PGIM FIXED INCOME

Moving Out of Cash: Opportunities in Today's Shifting Markets

Transcript

[Music]

James Meyers, CFA, Portfolio Strategist: Alright, hello everyone. Thank you so much for taking the time to join us for our webinar entitled; Moving Out of Cash: Opportunities in Today's Shifting Markets. My name is James Meyers, and I am a portfolio strategist at PGIM Fixed Income. I am thrilled to be your host today, and I am joined by our collective team of seasoned investment strategists, including Robert, Guillermo, and George. We have a fantastic and timely conversation lined up for you today. So, without further ado, let's jump right in. Alright, so on our first slide we will review our agenda, which centers on why we collectively see a great opportunity to once again make a strategic case for an allocation to bonds as yields have risen to levels not seen in the market for over a decade. Secondly, fixed income, especially the higher yielding segments of the fixed income market, are likely to outperform cash over the long-term. We'll also explore equity valuations and how they look elevated both in absolute and in relative terms compared to fixed income in particular. Next we'll talk about cash returns, while they are high and attractive at present, given the inversion of the yield curve, which has been with us for over two years now, over the long-run, the return from cash is much more uncertain than bonds. Finally, we'll talk about how cash on average underperforms bonds during significant equity corrections while bonds more often than not perform well in a stock market downturn. We begin today's discussion by going through current valuation metrics and potential future return scenarios for cash, bonds, and stocks. First off, let's turn to George. George, thank you so much for joining us. Let's start out with the most important current topic in the bond market; expectations about Fed policy. With the Fed still maintaining an effective Fed Funds range of 5 and 1/4 to 5 and 1/2, backing into the secured overnight financing rate, or SOFR rate, at just over 5.3 percent, cash definitely looks more attractive than it has been for quite some time. However, historically when the Fed has indicated that they are moving towards a pause in their hiking cycle, which is where we are at at PGIM Fixed Income, in our views of the cycle, cuts tend to follow and cash could outperform. Please guide us through this slide and give us your feedback.

George Jiranek, CFA, Global Macroeconomic Research: Thanks James, and thanks for having me. Yeah, if we just take a look at cash, honestly the yield that we see today is a lot higher than we've seen in a long time, and you'd actually have to go back to the early 2000s to be at these levels. And at the current juncture yields more than bonds. But, even given this more favorable starting point, we actually don't think cash will outperform bonds over the long-term and as you mentioned, we think it's important to consider the current environment that we're in, one in which the Fed has just paused after a significant tightening school. So this is what we show on this page. So the left hand side chart shows the Fed Funds rate back to 1960, and then each vertical line represents a moment in time where they've paused. And then on the right hand side, we show some summary statistics from each of these episodes and a couple key points jump out to us here, first being in almost all of these instances, cash actually ends up lower than its original starting point almost three years out. And then second, in many of these episodes, cash actually comes crashing down and declines quite significantly. While this is not our base case, as we see a series of moderate decreases over the coming year, it just highlights the risk of holding cash in such an environment. So in some, while cash rates might be appealing today, they look like they're in a place to head lower going forward.

James: Excellent, thank you so much, George, appreciate that. I think that's a great transition to our next section where we will turn to Guillermo. Welcome, Guillermo. Thank you for joining us, we appreciate it. As we know, one of the major macro drivers for central bank policy is the path and trajectory of inflation. So let's talk about current developed market policy rates. Not just here in the U.S. but also in the Euro area and UK, and what are your expectations for the path of inflation and policy rates going forward? And you can talk about that on our next slide.

Guillermo Felices, PhD, Global Investment Strategist: Thanks James. Yes, so cash also runs the risk of underperforming other, in other important developed economies as you said, namely the UK and the Euro Zone. In those cases for example, central banks are also pausing and this has happened after significant tightening cycles there. And given the rapid fall in inflation in both regions, we think the Bank of England and the ECB are also looking to cut rates later on this year, and that of course will naturally lead to significant underperformance of cash.

James: Excellent, thank you so much, Guillermo. We're going to stay with you and move on to the next section where we will talk about the higher yield environment in the bond market. A resilient economy of course combined with relatively sticky inflation and also labor market strength, has led to a recent rise in bond yields. As a result, if we look at the yield on the most widely tracked benchmark for the bond market, the Bloomberg Barclays Aggregate Index, it has touched just over 5 and 1/4 percent as of today. We like to say in our circles that yield is destiny, right, so we'd love for you to share your thoughts on the potential connection between higher yields and future bond market returns.

Guillermo: Yes, look one of the most interesting developments in the bond market is that now we're back at yields that we haven't seen since the early 2000s. So the overall fixed income backdrop looks very promising. And furthermore, I mean those higher yields signal that returns in the next few months and years, are likely to be high, and actually not very different in magnitude to those of the yields that prevail at the start of those periods. So for example, if current yields are between 4 and 1/2 and 5 percent, then returns over the next few years are likely to be similar; so between 4 and 1/2 and 5 percent, around that vicinity. So in other words, yield is destiny in the bond market.

