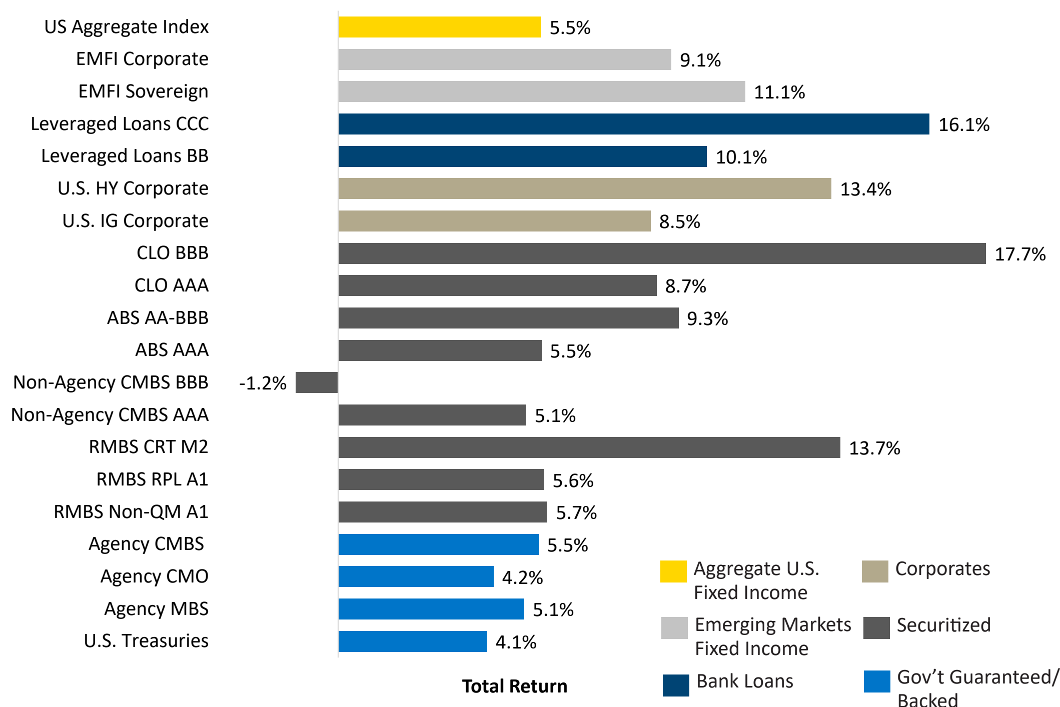


Figure 1
Source: DoubleLine, Bloomberg
Please see the Definitions page for a complete list of indexes and sources used in this figure. Non-Qualified Mortgage (Non-QM); Re-Performing Loan (RPL), Credit Risk Transfer (CRT), Emerging Markets Fixed Income (EMFI).

A theme discussed in our 2023 outlook was the return of yield across fixed-income asset classes. Although painful to arrive at decade-high yield levels, investors are now being better compensated for owning bonds. This risk premium, in the form of higher yields, drove fixed income returns in 2023, as much of the total returns across the fixed income universe were attributable to interest income. All-in yield levels fluctuated throughout the year, driven by volatility in the Treasury market and more-subdued swings in credit spreads. Turning attention to the year ahead also requires a brief assessment of the past, thanks largely to a two-month rally to close 2023 that Fed Chair Jerome H. Powell kicked off after his Nov. 1 Federal Open Market Committee (FOMC) press conference. From Nov. 1 to Dec. 31, the 10-year Treasury yield declined 105 bps, and credit spreads on both IG and below-IG corporate bonds compressed to their tightest levels of the year. Investors enter 2024 with a fixed income market that has a similar setup to where we entered 2023: attractive all-in yield levels enabling the potential to generate positive returns across a variety of economic outcomes.

Fixed Income Asset Allocation Outlook 2024

Expectations vs. Reality

Changes to monetary policy, continuing disinflation, softening consumer fundamentals and gradual labor market softening will be among the key economic themes that will drive fixed income market movements in 2024.

Relative to market expectations, monetary policy was more hawkish in 2023, as the FOMC stayed committed to its higher-for-longer rhetoric. Entering 2023, market participants expected the FFR to peak just below 5% before returning to 4.6% at year-end, but the FOMC increased the FFR by 100 bps, bringing the FFR upper bound to 5.5% by year's end. In similar fashion, another gap has formed between market expectations and the FOMC's projections, with the latter forecasting monetary policy to remain more restrictive throughout 2024. In the December Summary of Economic Projections, the FOMC forecast 75 bps of rate cuts by year-end 2024. This projection is at odds with market expectations for roughly 150 bps of cuts, with the first rate cut expected at the FOMC's March meeting.[1] At DoubleLine, we believe current market expectations for less-restrictive monetary policy are overly optimistic, absent a significant economic downturn. Where we do agree with market expectations is that the Fed's campaign of interest rate hikes has likely concluded for this cycle. A key question for investors remains how long the FOMC can keep monetary policy at current restrictive levels amid receding inflation.

Economic fundamentals thwarted forecasts of a downturn in 2023. Growth, as measured by real gross domestic product (GDP), accelerated throughout the year, with third quarter real GDP growing at a seasonally adjusted annualized rate of 4.9% quarter-over-quarter. Consumers remained resilient, as evidenced by a strong private consumption contribution to GDP and strong ISM Services PMI figures that remained in expansionary territory throughout the year. That said, recession risks remain, as the lagged effects of tighter monetary policy, a linchpin of many recession forecasts entering 2023, are still working their way through the economy. Consumer balance sheets started to show signs of deterioration over the course of the year as consumer delinquencies moved higher, use of revolving credit increased substantially, and savings rates dropped below pre-pandemic levels. The labor market softened slightly, with the U-3 unemployment rate at 3.7% in December, down from its high of 3.9% in October, but 30 bps above its low in January. With the full effect of restrictive monetary policy still permeating the U.S. economy, DoubleLine remains skeptical of a year of uninterrupted economic growth for the U.S. economy.

