PGIM FIXED INCOME

From Low Ranger to High Plains Drifter

Webcast Transcript

[Music]

Mike Collins, CFA, Senior Portfolio Manager, Multi-Sector Strategies: Hello, thank you for joining PGIM Fixed Income's webcast; From Low Ranger to High Plains Drifter. I'm Mike Collins, a Senior Portfolio Manager at PGIM Fixed Income. I'm delighted to be co-hosting today's webcast with Tom Porcelli, PGIM Fixed Income's newly appointed chief U.S. Economist. Tom recently joined the firm after a successful career at the Federal Reserve Bank of New York, Merrill Lynch, and most recently, RBC Capital Markets. Thanks for joining today, Tom.

Tom Porcelli, Chief U.S. Economist: Thanks for having me, it's great to be here.

Mike: Yeah, over the past few decades, PGIM Fixed Income has been famously known for our long-standing view that global interest rates, particularly in developed countries, would steadily decline and remain at historically low levels. In fact, we've published several papers over the years to express that contrarian view, in which we generally refer to that period of low range bound interest rates as the Low Ranger Era. However, given substantial changed in geopolitics, fiscal policy, supply chain dynamics, energy transition dynamics, labor markets and even climate related risks, we are now envisioning an interest rate environment that may more closely resemble the regime prior to the period of ultra-low interest rates. One in which rates remain in a somewhat higher and possibly more stable range. For example, we may see yields across the U.S. Government Yield Curve drifting within a range of say 3-5% for the intermediate future. We're referring to this likely next interest rate regime as the High Plains Drifter Period.

Tom: Awesome. Thank you, Mike. And so, to tie all this together, our guest today recently penned a paper titled, *From Low Ranger to High Plains Drifter*, which details the evolution of our interest rate outlook and inspired the discussion we're planning on having here today. So let me introduce Robert Tipp, PGIM Fixed Income's Chief Investment Strategist and Head of Global Bonds. Robert has been one of the primary architects of PGIM Fixed Income's long-term strategic interest rate views. Welcome, Robert. Great to have you.

Robert Tipp, CFA, Chief Investment Strategist and Head of Global Bonds: Thanks, Tom.

Mike: Yeah, so Robert, you have certainly been our de facto bond market historian over the years, and I actually did a little digging myself and found that the Lone Ranger, which is obviously named after the *Low Ranger*, actually made its debut on the radio in 1933, almost exactly 90 years ago today, and Clint Eastwood's *High Plains Drifter*, the famous movie, was released almost exactly 50 years ago today, in 1973. So certainly, a timely metaphor transition if you will.

Tom: And you had all that in mind, of course.

Robert: Absolutely.

Mike: Yeah, so interest rates are back, you know, right around that four percent long-term central tendency. And as you like to say, in fixed income, yield is destiny. So why don't we start off just by reminding the audience of the driving forces behind our previous low for long, low ranger view. And how did that ultra-low interest rate environment work out?

Robert: Sure, Mike. Yeah thanks. So, you know when we started in on this say three decades ago and we're looking at the market, first of all we were out of that 3-5% range, that was a level of interest rates that had never been seen before in the world's leading bond markets for any sustained period of time. Especially in the absence of a war. So, we're on our way back down to that range, and it was clear there were demographic arguments why we should expect to be back in that range, and then as the decades wore on, additional reasons for that ongoing bull market came to the fore. Private sector debt levels were piling up higher and higher, which probably reduced the equilibrium level of interest rates, and eventually, China came into the World Trade Organization (WTO) with the widespread use of the internet created a lot of downward price pressures as well. Low interest rates, low inflation, below target, and inflation targeting became all the vogue. And so that nexus brought us into that really low range, we could identify those factors as we went along. From an investment standpoint, to be long duration during that period, whether you're buying the [inaudible] of 21 in 1991, or whatever on the way down, you were picking up yield, yield curve was positively slow. You're getting roll down, and then on the off chance, the economy took a dive, we'd seen from Allen Greenspan, from his early days in 1987, he was going to cut interest rates and there was a put and being long duration was part of that. So that was something that worked very well throughout that entire period, until we changed views, the environment changed in the first quarter of last year. So, at the end of that period, with the inflation below target, the world had gone into a fiscal retrenchment, circa 2011, 2012, after the Eurozone crisis, they went into cutting spending, raising taxes in the midst of a recession. The United States. you may recall, something on the fiscal austerity side, the sequester in 2012. So, we were locked in a below target inflation environment. In 2012, the United States joined the crowd with inflation targeting and that kicked off a monomania of central bankers that were below two percent inflation, that were fixated on getting to higher levels. And in the case of the Europeans, we wrote that paper back in 2014, *Europe into the Void*. That brought on a period of time where their markets averages, you know, below zero interest rates as the ECB drove the interest rates down, culminating 17 trillion in negative yielding debt. As if having negative interest rates and burning people's money would inspire them to go spend more out of their retirement savings which they were no longer able to accumulate. It created a very hazardous era but we're really locked in that and we could see that from 2011, 2012 onward we were going to be stuck there until we had some cataclysmic change in the markets that brought higher growth, higher inflation, and freedom for central bankers to raise rates.