James: That's fantastic, appreciate that. That is definitely supportive for fixed income returns going forward. I think at this point we're going to turn back to George, and George, we're going to cover a little bit on starting yield levels for cash versus bonds, and how the correlations of those yields change over time with regards to potential forward returns.

George: Yeah, that's right. So in essence, for long-term investors holding cash actually becomes riskier than bonds. And to illustrate this, let's just look at the left hand side table, and so what that does is it correlates the starting yield, as Guillermo was just mentioning with forward returns. And we do this for both cash and bonds. So if we look at the top left hand side cell, we see that the starting yield for cash has a 0.99 correlation with its forward return over a one-year horizon. Now if we go down a cell, we now see that the starting yield for cash has a 0.94 correlation with its forward return over two horizons. And then if we continue looking down this row, we actually see that the correlation drops. What's' actually interesting here is that if you go, column to the right and you look at the same type of starting yield and forward return correlations, you see it rises for bonds. So for a one-year horizon, the correlation is lower at 0.66, but it actually rises to 0.96 over five years. And what you see on the right hand side is a visual depiction of these correlations. So the starting yield becomes more correlated for bonds than for cash as the horizon increases. And the reason for this is because of the duration embedded bonds which offsets the yield chains that you observe over time. And this is particularly important for long-term investors who have potential liabilities that have duration in them. And so by holding cash you have a mismatch between your duration and your, between the mismatch in, between your assets and liabilities in terms of duration. So it's important to consider holding bonds in this context.

James: That's fantastic. Thank you, George. And Guillermo, I'm actually going to turn back to you now, and go back a little bit in the presentation to a slide that talks about the current yield and equities, the earnings yield versus the risk free yield in Treasuries, the 10-year. I'd love to hear your thoughts about the differential there and the environment that we're in currently where actually yields look attractive versus equities, for bonds versus stocks.

Guillermo: Thank you, so the main take away of this slide is that equities are no longer cheap relative to bonds. After years of that being the case. So in the chart on the left, you can see that U.S. Treasury yields at the 10-year point are now actually above the U.S. Equity Earnings Yield. And if we exclude the [inaudible] crisis, this is the first time that we see that in the last couple of decades. Now on the right hand side, you can see the difference between those two metrics, which shows the gradual decline in the relative attractiveness of U.S. equities versus bonds from a yield perspective. So again, it's just to show that the value in bonds is a lot more interesting relative that to equities, compared to the last few years.

James: Fantastic, thank you, Guillermo. At this point in the conversation, we are going to turn to Robert. Welcome Robert. Let's now take a look at some cross asset class historical performance trends, bringing in some of the comments from George and Guillermo about relative valuations and equities versus bonds and cash, and kind of look at historical performance. So as we move on to the next slide in our presentation, we'd love to hear your thoughts about cash, bond, and equity performance with a focus on periods when we have equity market downturns and how in a lot of cases, bonds act as a better buffer than cash during those periods. So Robert, thank you for joining us.

Robert Tipp, CFA, Chief Investment Strategist and Head of Global Bonds: Sure, thanks James. So starting with this first graph on cumulative returns since 1990, you can see that stocks have been a tremendous wealth builder over the long-term. The top line here, the dark blue, that's the S&P 500, the green below that, high-yield corporate bonds, then investment grade corporate bonds, the [inaudible] treasuries, and at the very bottom is cash. So, no doubt over three, four, five decades,100 years, stocks have done great. The problem becomes one of time horizon, whereas with cash you had very little certainty as to what your returns were going to be over time. Stocks have a similar problem in the five, 10, 15 year zone, where that uncertainty can cause big problems. So you can see here that the stock returns during the periods of high volatility, like following the peak in 2000 and global financial crisis, has steep drops and that erased basically 10, 20 plus years of cumulative returns. The equity returns we traced all the way back down to those of fixed income. The other thing to keep in mind on that time horizon is that from 2000 for over 10 years, the cumulative total return on equities was even negative, but it was not positive. And the same was true in the 1970s, where you basically had a horizontal decade for stock prices. And in both cases, to varying degrees, equities lost value. So in terms of time frame, if your time horizon is five, 10, 15 years, you can really have as high degree of confidence in the returns of stocks as you would say with bonds, as Guillermo went through on the yield is destiny of a period of say 5-10 years, that correlation between starting yield and returns, in that case by contrast is really very firm.

James: That's excellent Robert, thank you so much. Let's stay with you in the conversation, and dive a bit deeper into average returns on cash compared to bonds during similar historical periods actually when equities have fallen by at least 5 percent. So we'd love you to walk us through the next slide and tie your comments into our current views on where we are in the Fed cycle, or at least where we think we are as a firm, and the impact that that could have, the potential returns in cash versus bonds.

