PGIM FIXED INCOME

All the Credit® Episode 34

Transcript

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Female Voice: You're listening to All the Credit, a monthly podcast series brought to you by PGIM Fixed Income an active global fixed income investment manager. And now your host senior portfolio manager, Mike Collins.

Mike Collins, CFA, Host and Senior Portfolio Manager, Multi-sector Strategies: Hello. Welcome to Episode 34 of All the Credit, PGIM Fixed Income's monthly podcast. I'm Mike Collins, just one of the many investment professionals at PGIM Fixed Income and your host of All the Credit. Way back in Episode 17, almost exactly a year-and-a-half ago in June of 2021, All the Credit did a deep dive into the frustratingly persistent supply side constraints that were plaguing the global economy and presumably were responsible for the surge in global inflation. And earlier this year to better understand the actual drivers of inflation and to try to gain some insight into the future direction of inflation, we developed an important inflation indicator tool using a variety of economic variables. We were able to segregate the factors that explain the change in inflation into those associated with supply and those associated with demand. And the findings were actually very interesting. And this indicator is now revealing a much-improved supply chain at least in the U.S. and it's pointing to much lower goods inflation going forward, but more on that later. We've also rolled this inflation indicator out to evaluate the supply and demand trends and inflation dynamics in Europe, a region that seems to be in a very different situation than that of the U.S. The status of supply chains, the level of demand destruction both from higher prices and tightening monetary and fiscal policies and the path of inflation are such critical elements in determining the ultimate level of central bank policy rates and economic trajectories which in turn obviously drive long-term interest rates and credit market valuations. So, in this episode of All the Credit, we'll explain our proprietary inflation model, review the findings and provide an update on the direction and level of inflation that we're expecting over the next few quarters and year. Then we'll delve into the policy implications and highlight the different macroeconomic scenarios we envision for 2023. And importantly, share our views on the level of interest rates and credit spreads in each of these potential scenarios. And our guest for this important discussion is my colleague, Guillermo Felices. Guillermo is a Global Investment Strategist at PGIM Fixed Income responsible for designing macro-based investment strategy across asset classes and is based in our London, office where it's freezing cold right now. Prior to joining our firm about a year-and-a-half ago Mr. Felices was Head of Investment Strategy and a member of the Multi-Asset Investment Committee at BNP Paribas Asset Management. Previously, he held several senior research positions at Barclays and the Bank of England and Citibank. His research has been widely published. Mr. Felices holds a PhD and an MA in Economics from New York University and received his BA in Economics from Universidad del Pacifico in Lima, Peru. In other words, Guillermo is the real deal. And he's been an invaluable asset for us and our clients in joining us at PGIM Fixed Income. Guillermo and I are here to give you All the Credit. Guillermo, welcome to your inaugural appearance on All the Credit and thank you for all the great research you and your team generate to make us all better investors. I'm really excited to share some of your research with our clients. And stuff I talk about all the time with our clients is inflation model, the scenario analysis. So, it'd be really fun to do a deep dive for all of our loyal listeners on the topic.

Guillermo Felices, Principal and Global Investment Strategist: Hi, Mike. Thank you for the intro. And yeah, happy to take your questions and to have a good chat.

Mike: Yeah. So, you're a relative newcomer to PGIM Fixed Income. It seems like just yesterday but it's been about a year-and-a-half already. You know, after a very impressive career already prior to coming here, why don't you just quickly explain to your listeners like what brought you over here and what your initial impressions of PGIM Fixed Income are so far?

Guillermo: Yeah. Look, what really, you know, appealed to me was this opportunity to come up with frameworks that we could use to develop use across asset classes. And to combine that with this idea of scenario analysis or thinking about macro-environments that markets could plausibly price in the next six to 12 months or so. And coming up with views that then can foster discussion with risk takers, that's a way of adding value that, you know, has proved I think quite effective. And then the other thing that I think is what's really interesting and appealing was thinking about deep dives in terms of thematic research. So, identifying an issue that is market relevant and that could have significant market implications. And the tool or the framework that we are going to discuss today is actually an example of that.