Back to Basics

Return dispersions across fixed income have created an opportunity for investors to get back to basics. For low-duration, high-quality bond investors, short-term bond portfolios offer attractive yields in excess of short-end Treasury yields with substantial credit protection. In addition, the end of the Fed's hiking cycle has been a historically beneficial time for investors to step out of money market funds or Treasury bills into longer-dated bond portfolios. *(Figure 2)* For intermediate-term fixed-income investors, we maintain our belief that a portfolio with a mixture of shorter-duration credit paired with longer-duration government-guaranteed exposure is a prudent asset allocation approach in 2024. Yields for many IG bonds are in the mid- to high single digits and can be paired with Treasuries with their relatively elevated yields, which can provide price appreciation and act as a ballast to credit-sensitive debt in a risk-off, falling-rate scenario. *(Figure 3)* For more aggressive fixed-income investors, yields range from high single digits to low teens further down the capital structure. *(Figure 4)* This allows for investors to create relatively high-quality, diversified fixed-income portfolios with yields comparable to the long-run average return of equities. The bigger benefit, we believe, is the potential to generate these returns with less volatility and lower drawdowns compared to equities.

Average Returns After Fed Stopped Tightening

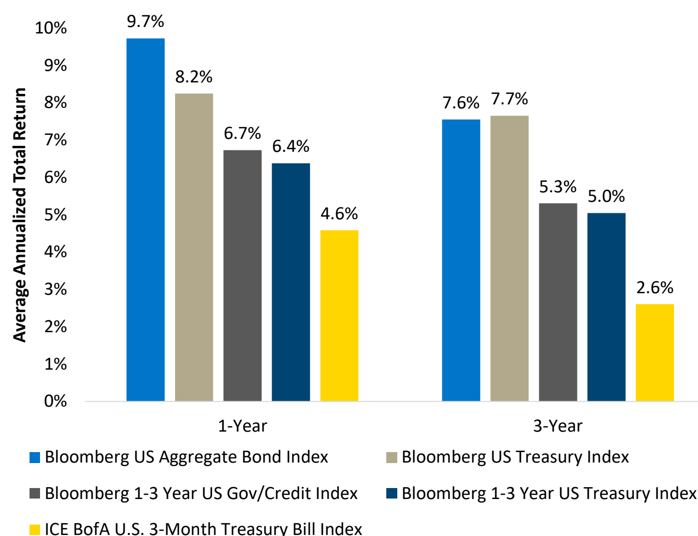


Figure 2

Source: DoubleLine, Bloomberg. A pause is the period between the last Fed rate hike and the first rate cut. Time periods used for analysis were: Dot.com pause: May 16, 2000, until Jan. 3, 2001 (eight months). Global Financial Crisis pause: June 29, 2006, to Sept. 18, 2007 (15 months). COVID-19 pause: Dec. 20, 2018, to Aug. 1, 2019 (nine months). Time period returns greater than one year are annualized. You cannot invest directly in an index.

Higher-Credit-Quality Fixed Income Yields
As of December 31, 2023

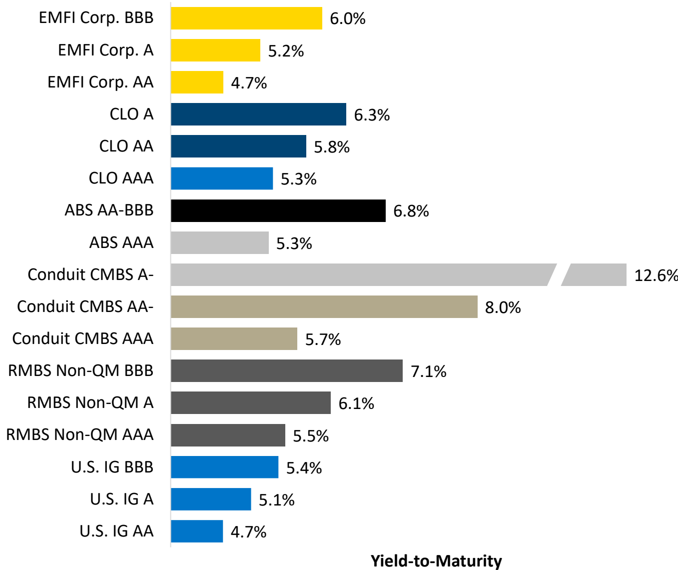


Figure 3
Source: DoubleLine, Bloomberg, BofA Global Research, J.P. Morgan. Please see the Definitions page for a complete list of indexes and sources used in this figure. Non-Qualified Mortgage (Non-QM); Emerging Markets Fixed Income (EMFI).

Lower-Credit-Quality Fixed Income Yields
As of December 31, 2023

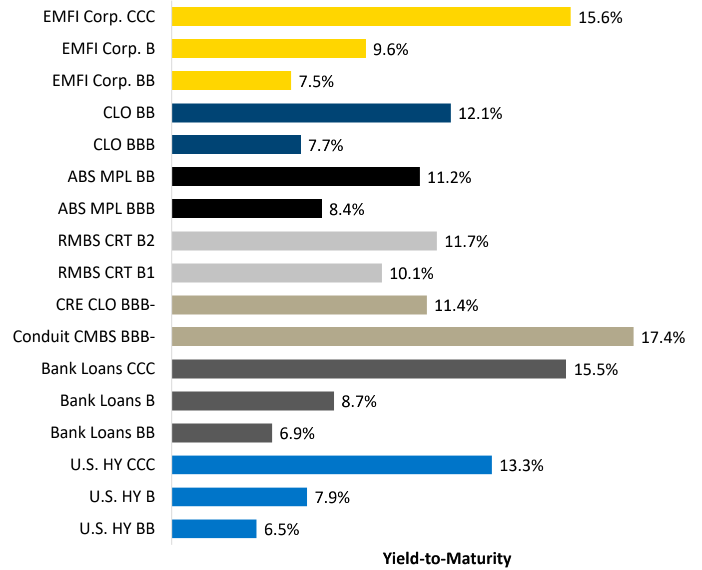


Figure 4
Source: DoubleLine, Bloomberg, BofA Global Research, J.P. Morgan. Please see the Definitions page for a complete list of indexes and sources used in this figure. Credit Risk Transfer (CRT); Marketplace Loan (MPL); Emerging Markets Fixed Income (EMFI).