Tom: Yeah, and of course that has now happened, right? And so here we are, right? So now rates are well-above 4% across the entire U.S. curve and have risen by hundreds of basis points in other, most other countries. Meanwhile, some of the secular forces that prevailed in the low ranger period, aging workforces, high debt levels, are still in place. So, Robert, what are the conditions that you expect to prevail over say the next 5-10 years that will support higher rates, or are these higher rates doomed to fall back down?

Robert: Sure, so some of these things have brought really low prices, like China coming into WTO, have been replaced with friendshoring, a desire to have more robust supply chains, and those things create investment, and frankly, a little bit less efficient solutions, a little bit higher prices. That's one of them. Post-pandemic periods are notorious for having higher rates of growth and for having upward wage inflation.

Another thing that had depressed interest rates, that fiscal retrenchment, boy, fiscal retrenchment is over. Fiscal is wide open, whether it's spending on renewables, it's creating a lot of CapEx, so a complete change on that front. And the inflation has risen above target and central banks have been given free rein, even if it means economic pain to get interest rates up high enough to get inflation down. So, I think those conditions have been met. The debt burdens have shifted around, the public side is going wild, the private side is pretty clean though. The financial crisis ushered in 10 years of subpar growth and while the private sector worked itself out—banks recapitalized, cleaned up their assets, households cleaned up, corporations cleaned up, and then everybody has been extremely cautious for the last few years because we're coming out of a pandemic, had a war start, had interest rates going up, everybody's been warned, things are going to be terrible, there's going to be recessions. So, I think this is an environment that can actually sustain the higher rates. The last one, the demographics. There's been record immigration in a number of countries—the U.S., UK, Australia, Canada—and there are a lot of forces in the world that are causing that, in some places those people are coming into the workforce, in other places they're students, a lot of variations on that. But it does tend to create growth, a little bit higher inflation, and a different population than a static system with an aging demographic would bring you.

Mike: So, Robert, what is, you know, the Fed and other central banks' role at this point? I mean you have these deeply inverted yield curves, right? Does that mean either that they're prone to cut aggressively in the near term or is it a sign of a recession to come?

Robert: Sure, well, I think historically that when central banks have hyped a lot, especially during this post war period where interest rates were falling and debt was piling up, usually they'd hike interest rates a lot like in the '80s let's say, and they would run into an iceberg of underlying problems and the whole thing would melt down. But there have been soft landings in the mid-'90s. But as a practitioner in the bond market, not an economist, it looks to me like the Fed has hiked over 500 basis points, ECB has hiked over 400 basis points, central banks have gone to town. Most of this hiking cycle, I mean it's got to be behind us. You're seeing a response, looks to me like in the economies, you're somewhere near a peak in interest rates. I think that is why we have an inverted curve this time. Is that people see this and they know we're somewhere in the vicinity of a peak in interest rates, and I actually need the high income for a very long time and therefore, I need to extend duration, even if it means taking a bite out of the yield in some way, shape, or form? I think this time that's what's driving the inversion and actually, if you go back long enough over the decades and centuries, you can see comparable periods but I think that's what's driving it, not the recession.

Mike: And Tom, you were, obviously a market analyst at the Fed and you're our Fed watcher and a real economist, does that sound reasonable to you that the Fed can keep interest rates maybe near or around 5% or at least above 3% let's say, for the next 5 or 10 years and not get back to their long-term target of 2.5%?

Tom: Yeah, so I think that this is such an important idea, right? Because I think for a lot of people, their view is colored by the idea of well "Hey, when the Fed has cut rates the last couple of times, they get down to zero." That is atypical. Right, I mean in the history of the Fed, those are the only two times it happened, and they were massive events. It was the GFC, the Great Financial Crisis, and the pandemic. So, I think getting back down to sort of anything resembling zero in the more immediate term, short of a major event happening, I think is incredibly unlikely. So, when we think about the Fed, in this cycle, and when they finally do start cutting, I think it's going to be incredibly modest. I mean I think Robert rightly highlighted sort of the mid-'90s period, I think that is a useful way of framing the Fed conversation today, where the Fed basically cut 75 basis points or so, I can easily see that playing out. And again, just to be clear on that point, that's very consistent with the idea that whatever slowing we do have in front of us, it's not going to be big and aggressive, so the Fed's reaction function doesn't have to be big and aggressive.

