Caron's Corner Transcript - 9.12.2022

Rates Are Rising and Inflation Is Peaking. Is it Time to Buy Bonds?

- The short answer? Well, yes **and** no, depending on my four Ws: **Where** geographically, **Which** bonds, **What** maturity, and **When** to buy.
- **Where:** The **U.S**. as inflation has likely peaked and Fed may reach terminal Fed funds of 4% by the end of the year. **UK & Europe** as inflation and policy lags the U.S. by three months. **Emerging Markets** may be a little early but idiosyncratic to country risk.
- **What:** Per the "Three Bears": **Long duration is** "**too hot" -** an attractive play for a recession but also riskier. **Short rates are "too cold"** as central banks become aggressive. **3-4 years of duration looks "just right."**
- **Which: Investment Grade/High Quality** offers yield, duration sensitivity and lower default risks but if we have a mild recession, then **High Yield** can offer more potential upside.
- **When:** Timing is everything. U.S. policy rates are likely to peak and hold first. This, plus a strong U.S. dollar gives **U.S. assets an edge over other markets**.

"Well, we are at an interesting juncture for the markets. Rates are rising and inflation seems to be peaking, well at least in the U. S., which begs the question: is it time to buy bonds? The short answer is well, yes and no. It really depends on where in terms of geographic region, what maturities, which bonds and when to buy. Let's take each of those and dissect them.

Starting with where, and I call this "looking for bonds and all the right places." One of the things that we have to do is think about the geographic cycle that's taking place right now in terms of which rates are going up, which rates are going down, where is inflation peaking, where is inflation yet to peak and so on. As we look at the U.S. inflation likely peaked in July or August and the Fed may reach a Terminal Fed funds rate of 4% by the end of the year based on what they're telling us. But then when we look at the UK and Europe (which has typically lagged the US by about three months since the pandemic in terms of their economic data releases), where we expect inflation to really peak by October. In all I don't think the UK and Europe have really gotten there just yet. In Australia and New Zealand, central banks are starting to hint at a slower pace of policy hikes. They're still hiking, but hinting that they may be coming towards an end. Finally Emerging Markets are always very interesting, a very idiosyncratic market. I would say that we need to be a little bit careful there, but it doesn't hurt to start to think about it, start to do some research. Emerging Markets at this point have areas with the highest real yields and the most inflation protection. It's really just a question of the global economic growth cycle and where you want to take the credit risks within Emerging Markets.

Now in terms of maturity, well, this is what I like to call the lessons learned from the proverbial three bears – maturities that are too hot, too cold and just right. In terms of "too hot," areas that I'd maybe stay away from as rates are going up are long duration. 10 years and longer, even 7 years and longer in terms of duration are attractive plays for a hard landing or recession scenario, but it's also a lot riskier if we get that wrong. It's going to hurt your returns. Areas that are “too cold?” I would say short rates, as short rates are rising. Central banks are becoming very, very aggressive and I wouldn't stand in their way at this point. There may be time to buy the front end of yield curves, but maybe not at the moment. That leaves us with “just right” and this is something that we've been talking about for the last several audio casts, which is having duration around 3 to 4 years in a fixed income portfolio, which looks like a good balancing point between these two hot and cold risks. That's something that I'd like to really focus on as we construct a bond portfolio and fixed income.

In terms of which bonds, well, you know, a lot of people like credit right now because the yields are attractive and the spreads are widening. But a lot of people are a little bit concerned that if we do move into a recession that spreads could move out further and many are even thinking that spreads **should** move out further. Well, as I like to say, credit can remain strong longer than one betting against it can stay solvent. Credit tends to surprise people and it's going to really be something that I would argue is more attached to your outlook for recession. Whether it's a mild recession or a long, protracted, deeper recession. So yes, owning high quality credit has been a theme for us, but remember not all credits are created equal. When we look at investment grade and high yield, both offer decent yields and have some duration sensitivity. But we expect lower default risks than normal, even in this economic slowdown. This all goes through the process of thinking that if we have a recession that its more likely to be mild than deep and protracted. If that's the case then high yield may offer more upside potential. But these are the risks between high quality and high yield that really need to be balanced in in a portfolio.

In terms of timing, well, as they say timing is everything. So when do we start to think about adding to fixed income portfolios? Well U. S. policy rates are likely to peak and hold first. We think that the Fed is going to get to 4%. That might be the peak in the cycle for policy rates based on what they're telling us and then they're likely to be on hold for an extended period of time. We think that of the major central banks, the U. S. is likely to reach that terminal rate and start holding first. The strong U.S. dollar gives U.S. assets an edge over other markets. If you're in the UK or in Europe and watching the pound or euro start to decline, the dollar or dollar-related assets might be attractive. I would expect it to be somewhat of a tailwind for U.S. assets now. Europe and UK may price peak policy risk in the early fourth quarter. We've obviously seen what the European Central Bank did. They went 75 basis points and they may do another 75 in October. The Bank of England may do the same. We do think that most of this is being priced in terms of policy risk in Europe and the U. K. and once you get to the peak of that policy risk that maybe you'll have gone high enough. That might create some interesting opportunities for purchases. We also have to recognize that particularly in Europe, there are a lot of asset purchase facilities as well as the TPI, the Transmission Protection Instrument. All these various policy supports for Europe may also create support for many of these bonds. We also can't forget that Australia and New Zealand central banks are signaling a policy tightening pace and we also have to factor in that China plays a big role. China is a drag on the region just given the weakness that we're that we're seeing coming out of China. Once again, the fourth quarter looks like a really interesting time to start thinking about adding to your fixed income exposure just based on all of the events that I've been mentioning.