The Right Opportunities

Despite the year-end rally in fixed income and a steady downdraft of yields since mid-October, DoubleLine believes multisector fixed-income portfolios are poised for a solid year in 2024. Our conviction comes from our belief in active management and the reward-to-risk setup of fixed income tilting in investors' favor. Market expectations are optimistic for a variety of conditions to align in 2024, which taken together could neatly be characterized as a "soft landing," including: monetary policy easing, continued disinflation, gradual labor market softening and slowing but positive real growth. Should all these conditions be met, returns will likely be strong across the fixed income universe with risk-taking being rewarded once again. As active managers, however, we are mindful of outcomes in which economic conditions deviate from expectations. The potential for fixed income to deliver attractive returns in such a scenario are dependent on selecting the right opportunities across a broad investment universe and with appropriate risk controls.

Sector Outlooks

A more in-depth view of our 2024 outlook for Securitized Products and Corporate Credit can be found here.

U.S. Treasuries

The shape of the Treasury yield curve, which was supposed to presage economic hardship entering 2023, enters 2024 still inverted. The yield curve has now been inverted for over 18 months, as measured by the spread between the two- and 10-year yields, the second longest span dating back to 1941. With Fed hikes likely on hold and the Fed poised to cut rates in 2024, we expect the curve to steepen, driven by falling short-end yields. The longer end of the curve, particularly 10- and 20-year tenors, still look relatively attractive. Despite the strong year-end rally, long-end yields could continue to fall over the course of 2024. The road to lower long-end yields, however, might be choppy, especially in the near term as the market might have gotten ahead of itself by aggressively pricing in more Fed rate cuts than could come to pass.

> The road to lower long-end yields, however, might be choppy, especially in the near term.

Improving inflation dynamics are certainly driving the dovish Fed outlook, but we would caution that the Fed is highly attentive to the risks of a premature loosening of policy. Therefore, the market might be disappointed that while 2024 marks the start of the Fed's easing cycle, cuts won't be delivered as fast or as forcefully as expected by year-end.

While some fundamental drivers of Treasury yields remain favorable, the technical backdrop is mixed. Treasury supply is expected to be elevated in 2024, with little chance of any resolution to the U.S. fiscal imbalance in what's likely to be a contentious presidential election year. Elevated supply could be met by lackluster demand for Treasuries as foreign buyers and banks are unlikely to resume robust buying. The Fed, though, independent of how many rate cuts it can deliver, is likely to examine its quantitative tightening (QT) program in 2024. QT, which has resulted in a nearly $1.3 trillion contraction of the central bank's balance sheet from its roughly $9 trillion peak in April 2022, has likely contributed to the elevated interest-rate volatility environment that Treasury investors have faced since 2022. The minutes of December's FOMC meeting hinted at a coming review of QT, and we expect more discourse on the policy at coming meetings, including a possible determination of the terminal size of the balance sheet under neutral policy conditions.

Agency Mortgage-Backed Securities

Agency MBS faced a perfect storm of headwinds in 2023, leading to current-coupon spreads reaching their widest levels in the post-Global Financial Crisis (GFC) era. Spread widening was driven in part by technicals, as supply via Federal Deposit Insurance Corp. (FDIC) sales from the collapse of Silicon Valley Bank and Signature Bank, QT and overall reduced bank demand left money managers as the primary buyer. Further contributing to spread moves was elevated interest-rate volatility and an inverted yield curve. The net result was a year of highs and lows, with the current coupon trading in a range of 75 bps.

We remain of the view that Agency MBS are attractive on a historical and relative-value basis and expect excess returns versus Treasuries this year. Lower Treasury rates and an environment of lower rate volatility should be supportive of Agency MBS spreads this year. While some technical challenges remain with QT ongoing and bank demand remaining subdued relative to prior years, the biggest difference is the market no longer faces FDIC sales of $100 billion in supply via the collapsed Silicon Valley Bank and Signature Bank; sales that began in April and concluded in November.

We do not believe these factors represent a permanent structural shift that dislocates Agency MBS from other spread markets going forward. In fact, we believe that Agency MBS have gotten the message first and are poised to offer an advantageous relative risk-reward dynamic in 2024.

In general, we believe there's several opportunities across the coupon stack for attractive risk-adjusted returns. Coupons trading slightly below par may offer advantageous carry without sacrificing too much convexity, while lower-coupon bonds may provide optimal optionality to increasing prepayments in the future. We also see attractive opportunities in Agency collateralized mortgage obligations, as it's possible to source lower-dollar-priced securities with positive convexity that can be broadly used to help manage duration.

Non-Agency Residential Mortgage-Backed Securities

Residential credit performance was robust in 2023, driven by higher home prices, low defaults and relatively strong demand for non-Agency residential MBS (RMBS) new issuance. We expect performance to remain resilient in 2024 as home prices remain supported by strong demand from increased household formation and low housing supply driven by the lock-in effect, with approximately 75% of existing homeowners having mortgage rates of 4% or lower.