Mike: Yeah, great, great. I mean, the scenario analysis is so important, right? A lot of firms or economists just kind of put a point estimate on GDP for the year, on inflation for the year, on interest rates for the year. But you and I know, I mean, this environment, this market and financial markets in general are very humbling, right? And you have to understand that there's actually always a range of outcomes. And in this environment, it seems like that range is actually wider and less certain than we've actually seen in the past. But let's dive into that really cool inflation indicator tool that you and your team and you have a really strong team supporting you doing a lot of this great quantitative modeling and research. You know, why don't you just explain how you developed it and how it was constructed for our listeners?

Guillermo: Yeah, sure. So, our aim with this tool was to try to understand the U.S. inflation dynamics at a time when all the headlines we were seeing were about supply chain disruptions, chip shortages, ports that were completely clogged, trade that wasn't flowing properly. And of course, that was causing problems and dysfunctions in inflation. Now, most people associate that with the supply side isn't working. But when we looked at a variety of indicators, we noticed that the manufacturing sector in the U.S. was actually tight, not just because of supply. This was also a reflection of demand. Now, disentangling demand and supply is easier said than done. So, we took an approach that I think is really interesting which is to look at say 10, 15 measures of tightness in the manufacturing sector in the U.S., including things like supplier delivery times or over time in manufacturing workloads, that sort of thing. And basically, what we did was, we applied a principal component analysis to try to disentangle demand from supply. That will be useful, because if you can have a view on where demand will go and where supply will go, you can have interesting insights into the inflation dynamics at least for the core goods sector. So, this tool was designed to try to crack the goods inflation puzzle at the time where we had significant supply chain strains.

Mike: Yeah. I mean, I think it's really interesting, right? When you segregated those supply and demand factors, it became clear to us that demand was as big of a problem, if not, a bigger problem than supply. And the conventional wisdom out there as you said is, “Oh, it's all supply, supply, supply. It's all COVID, COVID, COVID.” It wasn't. I mean, the demand, the increase in global demand for goods we saw coming out of COVID, first of all, everybody was sitting in their homes so they weren't using any services, they were shifting to goods. Secondly, they were getting all this money from these governments, right? So, it was really interesting. And I always say there were no supply chains in the world that could keep up with that kind of sudden surge or increase in demand for goods globally. So, why don't you just explain that distinction a little bit for audience and the difference between supply and demand and how we're seeing that play out?

Guillermo: Yeah. So, I think one of the most interesting findings from our framework was first that right after the pandemic, we saw a significant divergence between the demand component and the supply components. So, to your point about demand, in the U.S. at least, demand exploded higher. And it exploded higher because of the reopening, you know, after the pandemic but also because of the very aggressive policy stimulus that we saw not just on the monetary policy side but also on the fiscal side. And especially in the U.S. where there were checks that were extended to people to support consumption, etcetera. So, it was a really, really aggressive improvement on the demand side. But of course, at the same time, you also had these severe disruptions on the supply side. So, that led to a significant imbalance between demand and supply. And when demand outstrips supply, typically you have higher prices. And that's exactly what we saw. And of course, the question there was how is this going to pan out? What we noticed was that if you actually take the difference between our demand component and our supply component, that actually lined up very, very well with the dynamics of core goods prices or goods price inflation in the U.S. So, we thought, "OK, we have an interesting tool here. We can actually crack kind of the core goods inflation puzzle." And it has served us really well.

Mike: How has that evolved over the course of the year that the change in the demand component, the changes in supply component and what does that mean for our outlook for core goods inflation going forward?

Guillermo: So, over the last year, we have seen a significant normalization of those strengths. So, the demand component is rolling over quite quickly, but the supply component is also normalizing very quickly as well. So, essentially if you combine both, that was telling us that core goods should be, you know, about to fall pretty quickly. And the nice thing about this model is that it actually gives us a bit of lead time. So, it's kind of a nice summary statistic of, you know, what will happen to core goods inflation. And that's exactly what we're seeing. So, the model for several months has been telling us that core goods inflation was going to roll over. And now, we're starting to see that coming in full force.