Robert: Sure. So the graph to the left here shows the return for bonds in blue and for cash in gray, in quarters like you said, where equities have been down more than 5 percent. On average bond returns have been a couple percent, 2 percent, cash one, and so that is some kind of a positive buffer. The table to the right though breaks this down as you suggested, into three categories of periods; when the Fed is hiking, when the Fed is on hold, and when the Fed is cutting. And as you can see, the column of the Fed hikes is red, this is a bad period for asset classes across the board, nonetheless, bonds do outperform equities in that scenario. But we're in the point in the cycle where we're probably beyond Fed rate hikes, the Fed is probably on hold or cutting and in those two columns you can see that bond returns have been solid, both in absolute returns and really very strong in relative returns. So the prospects from these yield levels at this point in the Fed cycle, suggest pretty good prospects for bonds as a shock absorber from current levels relative to stocks.

James That's excellent, Robert and I just want to reiterate for our audience that we do in fact think we are either in the hold or cutting cycle and the chances or prospects or probabilities for hikes from here, despite lots of talk in the market, are relatively low in our opinion. Excellent. Alright, so let's continue on with Robert, we'll talk about our final slide in the presentation to close out our conversation. So we've talked a lot about today about how bond yields currently are historically attractive compared to the earnings yield available in stocks. So let's dive a little deeper into that topic, but instead focus on the performance of bonds versus stocks during periods where bond yields are relatively more attractive. Robert, please walk us through this.

Robert: Sure, yeah, this is a little bit of a complicated slide, but the results are really quite compelling. So it looks at, as you suggested, the difference between earnings yields on stocks and the nominal yields on the 10-year Treasury. And Guillermo had shown a historical series of that and how the earnings yield of stocks has pretty much eroded at this point, and bond yields are a little ahead of stocks. So that would put our currently location on the scatter chart to the left a little bit below the line. But more importantly, the graph to the right takes a look at investment performance in periods of time when either the earnings yield on stocks is about that on bonds, so the three bars to the left are when stocks are more attractive, the three bars to the right on the graph to the right, are when stocks were less attractive and bond yields were greater than earnings yields. The three bars are those of equities, or corporate bonds, and for treasuries. And what you can see here is that these are information ratios, of the, or sharp ratios, excuse me, sharp ratios so efficiency measures are return for the three asset classes in those two environments. So, equities, the sharp ratio deteriorates a bit from the left to the right, and that's not so much a function of returns going down as it is a function of volatility being higher for equities in these periods when the route evaluations have not been as favorable. On the bond side, the sharp ratios are really solid, they're rivaling equities in these periods of time and it is a function in this case of the returns rising. The volatility of bonds, regardless of the relative equity evaluation, is not that different, it's the returns. So on the bond returns have been at these favorable levels relative to equities bonds have tended to be quite competitive, which really is the whole argument for the webinar here, reevaluation, revaluation of bonds relative to stocks, and looking at their relative expected performance, their cushion value is really quite striking at this point in the cycle.

James: Excellent, thank you so much, Robert. And as we wrap up our webinar, Moving Out of Cash: Opportunities in Today's Shifting Markets, at this point I would like to thank George, Guillermo, and Robert for joining us and participating in this fantastic discussion. It has been a pleasure hosting all of you, so let's move on to our final slide, and summarize some key takeaways from today. First off as we have shown, equities have and may continue to perform well over the long-term but this might not be the best time to be overweight. And many clients we talk to are in fact heavily overweight equities. We saw some news that pension funds are possibly moving some money out of equities into fixed income, and that could be supportive for the market. Secondly, cash yields are attractive now but as we pointed out, are likely to drop as the Fed moves towards either stable policy for this year, but eventually cuts. Moreover, cash is riskier than bonds over the long-term in a lot of those scenarios historically as bonds have potential to outperform cash over the long-term. As we look at bond yields, we think that they are very attractive at these current levels, again with the aggregate index over 5 and 1/4 in yield, and you can allocate to high quality diversified fixed income portfolios, which is our focus at the firm, and get a very solid indicator, high coloration between that yield and your forward return as we like to say, yield is destiny, and yields are attractive. In addition to that, a positive return outlook for bonds or a risk reducer over the long run, first off bonds to match the long-term horizon of most investors. We are talking five to 10 years an out, and secondly, bonds tend to outperform or perform well as a shock absorber when equities fall significantly and with lots of geopolitical, domestic election risks, worries about potentially a slowing economy or a weaker labor market, we think the value of bonds at this point in the cycle is really important to focus on. That is it for our webinar, we really appreciate all of you joining us, and with that I will say thank you for your confidence in PGIM Fixed Income.

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IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of April 24, 2024.

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