Although delinquencies might increase should unemployment rise, we expect that to impact recent-vintage cohorts more than seasoned borrowers with substantial equity. Further, having tested the efficiency of servicing toolkits during the pandemic, we expect modification, as opposed to default, will continue to be the favored resolution process for borrowers facing financial hardships. We also expect lending standards to remain tight, which should help limit non-Agency loss rates.

After reaching local lows in January, national home prices rose for eight consecutive months through September and were up nearly 4% YoY. Limited supply helped push home prices higher, as the existing inventory of single-family homes continued to fall at an accelerated pace and remained near a 40-year low. Limited supply should continue to provide support to home prices this year, even as affordability is likely to remain challenged.

Through the end of October, non-Agency RMBS gross issuance was $64 billion, down 50% YoY. We expect a modest increase in 2024 issuance versus 2023 and believe this will be readily absorbed by the market. As such, we believe technicals will remain positive for residential mortgage credit this year.

Absent a significant change in economic conditions this year, we believe the market landscape will remain supportive of residential credit performance. In general, we believe there are opportunities for strong total return potential across the non-Agency RMBS capital structure, as many subsectors look attractive from a relative-value perspective. New-issue qualified mortgage bonds exhibit all-in yields of approximately 6% for bonds rated AAA and approximately 8% for bonds rated BBB. Seasoned credit risk transfer bonds also offer strong total return potential due to structural deleveraging, limited issuance and resilient housing fundamentals.

Non-Agency Commercial Mortgage-Backed Securities

Commercial real estate (CRE) was in the spotlight for much of 2023 as the market struggled with a convergence of higher borrowing costs, lower valuations and economic uncertainty. While we expect similar trends to continue in 2024, we caution against painting the CRE market with broad strokes, as we believe most CRE fundamentals ex office are poised to enter 2024 on somewhat reasonable footing.

Reduced property valuations and increased debt service costs are likely to push delinquencies higher in 2024, although the issues should largely be concentrated in maturing loans, floating-rate loans and loans secured with office collateral. It is likely that a growing portion of delinquent loans and/or those in special servicing will be loans unable to successfully refinance at maturity, of which a majority have been loans collateralized by office properties.

Although delinquencies are likely to increase next year, we do not believe that higher interest rates will hinder all borrowers' abilities to refinance. We expect lenders and servicers will continue to employ modifications and extensions – practices expected to result in higher recoveries than near-term foreclosures and liquidations. Borrowers with cash-flowing assets that are willing to put more equity in are likely to receive extensions. This leads into a continued performance bifurcation between the haves and have-nots. Property types that we anticipate investors will continue to favor include industrial, higher-quality multifamily, trophy office, resort hotel and stronger retail.

We caution against painting the CRE market with broad strokes, as we believe most CRE fundamentals ex office are poised to enter 2024 on somewhat reasonable footing.

Rising interest rates have also weighed on deal activity, with transaction volume down 68% YoY, making it difficult to assess exactly how much prices have fallen. Further clarity on the direction of Fed policy might allow the CRE market to begin to function more normally and give way to a greater number of transactions. This should give the market a better feel for valuations, forming a feedback loop that begets additional transactions and, subsequently, greater clarity.

CRE uncertainty contributed to considerable non-Agency commercial MBS (CMBS) spread widening in 2023, particularly down the capital structure. While lower-rated non-Agency CMBS have been trading at historically wide spreads, we remain cautious on these tranches until there is more clarity on fundamentals. Instead, we prefer senior-rated, seasoned conduit bonds that have delevered through time and exhibit limited extension risk as well as well-located nonoffice properties with strong cash flow and sponsorship in addition to low refinancing risk. These bonds are unlikely to suffer losses, potentially trading at attractive valuations to corporate bonds with additional upside potential should fundamental scenarios play out better than expectations.

Asset-Backed Securities

Throughout 2023, the consumer backdrop generally remained strong amid a tight labor market. However, consumer asset-backed securities (ABS) performance was bifurcated, as lower-income borrowers experienced larger degrees of credit deterioration relative to higher-income borrowers. We expect this trend will continue in 2024, as the unemployment rate is expected to move higher. While our base case is modestly weakening consumer fundamentals, we remain relatively constructive on consumer-related credit performance this year, driven by the better credit quality of loans underwritten to tighter lending standards and resilient ABS bond structures that can provide investors safety and offer attractive yield per unit of duration. (See: An Update on the U.S. Consumer)

ABS performance was bifurcated, as lower-income borrowers experienced larger degrees of credit deterioration relative to higher-income borrowers.

Our expectations for continued deterioration in credit trends lead us to prefer senior-rated consumer bonds. That said, we believe ABS broadly offer attractive relative value with the potential for strong performance across various scenarios. The increasing likelihood of the Fed achieving an economic soft landing while effectively taming inflation bodes well for potential spread tightening across ABS subsectors. Relative return potential remains particularly compelling, as many consumer ABS are priced off the front end of the Treasury yield curve, which offers higher yields compared to other Treasury tenors and equates to attractive yield per unit of duration compared to other parts of fixed income.

Within hard-asset ABS sectors, economic growth and business conditions are expected to be modest headwinds in 2024 while tighter lending standards should be supportive of overall credit performance.

Like consumer ABS, we believe there are opportunities for attractive risk-adjusted returns in hard-asset collateral this year. In general, esoteric parts of ABS offer an attractive spread pickup relative to corporate bonds. Should economic growth exceed expectations, we believe there is the potential for greater spread tightening relative to more-traditional fixed-income sectors. The aircraft sector continues to mark improving metrics relative to a 2020 trough. Given the robust structure, senior portions of legacy aircraft ABS can potentially provide attractive total return opportunities, as these deals continue to accrete to par.

Collateralized Loan Obligations

Collateralized loan obligations (CLOs) were one of the best-performing fixed-income asset classes last year, driven by high interest income from floating-rate coupons and spread compression. While we expect a potentially weaker macroeconomic environment this year and for loan defaults to increase, we remain constructive on CLO performance and see potential tailwinds for the sector to again deliver strong total returns across the capital structure. That said, there might be bouts of volatility in the near term as the market digests the impact of broader macro concerns and Fed policy.

