The Pendulum of Central Bank Policies: Discerning the Effects on Asset Prices

Transcript

Keegan Gorman, Client Manager: Hello, and welcome to the Pendulum of Central Bank Policies webcast. My name is Keegan Gorman. I'm a client manager for PGIM Fixed Income and I'm very excited to be your host for today's conversation. I'm joined by a stellar panel from across PGIM Fixed Income's global economics and investment strategy teams. Including Katharine Neiss, our Deputy Head of Global Economics, as well as Chief European Economist, Tom Porcelli, Chief US Economist; and Guillermo Felices, Principal and Global Investment Strategist. So thank you very much, Tom, Katharine and Guillermo, for joining me today. If we turn to the first slide, thus far in 2024, markets have been shaped by shifts in central bank policy expectations across advanced economies. These shifts and expectations are coming in the wake of varying inflation growth and employment data within as well as across developed markets. A trend that we've not seen in earnest in the post-COVID era. Market participants now are closely parsing new economic data and the latest policymaker rhetoric. As the implications of a less-synchronized global central bank policy mix are getting priced into each sector of the market. Today, we'll aim to revisit and update our outlook for central bank policy across the advanced economies, as well as what these evolving policy backdrops mean for risk assets globally. So Tom, maybe I'll start with you. Just given the cues that other central banks have taken from the fed in the past, forecasted fed funds, at least what they've been getting priced into the market. Shifted pretty dramatically here in 2024, ranging from expectations for half a dozen policy cuts at the beginning of the year. To now a real question as to whether the fed will initiate any easing at all in 2024. What's your impression as to where the most recent string of strong economic data leaves the fed in its current projection for three cuts in 2024?

Tom Porcelli, Chief U.S. Economist: Well, Keegan, first good to be with you and my colleagues, Katharine and Guillermo. Look, I think, you know, we've had all these big swings, right? I mean, if you remember at the beginning of the year, the market was forecasting six cuts. You know, the market has since scaled that back and the fed, currently, as you rightly highlight, has three cuts built into their Summary of Economic Projections. I think three cuts is going to be tricky for -- to see that come about. You know, I think, at this point, our view is they'll get one cut in this year. You know, maybe they try to squeeze in a second cut this year, but I think about this in the context of Jay Powell, and Katharine and Guillermo have heard me say this many times. I think Jay Powell is more of a dove than he is a hawk. And I think, you know, when he sees like -- and if you go to my slides, my first slide, you know, my first slide, you know, that's just the labor market. And what you can see is the labor market is slowing down. Again, I think people always want it to be, you know, sort of very definitive, right? Like it's slowing down into recession or it's, you know, accelerating into an expansion. What we're showing here is that you're slowing down in a healthy sort of way, right? I mean, things have been very robust from an economic perspective in the US. And so what we're seeing now is the slowing, particularly in the labor [inaudible]. I want to be clear. It's taking time for this to evolve, but I think, you know, sort of beneath the surface, you are seeing some slowing and I think that this is I think going to be very welcome from the fed's perspective. And I think this is the thing that I think Powell is really focused on. Again, make no mistake. There's a question that he'll keep on saying it's all about inflation. I totally get that. I think we all do. I think we all appreciate that. But I think the thing, you know, you'd step back and you think about that last meeting where it would have been very easy for him to have sounded hawkish but he didn't, right? He sounded dovish and I think the reason he did is because he's aware of some of these little cracks that are forming beneath the surface of the labor market and I think he wants to protect the downside. So, you know, sort of just to bring that whole idea full circle, the fed, you know, the next move will be a cut, will not be a hike, which some people have been talking about of late. And I think he'll try to get in as many cuts as he can. Again, I think it's probably one this year, with the possibility of two, and the reason is because of those charts that you see right there.

Keegan: Thanks, Tom, and at his most recent press conference, Chair Powell, again, faced the question on the effectiveness of monetary policy alone in achieving the 2% target on inflation. And in your opinion, has anything changed structurally here in the US to make monetary policy less effective in controlling this recent bout of -- about trend inflation?