Mike: Makes sense.

Tom: Yeah, so Robert, you've had a knack for taking a contrarian stance and getting it right, how's it possible that the market can be so wrong?

Robert: Yeah, well, the markets are amazing and has a way of making you feel like an alien that just landed from outer space, or at least in my case. That's how it's been. Because if you think about that period from 1980 all the way down until 2022, with the positively slow yield curve suggesting rates were going to go up when in fact, they were falling the entire time. And there were economic advantages to being long. And that 40-year period came after two decades of rising interest rates with often inverted yield curves. So, the yield curve pointing down and yields actually moving up. I think right now we have one of those kind of counterintuitive periods where the awkwardness is that the yield curve is concave up. It's arched upward and it tends to be arched downward. So, I think that markets are assuming there's going to be a recession, they're betting that there's going to be a drop in the next one, two, three, four, five years down into the 3s, when the best approach to the market I think is to be in the market. Yields are high, they are hundreds of base points higher than they've been, you know, for 10-plus years, they're back at 2002 levels, you're not at zero or minus, or 1 and or 2 and, you're at 5 and percent on the U.S. market. And that's what's going to be earned but you need to be careful on how you position on the yield curve. And if past is prologue, having effectively an incorrect forecast built into the market seems to be something that can persist for years and even decades.

Mike: To that point, Robert. The yield curve is deeply inverted, right? A lot of our global clients, big institutional clients, high net worth individuals are kind of piling into the highest yielding part of the yield curve, right, we're on an ex ante basis at least, it looks like they're going to have the highest return, I mean, how do you respond to folks who are employing that type of strategy?

Robert: Sure, I can remember circa 2000, being with you in other countries and talking about the appeal of hedged foreign bonds, even though there was on a static basis, instantaneously no hedge deal pickup, but the fact is, when you're at a flat curve, inverted curve, you're usually at a peak in interest rates, there's going to be capital appreciation ahead. So if you look at the long-term, what's tended to happen is the curve reverts to a positive slope and yields tend to come down a bit from this kind of an environment, so that's a plus. The other is if you are in the full fixed income market, the frontend is really picked over, the money market area does not leave a lot on the table in terms of alpha opportunities. If you're extending out into the spread sectors, whether they're investment grades, structured products, corporate bonds, or below investment grade, or high currency emerging markets and so on, high yield corporate bonds. The yield pickups, they translate into higher returns over time, there's also more alpha opportunities, you know, in those sectors. So, I think that the record of time is really proven that once fixed income has revalued and you've been through a rate hiking cycle, it really pays to be in the full market and not just in the frontend of the curve.

Tom: Yeah, I mean I just think that all of that is super interesting. We've obviously talked a lot about interest rates, what would you say makes up an optimal fixed income portfolio today, and with regard to duration, both in the U.S. and internationally, yield curve positioning, credit risk, credit spreads on those corporate bonds don't seem cheap.

Robert: Right, well I think there's a tendency you know, with the spread markets, to rapidly widen out to extreme levels in a crisis and then spend a very long time first moving to average levels and then getting tighter than average. So, there's a good chance that given what we've seen in markets say over the last year, that the biggest enemy of the market has been volatility. And so when rates go up, we see taper tantrums last year, 2013, 2018, when the markets calm down, the spread product tends to see a search for yield take hold, and corporate fundamentals, as I mentioned in a lot of areas, actors have been, economic actors, whether it be corporations, but lenders have been very cautious in their activities so there's a lot of decent credits that can make it through a slower economic cycle. So I think that you know, credit is poised to have good performance, as [inaudible] remain range bound to tighter on average, and on the yield curve, that it's going to be a tactical market. It may be a steep one today, maybe a flattener tomorrow, may be a little bit on the long side, little bit on the short side, but from a strategic perspective, fixed income is at a very attractive level.