CLO new-issue arbitrage was challenged last year, as the lack of loan supply made it more difficult to ramp up good-quality assets at economically attractive prices. Despite this, CLO issuance largely remained strong throughout 2023, and we expect issuance to remain robust in 2024.

Last year, we favored senior-rated CLOs for relative value and price stability and CLOs rated BB for carry and convexity. Heading into 2024, we believe a similar barbell can perform well, as CLOs remain a unique asset class as a scalable floating-rate investment opportunity in a higher-for-longer interest-rate scenario. From a relative-value perspective, CLOs remain an attractive alternative relative to similarly rated corporate bonds.

With increasing expectations for a soft landing and technicals expected to remain supportive, we believe CLOs can continue to offer attractive risk-adjusted returns due to high all-in yields across the capital structure. That said, the threat of a recession cannot be ruled out, which might keep the riskier parts of the loan market under pressure. While this would have an adverse impact on CLO equity, we believe much of that risk is priced in.

Investment Grade Corporate Credit

IG corporates were propelled in 2023 by a combination of investors seeking to lock in roughly 5%-6% yields and a robust fundamental backdrop. For the year, the Bloomberg US Corporate Bond Index returned 8.5%. Spread tightening in the second half of the year reflected optimism surrounding the asset class, as spreads closed the year at 99 bps, 31 bps tighter YoY. 2023 returns were primarily driven by a 10% cumulative return in November and December, which was the best two-month return for the index since the final two months of 2008.

The close of 2023 coincided with a long-awaited shift in monetary policy rhetoric. Given the IG sector's longer duration, the steady march higher in Treasury yields penalized investors in 2022 and the first three quarters of 2023. We anticipate continued rate volatility in 2024 but overall expect the yield curve to steepen, which should be supportive of IG corporates. (See: IG Corporate Update)

We believe that IG corporates are attractive on a historical basis despite the strong finish to 2023. Given the index's yield-to-duration ratio of 0.71, the sector is well insulated to withstand a potential rise in interest rates.

On the technical front, IG experienced a tailwind from fund flows with an inflow of $182.1 billion in 2023. Corporate earnings remained stable throughout the year and are expected to grow in 2024. Notably, EBITDA margins slightly deteriorated to 30.5% in the third quarter as cost inflation outpaced revenue inflation, but they remained at a strong level. Also of note, higher-rated issuance increased significantly over the past 18 months, causing the share of the index rated BBB to reach 47%, its lowest level since 2017.

In general, DoubleLine believes there are several opportunities across IG sectors for attractive risk-adjusted returns. The team is positioning portfolios to offset any potential economic weakness by favoring credits that are better suited to withstand margin pressures as well as targeting credits that have positively sloped spread curves. We prefer pharmaceutical companies that are highly cash-flow generative without significant loss of drug exclusivity in the near term. We are avoiding food and beverage companies with declining sales and margins, high merger and acquisition risk, and secular risk from GLP-1 diet drug uptake.

High Yield Corporate Credit

HY corporates posted strong returns in 2023, boosted by a combination of better-than-expected corporate earnings, surprising economic strength, a solid fundamental backdrop and falling Treasury yields across the belly of the curve YoY. For the year, the Bloomberg US Corporate High Yield Bond Index returned 13.5%, as 2023 returns were primarily driven by a 10% cumulative return in November and December. Spreads tightened materially in the final two months of 2023, which reflected optimism surrounding a dovish Fed pivot, as spreads closed the year at 323 bps, just shy of their 2023 low of 312 bps. Market stress in the wake of the regional banking crisis caused HY spreads to peak at 516 bps in March.

> Active managers should have an advantage in 2024 relative to index-tracking products.

Looking forward, the impending maturity wall will remain a key issue, however lower rates should increase supply as borrowers look to refinance and term out their debt. To whet investor appetite, HY issuers increased the quality of their issuance as secured bond volume more than tripled YoY, setting an annual record at $100 billion, or 57% of overall issuance volume. Meanwhile, issuance of unsecured bonds dipped to $74 billion, a second consecutive annual post-GFC low.

On the technical front, HY experienced a headwind from fund flows with an outflow of $7.6 billion for the year. Looking at fundamentals, HY corporate earnings are eroding slowly but are coming off a strong base. For example, net leverage remains below the long-term quarterly average of 4.32x. Meanwhile, revenue and EBITDA growth was roughly flat in the third quarter despite some margin deterioration, as stickier cost inflation ate into revenue.

We believe HY defaults will continue to increase toward their long-term average of 3.2% in 2024 amid sustained higher rates as restrictive financial conditions weigh on fundamentals. With this in mind, active managers should have an advantage in 2024 relative to index-tracking products. The DoubleLine team is looking to take advantage of resilient consumer spending and prefers companies that are focused on multi-year balance-sheet repair. For example, we are constructive on cruise lines, as consumer travel demand has been buoyed by savings. We are avoiding cyclically exposed companies, such as metals and mining, due to broader concerns surrounding economic growth and weakening fundamentals.

Bank Loans

Leveraged loans were one of the best-performing fixed-income asset classes in 2023, as the Morningstar LSTA US Leveraged Loan TR USD Index returned 13.3%, boosted by the index's 9.2% coupon, its second best calendar-year return on record behind 2009. Loan gains defied consensus predictions for economic weakness in 2023 and were driven by a combination of better-than-expected corporate earnings, high interest income from floating-rate coupons and discount margin compression due in part to a generally resilient U.S. economy. Strong demand from CLOs also boosted loan prices, as CLO issuance remained strong throughout 2023 despite falling YoY.