Now we have to turn to another asset class and that I'm not going to spend too much time on, namely equities. Equities are going to be related to fixed income because it's an alternative place that you would go to invest, in the sense that you are investing in bonds, or investing in equities. Typically there's a toggle between the two. Now one of the things that we have to focus on in equities is the demise of earnings, which may not be greatly exaggerated. We do expect there to be some downward revisions to earnings and one of the ways we get to this is by looking at global PMIs, which are falling, increasing recession risks. But global short rates are rising as central banks aggressively combat inflation. Altogether this really defines what we have dubbed in previous auto audio cast as the R.I.P. cycle which is recession, inflation and policy risk. On one hand you have recession risks and on the other inflation risks. Policy is needed to address both of those, and is at odds with itself creating a dangerous environment for policy making and how assets may react to that. Based on Bloomberg as of September 9th, consensus earnings are somewhere around $225 - $235 and they're expected to decline. Some forecasters are saying around $215, some are saying $210, some $200 and some even less than $200. I don't have the answer to that, but the point is that the one thing most people agree on is that the upcoming revisions are more likely to be lower, not higher. We are directionally interested in where earnings are going, as opposed to the absolute level. But directionally it does seem that falling earnings create some headwind to the asset class, but also can be somewhat of a tailwind for bonds as it makes people shift from one asset class to the other. These are factors to consider. Mathematically, to keep the S&P 500 levels unchanged as earnings falls, it requires a rise in P/E ratios and certainly that's possible, but it's going to be very, very hard to see that as earnings are coming down. Again, this is not about forecasting where equities are going, just forecasting where the headwinds are, and I think there is a pretty decent headwind on equities, which might be a tailwind starting to develop on fixed income.

So while equity markets worry about earnings, bond markets worry about default risk. The two are related, but are different in that default rates are low because most people expect there to be a mild recession. We can see that investment grade and high yield bond yields have risen to levels that may seem attractive in a mild recession or slow default risk scenario. You can construct a portfolio of investment grade with yields around 4.5 to 5% and high yield at 8.5 to 9% yields. This is based on index level data from Bloomberg as of September 9th and these are assets that start to look attractive at this level of yield. EM yields are also high, some of the highest real yields in the world. But again, there are risks with that and it's something that we have to take into account. Suffice it to say credit spreads are not priced for a deep protracted recession and this is a risk that we have to forecast or think about. That's not my base case that we get a deeper protracted recession, but I do think that we get a slowdown, a mild recession but not something that causes default risks to rise. An economic slowdown could be supportive for bonds and that's really where we need to start thinking about this.

The final message I'd like to convey is that it's really important right now to look outside the U.S. Investors will typically focus on the Fed and what's going on in the U.S. and that often drives asset performance. But I think today the global events are much more important and impactful in terms of explaining what might be happening to U.S. assets. By comparative measures, the U.S. is a boring market when compared to other global markets. Let me explain inflation speak. The Fed is nearing the end of its rate hiking cycle and there are likely to be downward earnings revisions which commonly lag the economic cycle and that may be ahead of us. This is a pretty normal cycle of events. Now, compare that to what's happening in the UK and Europe where there is a full blown energy crisis as they head towards winter. There's energy rationing and suffering, manufacturing sky high levels of inflation that have yet to peak, weakening currencies that exacerbate inflation risks and so on. Not to mention there's been a 75 basis point rate hike from a low base out of the ECB, one that may be replicated by the Bank of England. There's going to be a fiscal stimulus which really creates a lot of bond issuance to pay for these energy caps that are being discussed. There are China risks too. A housing crisis and financial crisis are both fully underway within China, creating a drag in terms of economic growth in the region and globally. It certainly exacerbates all of these global event risks that are very hard to predict.

Compare that to what's happening in the U. S. and the U. S. is boring compared to the rest of the world. But boring can be beautiful for bonds. We always have to remember that because bonds prefer a stable environment where rates and inflation peaks, and inflation then starts to come down, bonds tend to do reasonably well in that type of environment unless the slowdown is so severe that you get a deep recession and a big spike in default risks. If that's not your base case then bonds do start to seem to be somewhat interesting. So look, it's hard to predict the future but on balance - and the timing may not be perfect - but a balanced portfolio allocation of bonds with a 3 to 4 year duration range doesn't seem all that bad. If we create a mixture, look at mortgage-related assets, non-agency mortgages, asset-backed securities, investment grade, high yield and maybe even some idiosyncratic areas within emerging markets, these all might look interesting too. Putting it all together, we can construct what I think is a reasonably balanced fixed income approach. Remember too that there's some floating rate component to this as well that could also be an attractive hedge against those rising policy rates that are out there. Again, all of this together can construct a reasonably good fixed income portfolio. As we start to enter the fourth quarter, we need to start thinking about what the next 12 months may look like. If it's more of slowing growth and declining inflation - as long as we don't get that deep recession - bonds start to look attractive."

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CRC 4944359 Exp. 9/30/2023