Mike: Yeah. I mean, it looks like – the listeners can't see the charts but we do have a paper that I'll highlight at the end of this podcast where they can kind of dive in and see the charts. But it's really fascinating. The demand has come down so much and the supply has improved so much. They've actually not only hit equilibrium, they've crossed. So, it almost looks and on some empirical measures based on the model, that supply now is outstripping demand in parts of the goods economy. And you're seeing that in the retailer's earnings, they're increasingly worried about inventories, right? Autos, they're used car inventories are surging. The rental car companies are finally having problems after not being able to get any cars two years ago, right? And you don't see it in the chip sector yet but I wouldn't be surprised. As demand for, you know, PCs and technology and electronics comes down, you know, you see supply issues there. So, it's really amazing how quickly they've equilibrated and actually crossed. But obviously, goods. So, goods inflation, what does it mean? What is goods core inflation going to be in 3, 6, 12 months from now assuming these trends remain intact?

Guillermo: So look, we're fairly confident based on this model that core goods inflation is at least heading to zero. And actually, as you said, if you look at the latest results of the model, we wouldn't be surprised if we actually go into some deflation for core goods inflation which would be remarkable, right? Because of course in some other areas, we're seeing high inflation and quite persistent inflation, but this is at least some clear visibility that we have into one important sector of the economy.

Mike: Yeah. I was looking at a lot of the commodity series this morning as well. And year over year, a lot of them are down now, right? Oil is kind of flat or even down year over year. I mean, house prices are going to be down year over year. Probably pretty significantly sometime next spring, they kind of peaked earlier in the spring of 2022. So yeah, so that year over year, stuff is going to start to roll over and possibly go negative but that's just the good side, right? So, let's talk about the big picture. The Fed is focused on, you know, overall kind of core PCE. And just explain the difference in the percentage contribution from goods versus services.

Guillermo: So, core goods account for something like 27% of the core basket. Services account for the rest, so 73%. So, as important as core goods are, the bulk of core inflation or core basket is really services. The story in services is quite complicated because there's two big drivers. One is shelter and the rest is basically the non-shelter component. And they have sometimes, you know, quite different dynamics and quite different ways of getting measured and drivers, etcetera. So, let me take them in turn. So, shelter has been, of course, you know, very, very hot and rents in particular over the last few months. And the official time series are still, you know, showing some momentum there. But if you look at some of the forward-looking indicators, they are starting to roll over. So, we're fairly confident that on the shelter side, services inflation is going to moderate. I think the part that is harder to be optimistic about at least in the short term is the non-shelter component of services. That is very tightly linked to the labor market. So, this is the part of the economy that is related to health care services, education, transport, all that. And that accounts for roughly 50% of the core basket. That component has proved to be quite sticky. And the main reason is that it's tightly linked to a labor market. And the labor market has been really, really hot. We're starting to see some signs of easing. So, if you look at vacancies or hiring, it's starting to moderate from very, very high levels. But we're confident over time that will also moderate. The problem is that, as I said, it's the most persistent component of inflation. And it has also been boosted by factors that are kind of beyond the demand for services. I mean, things like high net worth because of rising equity and house prices have been behind these or high savings rates following the pandemic have also been behind these. But eventually, we think this part of the inflation puzzle will also moderate but it will take time.