The focus for 2024 will likely shift to the impending maturity wall, as lower rates should lead to stronger funding conditions and allow issuers to step in from the sidelines . However, DoubleLine expects an environment of winners and losers, as companies with unviable capital structures built primarily on their ability to borrow at low cost will be exposed when trying to refinance their debt. As we saw in 2023, private credit will continue to take market share from the loan market, as private credit seems to favor smaller, more highly leveraged companies.

On the technical front, loans experienced a headwind from fund flows with an annual outflow of $14.3 billion in 2023. Looking at fundamentals, loan earnings are giving mixed signals with some signs of weakness. Quarterly leverage, at 4.88x, fell to a post-pandemic low while revenues and EBITDA expanded on a YoY basis but at the slowest rate in 10 quarters, largely due to stickier cost inflation. We anticipate interest coverage ratios will continue to decline given the lagged transmission of higher policy rates to paid coupons.

We believe loan defaults will continue to increase toward their long-term average of 2.7% in 2024 due to slowing economic growth amid sustained higher rates, as tight financial conditions weigh on fundamentals. With markets pricing in a Fed pivot next year in the face of economic uncertainty, some pockets of the loan market are poised to perform well. Loans rated B and BB offer high-single-digit yields with less credit risk relative to CCC loans. We favor companies in the leisure and gaming sectors that benefit from resilient consumer demand and a continued focus on deleveraging. We are avoiding overleveraged credits that face a challenging refinancing environment, including telecom issuers that have significant capital expenditure requirements in the face of consumer preferences shifting away from legacy cable and wirelines.

Emerging Markets Debt

Similar to other fixed income sectors, a strong nine-week rally to end 2023 drove calendar-year returns to high single or low double digits year for emerging markets (EM) fixed income. EM sovereigns outperformed their corporate counterparts, largely due to lower-rated and frontier EM sovereign markets rebounding from low price levels following the 2022 drawdown. The EM corporate HY default rate finished 2023 at 8.7%, largely driven by China property and Russia technical issues. Overall, credit fundamentals for EM corporates remain resilient. EM IG and EM HY corporates have net leverage ratios significantly lower than that of U.S. and European corporates, with only a slight weakening from a solid base in the last two years. This weakening has stemmed from inflationary pressures and higher funding costs. Similarly, interest coverage for EM IG and EM HY corporates continued to be strong, with ratios comparable to that of developed market (DM) corporates.

> EM IG and EM HY corporates have net leverage ratios significantly lower than that of U.S. and European corporates.

EM corporate issuance totaled $245 billion for 2023, up 11% from 2022 but still well below the trailing 10-year average. A shrinking total debt stock in U.S. dollar-denominated corporates remains a technical tailwind for the asset class, as companies increasingly source from local markets.

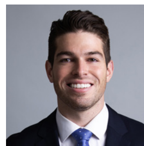
Overall, EM central banks moved earlier and more aggressively than their DM counterparts in raising interest rates in response to inflationary pressures. Disinflation has allowed central banks to start easing in select EM countries. We expect this will bode well for the EM growth outlook, and we anticipate higher GDP growth in EM relative to DM in 2024. DoubleLine continues to believe EM fixed income offers investors diversification benefits when paired with U.S. investments, as EM companies and countries have unique business cycles, revenue generators, natural resources, monetary and fiscal policies, and political cycles. We believe the asset class is likely to continue to migrate up the credit quality curve. With that backdrop, we expect EM corporates and EM sovereigns to remain resilient, although we do expect to see some credit metrics weakening in the coming year. The DoubleLine EM team is overweight Latin America entering 2024 relative to benchmarks, as the region offers attractive return-per-unit-of-risk profiles with less geopolitical risk. We believe 2024 will be a year when active management will have an opportunity to identify market dislocations, participate in the new-issue market and differentiate among credits through bottom-up fundamental analysis. Areas of EM present

good-quality bonds with attractive all-in-yields and prices at substantial discounts. Absent a global recession, DoubleLine believes EM fixed income could be poised for another high-single to low-double-digit year in 2024 and would advocate for adding more meaningfully to the asset class if credit spreads were to widen to 450 bps-500 bps over Treasuries.

Global Sovereign Bonds

Following the worst calendar year on record in 2022 for international government bonds, higher starting yields and a strong rally in the final nine weeks of 2023 led to mid-single-digit returns for the asset class, as measured by the FTSE World Government Bond Index. The dollar, as measured by the U.S. Dollar Index, traded in a range of roughly 100 to 107 throughout the year, finishing the year at the lower end of the range amid the rally in risk assets and rates. We believe the dollar is vulnerable to the downside over the medium to long term as global growth stabilizes, the U.S. struggles to narrow its fiscal and current account deficits, and as divergences in monetary policy expectations converge. Over 2023, DM central banks played catch-up to their EM counterparts on tightening monetary policy. We believe most DM central banks have reached peak policy rates, and continued disinflation progress might allow those central banks to begin easing monetary policy rates from current restrictive levels over 2024. The European Central Bank (ECB) hiked its deposit rate 450 basis points from negative 0.50% to 4.00% from July 2022 to September 2023. We believe the ECB has paused and will cut rates in sequence with the Fed in 2024. Eurozone growth has been hovering on either side of zero for most of 2023, and our expectations are for a mild pickup in 2024.