Tom: You know, I think -- I love this question because it's one that is being asked quite a lot, right? I mean, and it's really framed in the context of, you know, should policy be even higher, right, to control inflation. And I think the short answer is no. I don't think it needs to be higher. I just think that policy is just not working with the same sort of, you know, sharp teeth that it has in the past. And one of the key reasons for that is, you know, if you think about sort of the two big entities in the United States, right, the household and the corporation. They both do something very smart. They both basically termed out their debt. And, you know, and it wasn't just, you know, in the wake of the pandemic, though many did. It was even leading into the pandemic. And if you think about sort of, you know, the US consumer, the US consumer, they're basically their biggest debt burden is their house. Well, in the United States, we obviously have fixed-rate mortgages and most people use fixed-rate mortgages. And so, you know, in that whole period around the pandemic, leading into it, and just after, you know, you had quite a lot of people that were basically terming out their biggest debt load. Corporations did exactly the same thing and I think this really sort of helped sort of buffer all of the tightening that the fed did put in place. Of course, make no mistake. There was also the element of excess saving that obviously helped buffer, you know, the backdrop from the aggressive tightening of the fed to put in place. But, you know, one thing I would highlight is but you are starting to see some of that. Some of the tightening is starting to sort of clamp down now. And I think you can see that in delinquency rates. You know, if you look at delinquency rates for credit cards, and you're even starting to see this in auto loans, to some extent, too, but just to sort of pick on credit cards. You know, if you look back even just like a few quarters, a couple of quarters, what you would see is that delinquency rates were rising mostly for lower FICO scores, but that's not happening now. Now what you're actually seeing is it's bleeding up, right? Now you're actually starting to see more near prime FICO scores really start to get sort of clipped by the rising delinquency rates. And this is higher rates starting to sort of bite, to some extent. So no, you know, so that's a long answer to your question, Keegan, but I think, you know, again, the short answer is I don't think anything is really fundamentally changed. It's just taking more time given all of these factors that I just highlighted.

Keegan: Thanks, and maybe finally, should we expect any changes in the next Summary of Economic Projections in June from the red in terms of the number of cuts that they're signaling to the market. Or is it just too soon for that change?

Tom: Yeah, no. It's, again, it's a fair question, and I think the short answer is yes. I think that they're going to have to change and, you know, to my sort of my first response to you on the first question, look, I think right now the fed is forecasting three. I think that drifts lower. Whether it's one or two, I guess is open to debate, but there's almost no question that you're going to start to see that drift down. You know, the one thing that sort of as a -- as an add-on to that, I would highlight a couple of things and I have these in these couple of charts. I just I want to make sure people are very clear on a couple of things, and so actually this chart here is probably a good starting point. And I'll try to keep this very brief. It looks like just a bunch of lines on this chart and I guess it is. But I think they're really interesting lines. And what it shows is during election years, right, because obviously this is an election year. The fed has absolutely adjusted policy during election years and the chart in the upper left, that's what that basically shows. It's just it's fed funds indexed to one at the beginning of the year in each of those election years. And what you'd see -- and what you see from that chart is that policy does get adjusted quite a lot over the years in election years. And then the upper-right chart and the lower-left chart, those are on the same basis, right, indexed to one at the start of those election years. That's the inflation rate, core inflation, and the unemployment rate. And so what I've been saying to people is there's no question that policy has been adjusted in the past during election years. But the backdrop has to demand that the fed make those adjustments and I maintain that idea. So if the backdrop does not demand that the fed adjust policy, you know, at say the September meeting or the November meeting, right, two meetings that are sort of sandwiched around the election. If the data don't demand it then the fed won't do it. But thinking back on what I said earlier about Powell, and how he's dovish, and how he is I think looking for -- or he leans dovish and how he is looking for opportunity to adjust policy. I don't think the hurdle is all that high for them to actually go and make adjustments to policy. Again, I think people think -- might think that a hurdle is incredibly high just, you know, sort of given the inflation dynamic. I'm not so sure about that. Again, it's not necessarily that we're saying that they will do it in September or November. I'm just simply saying I think given Powell's inclination, which is to say try to protect the downside of labor, I think that you have to recognize that it's absolutely a possibility. And in fact, in our -- and again, in our base-case view of them doing one and trying to squeeze in a second. I think that's where this idea, I think, comes in pretty handy as a way of framing what could happen over the balance of a year in an election year.