Mike: In the prior episode of All the Credit, I had a great discussion with Robert Tipp, who I know that we all work closely with, Guillermo. And Robert and I kind of did a deep dive on the outlook for interest rates, the outlook for the Fed funds rate, the outlook for inflation, not dissimilar to what we're talking about here. And because it's all really important stuff right now and it's driving returns in fixed income. And one of the things we discussed is how the world's labor market is kind of shrinking, right? It's not just tightness in the U.S. This is a global phenomenon and wages maybe are just going to be stickier, you know, than they've been in the past. And we're seeing in the U.S. 5% kind of year over year nominal wage growth and it started to come down. And now, it's kind of stabilized at five. And maybe it doesn't come down to zero or one or two, maybe it stays kind of sticky. And the demand for services coming out of the pandemic have been really robust and resilient. And yeah, I think that's all going to roll over but that's actually been a problem. We've just got us some PPI data recently prior to this recording and even they were higher than expected. So, showing yeah, year over year declines but not as quickly as people expect so certainly problematic there. I just said that, you know, having a point estimate is a bad idea. But if I had to put you on the spot and say, "Where is core goods, services and total core inflation going to be in a year from now in the U.S.?"

Guillermo: I would say core probably goes down to between 2.5% and 3%. And I think headline probably goes to 3% as well which is a little bit above the target but still uncomfortably, you know, high. And I think what is going to be fascinating about this, what the Fed tells us about the persistence so how they see the persistence of inflation and how much more will they have to do to bring this market in line with their target.

Mike: Yes. And we'll get into the policy implications in a minute. And first, I want to switch to Europe, right? Obviously, you're sitting in our London office. We have a huge team of investment professionals. And in London, in Europe, a huge part of our client base is coming from Europe and the dynamics there have been very different. People are worried about stagflation in the U.S. But wow, in Europe and the UK, those stagflationary effects kind of higher inflation and weaker growth are really magnified over there. So, you've recently rolled out this model, incorporated it into the European markets and what does that tell us?

Guillermo: So, I mean, we cannot deny that the inflation picture in Europe is a lot more complicated than in the US. And the main reason is that the war in Ukraine has really kick started an energy crisis in Europe. So, Europe has been highly dependent on gas and oil that comes from Russia. And as we have to kind of delink from that source of energy, we're seeing significant spikes in particular in gas prices. But that's filtering through to the rest of the economy so – and, of course, complicating supply chains. So, we thought it would be a very interesting exercise to run the same sort of framework or model that we did for the U.S. supply chains to Europe. And the results are fascinating. They are fascinating because you also see that the reopening post-COVID led to a significant increase in the demand component, perhaps not as far as it went in the case of the U.S. where the policy stimulus was really, really aggressive. But it was impressive, nonetheless. But what is really different is the fact that the supply component in Europe has remained strained. So, we collected 15 to 20 time series which are also linked to the manufacturing sector in Europe. And we did a similar decomposition and you can still see severe strains on the supply side. And of course, that has implications for inflation because our model for Europe is also a decent predictor of core goods inflation in the Eurozone. And even though the demand component is normalizing, the fact that the supply component is still impaired basically tells us that goods inflation is likely to be more sticky in Europe than in the U.S.

Mike: Yeah. And it's really interesting the implications for policy, right? The policy difference between the U.S. Federal Reserve and the European Central Bank could be pretty stark here, right? In the U.S. you have moderating inflation, slowly moderating growth kind of starting to point to a soft landing, if not something worse. In Europe, you have this kind of tug of war between higher inflation and lower growth. And it seems like in both cases, the central banks are going to be really in a pickle. So, what is your perspective on the likely policy path for the Fed and then ultimately, the ECB?

Guillermo: In the case of the Fed, I think the path is more one where they will probably squeeze in a few more hikes, try to make sure that this lingering inflation problem is under control. But because it's been a demand-driven or mostly a demand-driven inflation problem, an overheating problem if you want, they have been quite aggressive in delivering that tightening. And you're starting to see the effect of that. So, as that filters through to the economy, the inflation will continue to fall as we discussed. And then the economy unfortunately, the side effect is that the economy will also roll over. And as that happens, we think the Fed can be off the hook and perhaps start cutting, you know, as early as, you know, mid next year. Now, the situation is very different in the case of Europe because as you said, we have more of a supply shock problem that is directly pushing inflation up but at the same time is pushing growth down. So, central banks cannot be as aggressive fighting inflation because they really kill the economy. So, we think they are going to be a bit more moderate in the way they tighten policy. They have to do it because they don't want high inflation to spill over to inflation expectations and then that complicates their lives further. But basically, we think their tightening paths are going to be perhaps more persistent or long lasting but also milder in terms of size and speed.