While our expectation for global sovereign bonds in 2024 is for continued volatility, it could be a year in which active management could shine. Broadly, we believe central bank policy will be net supportive for fixed income. While we believe there will be attractive opportunities in both DM sovereign and EM local markets in 2024, one must be active and selective in locating prudent return-per-unit-of-risk opportunities. Our investment focus is on local economies with stable political structure, improving economic fundamentals, high real yields and decent growth prospects. Areas on the EM local economies side include Latin America, select countries in Asia, and Central and Eastern European regions. Largely, we have been avoiding areas with current or potentially escalatory geopolitical tensions. ■



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Product Specialist

Mr. Clermont joined DoubleLine in 2018. He is a member of the Macro Asset Allocation Team, in which he serves as a Product Specialist. In this capacity, Mr. Clermont is responsible for various aspects of DoubleLine product marketing, investment strategy updates, portfolio communications and competitive analysis, with a focus on DoubleLine's Fixed Income Asset Allocation strategies. He is also responsible for producing market commentary and dedicated strategy content. Prior to DoubleLine, Mr. Clermont was in mutual fund distribution for Putnam Investments. He holds a B.S. in Finance and Marketing from University of Massachusetts Boston, the FINRA Series 7 and 63 Licenses and is a CFP® certificant.

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Endnotes

[1] Market expectations for FFR hikes based on Bloomberg's World Interest Rate Probability Function as of Dec. 31, 2023

Definitions of Terms and Indexes

Indexes Used in Figure 1

U.S. Treasuries: Bloomberg US Treasury Index; Agency MBS: Bloomberg US MBS Index; Agency CMO: ICE BofA U.S. Agency CMO Index; Agency CMBS: Bloomberg US CMBS Index; RMBS: BofA Global Research; Non-Agency CMBS: Bloomberg US Non-Agency Investment Grade CMBS Index; ABS AAA: Bloomberg US ABS AAA Index; ABS AA-BBB: ICE BofA AA-BBB U.S. Fixed-Rate Miscellaneous ABS Index; CLOs: Palmer Square CLO Total Return Index; U.S. IG Corporate: Bloomberg US Corporate Bond Index; U.S. HY Corporate: Bloomberg US Corporate High Yield Index; Leveraged Loans: Morningstar LSTA US Leveraged Loan TR USD Index; EMFI Sovereign: J.P. Morgan EMBI Global Diversified; EMFI Corporate: J.P Morgan CEMBI Broad Diversified; U.S. Aggregate: Bloomberg US Aggregate Bond Index

Indexes Used in Figure 2

U.S. IG: Bloomberg US Corporate Bond Index; RMBS: Citi Research; Conduit: Bloomberg US Non-Agency CMBS Index; ABS AAA: Bloomberg US ABS AAA Index; ABS AA-BBB: ICE BofA AA-BBB U.S. Fixed-Rate Miscellaneous ABS Index; CLOs: J.P. Morgan CLO Index; EMFI Corp: J.P. Morgan CEMBI BD Index

Indexes Used in Figure 3

U.S. HY: Bloomberg US Corporate HY Bond Index; Bank Loans: Credit Suisse Liquid Leveraged Loan Index; Conduit CMBS: Bloomberg US Non-Agency CMBS Index; CRE CLO: BofA Global Research; RMBS CRT: BofA Global Research; ABS MPL BB: ACHV ABS Trust 2023-4CP; ABS MPL BBB: Affirm Asset Securitization Trust 2023-B; CLO: J.P. Morgan CLO Index; EMFI Corp: J.P. Morgan CEMBI BD Index

Agency – Mortgage securities whose principal and interest are guaranteed by a U.S. government agency such as Fannie Mae (FNMA) or Freddie Mac (FHLMC).

Basis Points (BPS) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Bloomberg US Aggregate Bond Index – This index represents securities that are SEC registered, taxable and dollar denominated. It covers the U.S. investment grade, fixed-rate bond market, with components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

Bloomberg US Asset-Backed Securities (ABS) AAA Index – This index tracks the AAA-rated ABS component of the Bloomberg US Aggregate Bond Index, a flagship measure of the U.S. investment grade, fixed-rate bond market. The ABS index has three subsectors: credit and credit cards, autos and utility.

Bloomberg US Commercial Mortgage-Backed Securities (CMBS) Index – This index measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300 million.

Bloomberg US Corporate Bond Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg US Corporate High Yield (HY) Bond Index – This index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg US HY Long Bond Index, including bonds with maturities of 10 years or greater, and the Bloomberg US HY Intermediate Bond Index, including bonds with maturities of 1 to 9.999 years, are subindexes of the Bloomberg US Corporate HY Bond Index.

Bloomberg US Credit Index – This index is the U.S. credit component of the Bloomberg US Government/Credit Index. It consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC registered. The US Credit Index is the same as the former US Corporate Index.

Bloomberg US Mortgage-Backed Securities (MBS) Index – This index measures the performance of investment grade, fixed-rate, mortgage-backed, pass-through securities of the government-sponsored enterprises (GSEs): Federal Home Loan Mortgage Corp. (Freddie Mac), Federal National Mortgage Association (Fannie Mae) and Government National Mortgage Association (Ginnie Mae).

Bloomberg US Non-Agency Commercial Mortgage-Backed Securities (CMBS) Index – This index measures the market of non-Agency conduit and fusion CMBS deals with a minimum current deal size of $300 million.

Bloomberg US Non-Agency Investment Grade Commercial Mortgage-Backed Securities (CMBS) Index – This index measures the non-Agency investment grade component of the Bloomberg US CMBS Index market of conduit and fusion CMBS deals with a minimum current deal size of $300 million.

Bloomberg US 1-3 Year Credit Index – This index represents the one- to three-year component of the Bloomberg US Credit Index.

Bloomberg US Treasury Index – This index measures U.S. dollar-denominated, fixed-rate nominal debt issued by the U.S. Treasury with a remaining maturity of one year or more. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Bloomberg World Interest Rate Probability (WIRP) Function – Statistical function developed by Bloomberg that uses fed funds futures and options to assess the probability of future Federal Open Market Committee (FOMC) decisions. It seeks to calculate the chances of a rate hike at each of the FOMC meetings using futures trading data.