Mike: And of course, in the portfolios, the big, large domestic, global, multi-sector portfolios, Robert, that you and I co-manage, we've been positioned accordingly, right? On the duration side, we've been neutral, give or take, we've been short duration quite a bit at certain points this year, is that concave, you know, downward yield curve corrects, and that's worked to some extent, and in some cases when rates get to the higher end of the range, we've covered that. On the credit sectors, we've been pretty constructive, right? We own a lot and are overweight a lot of high quality credit, some in investment grade corporates as you mentioned, some in AAA structure products, some in our favorite high yield bonds, so there's a lot of yield, a decent amount of spread, and a lot of alpha opportunities on the table. So, we're taking advantage of those across the board. So, you laid out a really reasonable base case, right? That you know, heck, maybe rates do stay a little bit higher than longer, maybe economy doesn't have these big tipping points that cause a deep existential credit crisis, but things happen, right? And we've seen these throughout our careers and you get surprised. So, there are risks, right, there are upside risks and we could be sitting here in a year from now and growth in the U.S. could be between two and three and inflation could be stuck at four. Right? And the funds rate, heck, could be at six percent. And obviously there's those downside risks; global growth is slowing and mistakes happen, and they are non-linear, right? And the unemployment rate starts going up and it goes up a lot. Right? So how do you think about those different scenarios, maybe what kind of probability would you put on that upside and downside and how would fixed income in general perform maybe in each of these different scenarios?

Robert: Sure, yeah, I mean obviously as portfolio managers we'll stay attuned as best we can to the data that's coming and all the signs that we can read to adjust the portfolio accordingly, but once you're up at these yield levels, you have more room for error if you will. I mean interest rates are not going to go up another five percent. They could go up another hundred basis points at the Fed Funds point, they'll probably go up less at the long end of the curve. Could that be jarring for spread product? It could, but is it going to make, render the vast majority of the credit universe un-investable, I'm highly skeptical of that. I think it would create opportunities in a taper environment. So, to have a moderate or moderately high exposure to spread sectors here, will leave you in a position where you could add in a taper tantrum kind of environment, being tactical on duration could give us the ability to add. If and as rates are high or to be underweight duration, as we see rates as getting to the overvalued part of the curve, end of the range like we saw after the SVB crisis. The downside risks I think that there are opportunities in every sector where we see things that look like good value that are reasonably defensive that would make it through a recession, so hopefully downside scenario, it may have price volatility for those but we would end up capturing our incremental spread by remaining fully invested in the market and keeping in mind that a recession could bring lower rates. Interest rates have risen a lot, that we need to be attuned to that, and if there's an opportunity to stay long duration, say as was the case going into the pandemic, that we may need to do that as a hedge against the spread product in the portfolio if [inaudible].

Tom: Yeah, that's great. So, as we wrap this up, what final thoughts would you leave us with?

Robert: Sure, I think two things, the one would be it looks like we're back up in that normal range for yields, back up into that three to five range, things have been reset, and frankly, in DM economies that are aging, that are under saved, having a higher interest rates on average, if those can be maintained, is going to be a much healthier backdrop. But for fixed income, having those high yields make it very likely over the next five, 10 years that we're going to have much higher returns to what we've seen over the last 10 years, and that'll be the case in the U.S., will be the case in European markets, and that there's a period here, like we saw in the mid-'90s, where we could be in for an unusual period of stability as well. But we'll stay tuned in terms of the volatility. But fixed income is re-valued and it's noteworthy that cash temporarily, those yields are very high, that may not be sustained, and in the case of equities, they have not visibly re-valued to the cheap end of their range. So fixed income really looks like in the abstract is attractive, but also on a relative basis to other asset classes, is really well-positioned at this point.

Mike: Yeah, thank you for those final thoughts, Robert, for our audience. So as we conclude, I'd like to quickly summarize the key points we covered today. First, interest rates have reverted back to historically normal ranges, following the period of ultra-low interest rates. The conditions that have spurred the increase in interest rates may actually prevail for an extended period. The higher level of interest rates combined with solid credit fundamentals and moderating rate volatility, should actually support credit markets. Forward looking expected returns for fixed income are actually really compelling across a variety of different potential economic scenarios and as we all know, in fixed income, yield is destiny.

Tom: And there you have it. For more great insights from PGIM Fixed Income, please visit pgimfixedincome.com. There you'll find Robert's paper, which inspired today's conversation, *From Low Ranger to High Plains Drifter*, along with a ton of timely, quick hitting thought leadership, including blogs and podcasts and webcasts.

Mike: And Robert and Tom also just put out a webcast called, *Playing the Long Game: Looking Through Economic Uncertainty to the Value in Bonds*, where they cover a whole host of topics at the forefront of conversations we're currently having with our clients. So, thank you, Robert and Tom, for co-hosting with me today. And to our audience, thank you so much for tuning in and for all your confidence in PGIM Fixed Income.

[Music]