Mike: Yeah. I mean, I've certainly had the view that the Fed will get the funds rate to close to five. And then, you know, if inflation is really 3% in a year from now, I think the Fed will be in an environment where a 5% funds rate is too high and monetary policy is too tight. On the heels of all the quantitative tightening, they're going to reduce their balance sheet by a trillion dollars next year. That's a lot of tightening as well. So, a 3% inflation rate probably equates to a funds rate not much higher than 3%, ultimately.

Guillermo: Yeah, I think that sounds right, Mike. So, if the funds rate goes all the way to 5% and inflation eventually moderates to something between 2.5% and 3%, so effectively, you have enough tightening in there. So, you have basically a positive real rate. And that should be enough to keep all this in restrictive territory for some time. And that should actually cool down the economy.

Mike: Then for what it's worth, the markets are pricing in. Some cuts next year. Our funds rate, that picks out around 5% early next year in 2023. And then a few cuts next year, a few more of the following year. And even out 10 years, the markets are pricing in like a 3% permanent funds rate at some point. Not a zero, not a one, not a two, those scenarios are not priced in at all. So, where do you see the ECB peeking out in the cycle? What's priced in, in Europe?

Guillermo: So, the market is pricing in a peak at around 3%, a bit less than that. And the big difference between the Europe and the U.S. is that basically in Europe, we stay at those high levels of the ECB depo rate for longer precisely because of the persistence of inflation in Europe that we've discussed. So, I don't think that's a surprise to the market. What is very different though is the level of rates. So, we think we peak at, in our base case at something like 2.75% for the depo rate, so a bit lower than what the market is pricing.

Mike: Got you, got you. So, let's dive into these different scenarios, right? Like I said, the credit markets and the risk markets in general, I'd say even the equity markets, are kind of pricing in a pretty mild recession or soft landing in the U.S. And that could happen. But obviously, there's a whole other range of scenarios. And like I said, that funds rate, the markets are assuming the Fed ultimately in like two or three years from now gets the funds rate down to three and keeps it there basically forever. So, the markets are not pricing in something more dire like a disinflationary world or deeper recession which would presumably force the Fed to cut the funds rate more aggressively. So, why don't you describe first how you guys do this scenario analysis? It's something that we find really useful as portfolio managers.

Guillermo: Yeah, sure. So, what is fascinating about the current environment is the uncertainty that we have around some of the most important macro-variables that we can think of. So, growth, inflation, of course, the policy response is associated with that. So, we have to keep an open mind, some sense of humility as well when we do this exercise. But, you know, we have to think hard about what scenarios are plausible ones for the market to price that perhaps are not yet reflected in asset prices. So, the obvious one is high inflation. So, what if we have this nasty combination of high inflation and weak growth or in other words, stagflation? So, that's something we haven't seen in a long time, right? So, conventional models just basically don't really work. For us, basically, we try to come up with a base case that is going to have a high conviction view on macro and then the alternative scenarios around that. So, in the case of the U.S., our highest probability environment now is one of recession. If you want a recession of the garden variety where the economy slows down but inflation also rolls over eventually, right? And that means that the Fed can take the foot off the brakes. And it also means that opens up a nice asymmetry to the downside in terms of yields. But the problem is that even as that happens, our recession will likely be the making already. And when that happens, typically spreads widen. So, that's basically our base case. So, the market has been a bit complacent, you know, about that recently but we think that's still, you know, a reasonable base case. Now, the alternative scenarios are also interesting for the U.S. For example, we could easily see more persistent inflation. As you said, you mentioned the PPI numbers, the wage growth numbers have been quite punchy, you know, recently. So, we'll see what the Fed tells us. But basically, we think, you know, there is a plausible case where inflation could remain sticky and the Fed will have to hike for longer. So, that's just to give you a flavor of an alternate scenario that we think would be a lot more damaging actually for asset prices because that means that they have to stay hawkish for longer and that damages also the economic recovery. In the case of Europe, I would say the stagflation scenario is even more pronounced or carries a higher probability because of the issues that we've discussed. And there, if anything, that puts more weight to the bad environments for risky assets. So, we're still cautious generally. We think the market has been a little bit complacent in terms of pricing. Too much good news when the environment that we see into next year is likely to be one of recession in Europe and the U.S.