Conduit Loans – Type of loans, also known as commercial mortgage-backed securities (CMBS) loans, that are commercial real estate loans pooled together with similar commercial mortgages and sold on the secondary market. CMBS loans are known for their relaxed credit requirements but are only available for income-generating properties, and cannot typically be used as land or construction loans. On the secondary market, conduit loans are divided into tranches based on risk, return and loan maturity. Riskier loans with longer terms and higher interest rates will likely be sold to higher-risk investors, like hedge funds, while lower-risk investors, such as pension funds, are more likely to go with lower-risk tranches.

Credit Risk Transfer (CRT) – Pioneered by Freddie Mac in 2013, CRT programs structure mortgage credit risk into securities and (re)insurance offerings, transferring credit risk exposure from U.S taxpayers to private capital.

Credit Suisse Liquid Leveraged Loan Index (LELI) – This index is a subindex of the Credit Suisse Leveraged Loan Index, which, with over 1,664 fully funded term loan facilities as of December 2018, is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. LELI contains about 284 term loan facilities as of December 2018 and seeks to track the liquid segment of the loan market. LELI includes only large loan facilities, over $1 billion in face value, in order to sample loans that are actively traded in the secondary market.

Duration – Measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) – Measure of a company's overall financial performance that is used as an alternative to net income in some circumstances.

Federal Funds Rate (FFR) – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

Federal Open Market Committee (FOMC) – Branch of the Federal Reserve System that determines the direction of monetary policy specifically by directing open market operations. The FOMC comprises the seven board governors and five (out of 12) Federal Reserve Bank presidents.

FTSE World Government Bond Index (FTSE WGBI) – This broad index measures the performance of fixed-rate, local currency, investment grade sovereign bonds. It is a widely used benchmark comprising sovereign debt from more than 20 countries that is denominated in a variety of currencies.

ICE BofA AA-BBB U.S. Fixed-Rate Miscellaneous Asset-Backed Securities (ABS) Index – This index tracks the subset of the ICE BofA U.S. Fixed-Rate ABS Index rated AA to BBB and includes all ABS collateralized by anything other than auto loans, home equity loans, manufactured housing, credit card receivables and utility assets.

ICE BofA 3-Month U.S. Treasury Bill Index – This unmanaged index comprises a single U.S. Treasury issue with approximately three months to final maturity, purchased at the beginning of each month and held for one full month.

ICE BofA U.S. Agency Collateralized Mortgage Obligation (CMO) Index – This index tracks the performance of U.S. dollar-denominated, fixed-rate Agency CMOs publicly issued in the U.S. domestic market. Qualifying securities must have at least one year remaining to final maturity, a fixed coupon schedule, an original deal size for the collateral group of at least $250 million and a current outstanding deal size for the collateral group that is greater than or equal to 10% of the original deal size.

ISM Services PMI – This index (which used to be called the ISM Non-Manufacturing Purchasing Managers Index) is compiled by the Institute for Supply Management and tracks the economic health of the services (formerly nonmanufacturing) sector. A number below 50 is considered a contractionary signal for the economy; a number above 50 is considered expansionary.

J.P. Morgan Collateralized Loan Obligation Index (CLOIE) – This market value-weighted index comprises U.S. dollar-denominated collateralized loan obligations (CLOs).

J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD) – This index is a uniquely weighted version of the CEMBI, which is a market capitalization-weighted index consisting of U.S. dollar-denominated emerging markets corporate bonds. The CEMBI BD limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI GD) – This index is a uniquely weighted version of the EMBI. The EMBI tracks bonds from emerging markets (EM), and comprises sovereign debt and EM corporate bonds. The EMBI GD limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

Morningstar LSTA US Leveraged Loan TR USD Index – This index (formerly the S&P/LSTA Leveraged Loan Index) tracks the market-weighted performance of institutional weighted loans based on market weightings, spreads and interest payments.

Palmer Square CLO Total Return Index – This index tracks on a total return basis the Palmer Square CLO (collateralized loan obligation) Senior Debt Index, which comprises CLOs issued after Jan. 1, 2009, and meet certain inclusion criteria.

Par – Short for "par value," par can refer to bonds, preferred stock, common stock or currencies, with different meanings depending on the context. Par most commonly refers to bonds, in which case, it means the face value, or value at which the bond will be redeemed at maturity.

Qualified Mortgage (QM) – Mortgage that meets certain requirements for lender protection and secondary market trading under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Quantitative Tightening (QT) – Reverse of quantitative easing (QE); a central bank that acquired financial assets under QE undertakes steps to reduce its balance sheet.

S&P CoreLogic Case-Shiller U.S. National Home Price SA (Seasonally Adjusted) Index – This index tracks the value of single-family housing within the United States and is a composite of single-family price indexes for the nine Census Bureau divisions.

Summary of Economic Projections (SEP) – Four times a year, the Federal Reserve releases a summary of Federal Open Market Committee (FOMC) participants' projections for gross domestic product (GDP) growth, the unemployment rate, inflation and the appropriate policy interest rate. The summary also provides information regarding policymakers' views on the uncertainty and risks attending the outlook. The projections provide information on the values that participants view as the most likely to prevail in the current year and the subsequent two years as well as over the longer run. The FOMC chair presents information about these projections in the press conference following the FOMC meeting for which they were prepared.

Tenor – Length of time remaining before a financial contract expires. It is sometimes used interchangeably with the term maturity, although the terms have distinct meanings. Tenor is used in relation to bank loans, insurance contracts and derivative products.

U-3 Unemployment Rate – Officially recognized rate of unemployment, compiled and released monthly by the U.S. Bureau of Labor Statistics, measuring the number of unemployed people as a percentage of the labor force.

U.S. Dollar Index (DXY) – A weighted geometric mean of the U.S. dollar's value relative to a basket of six major foreign currencies: the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc.

Yield to Worst (YTW) – The lowest yield of a bond that can be received short of default.

You cannot invest directly in an index.

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