Mike: So generally, to sum it up for the listeners, what you do is you highlight these possible scenarios. You assign a probability, a percent probability to each one and then an outcome in terms of rates and spreads. If you multiply that all together, what is kind of the weighted average expectation for let's say U.S. 10-year yields and U.S. credit spreads a year or so out?

Guillermo: Yeah. So, that's exactly what we do. So, when we have probabilities assigned to the various scenarios, then we compute expected returns across asset classes and then we come up with a summary statistic which is basically a probability weighted, expected return or a spread or rate. So, in the case of U.S. 10-year yields for example, we have penciled in something around 3%, so some downside from the numbers that we're seeing now. And in the case of spreads, you know, if you think about high-yield spreads and corporate spreads in the U.S., we have penciled in something around 700. That's for the next big move. Of course, once you get in that vicinity, the opportunity becomes a lot more interesting. And then typically when you price recessions, that turns quite quickly. But the next big move could be something, you know, as aggressive as that.

Mike: We actually as portfolio managers and analysts and investment managers on behalf of our clients, you know, we do take these different scenarios very seriously. We take them all into account. And as I always say, part of our job as money managers, as risk managers is build a portfolio that does well in your base case and doesn't blow up in the tail risks, right? So, we actually have positioned our portfolio, certainly our multi-sector portfolios for this increasing probability of recession. If you look at our credit positioning, we're about as low in terms of the percentage of our credit risk budget that we're using as we've been in, over a decade since I've been a lead PM on a lot of these strategies. So, we're really playing pretty defensively with regard to credit risk. We've cut our emerging market exposure. We've cut our investment grade corporate. We're generally underweight investment grade corporates. We've cut our high-yield exposure. We've decreased the kind of cyclicality in the portfolio. We've increased high-quality liquid positions in the portfolio. So, on the credit side, we're there. We're definitely taking into account that there's a possibility that spreads are wider. In fact, that would probably be our base case, right? That they're wider in a year from now. On the rate side, there's been just tremendous uncertainty, right? We just had kind of a huge rally not only in credit spreads in the last couple of months but in rates. And we're generally fading all of that right now thinking, you know, there's this upside risk to inflation, this upside risk to the funds rate that is not priced in. So, kind of still maintain a pretty neutral stance on duration for what that's worth. Let's wrap up there. Any closing remarks, Guillermo?

Guillermo: Yes. Look, I would say we're facing a unique and a very challenging macro-environment. We need to keep an open mind, consider scenarios that have not been the norm in the last few years and continue building tools that make RPMs, our investors better, right? So, that's the challenge that I face as a strategist. And hopefully we can succeed in any year.

Mike: So, we're going to have our work cut out for us like we always do, Guillermo. So, thank you so much, Guillermo Felices for everything you do. You've been like I said a great resource, a great asset to the team and for our clients. And thank you for all those thoughtful insights today on the potential path of inflation, those different likely scenarios for growth and the implications on the broader fixed income markets. And for all you listeners, you know, you can go to our website PGIMFixedIncome.com. You'll see all of our thought leadership, our views from the desk which is kind of a detailed summary of what happened in the fixed income markets, what are kind of near-term views are. We have a Bond Blog, aptly called the Bond Blog. That's easy to find. Then Guillermo recently published a paper called "Supply Chain Strain: Assessing the Divergence Between the Euro Area and the U.S." That's a recent paper. That has all the charts and the pictures of everything we talked about today. So, please take a look at that and thank you for listening.

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