Keegan: Thank you, Tom. Appreciate the thoughts. And Katharine, maybe shifting now to your perspective, as we look outside the US across economies in the Euro area, we're beginning to see growth in inflation dynamics to verge a bit vis-à-vis the US. And notably if we look first at the UK, we've now seen the most recent GDP reports surprising somewhat to the upside. And despite this upswing, the UK and the Bank of England, they've still managed to move further in the disinflation journey. So what's different in the underlying growth in inflation picture that's playing out in the UK?

Katharine Neiss, PhD, Deputy Head of Global Economics and Chief European Economist: Well, thanks for having me. And I think first we have to really recognize that the inflation shock here in Europe, and I include the United Kingdom in that, was an energy shock first and foremost. And this slide, on Slide 6, that should have just come up, I think illustrates this point quite nicely. If you compare, for example, the United Kingdom and also the Euro area, Japan, which we can come on to talk about in a moment, with the US. You can see a much clearer picture if you look at near-term trends in core inflation of how that sort of went up and is now coming back down. Because what happened was this energy shock really hit households' cost of living. We had a cost of living crisis here in the UK and elsewhere on the back of this higher energy cost and that led households to retrench. Now, though, that the energy shock is more in the rearview mirror with inflation coming back down, household real incomes are starting to rise, again. And that is really underpinning consumption and this recovery economic activity that you highlighted. And so that more clear picture of inflation coming back down is not only giving, I think, central banks like the one here at the Bank of England confidence that rate cuts are probably quite imminent. It's also helping to underpin this cyclical recovery.

Keegan: Thanks, and you alluded to Japan. I'd be curious how should we think about, you know, the central bank policy impacts on Japan. And, you know, the weakness we've seen recently in the yen and as well as the Ministry of Finance stepping in to support directly?

Katharine: Well, the Bank of Japan, of course, has been quite out of step with many central banks globally and that really reflects its very long experience of exceptionally low or deflationary period that we saw. But even there, as a consequence of the energy shock, we have seen inflation in Japan pick up. You can see, for example, in the chart, the green line is going above the red dotted line, which would point to the level consistent with the 2% inflation target. And so that has really helped the Bank of Japan for the first time really in decades to normalize its monetary policy. But even having done that, I think this resilience coming from the US and rates being higher for perhaps longer than what people had been expecting. Is putting pressure on the Bank of Japan to normalize even more quickly than perhaps it might like to. And that's really showing up in this weaker yen where, as you mentioned, we've seen some intervention. But, of course, intervention is only going to have a very short-term effect, in my view, and to really cure the problem of a excessively weak yen, you're going to need to see interest rates go higher. And I think people got a little bit excited about this when the Bank of Japan released, for example, their latest set of minutes. Which did indicate that some Bank of Japan policymakers there were deliberating higher rates over the course of this year where we've seen some repricing. As well as ending -- starting, apologies, a quantitative tightening a little bit sooner than perhaps people had been expecting, and then possibly even as soon as this summer. So again, we're seeing a big shift here, I think, on the stance of monetary policy in Japan.

Keegan: That's great, and moving on to the Euro area, you know, I wanted to hear your latest view as well on the growth in inflation backdrop there. And maybe whether we should expect the periphery countries to continue powering growth in the Euro area and whether that could provide any greater risk to the upside for ECB's policy rates.

Katharine: So this is a really unusual situation for people who've watched the Euro area, that we're seeing the peripheral countries, that is your Italys, your Spains, Greece, Portugal. They have been doing very well in the last 12 to 18 months coming out of the pandemic. But if you move to the next slide, Slide 7, you can see so these yellow bars outperforming the blue bars. That's these peripheral countries doing really very well. You can see that actually in the most latest data, we are now seeing some of the core Euro area countries, your Germanys, your Frances, of the world, starting to recover, as well. So it is looking a little bit more broad-based. That said, I think we need to, you know, not get overly excited about the picture in Europe because overall growth is still pretty weak. And that backdrop, combined with the fact that, you know, like in the UK, there are these more clear signs that inflation is coming off as the energy shock from 2022 dissipates in the rearview mirror. This, again, I think can give us more conviction that ECB rate cuts, for example, are really right around the corner. So, you know, before I, you know, kind of step back and let my other colleagues, you know, just to take a kind of big picture view on the global economy. I think broadly speaking, you've got some central banks that are a bit out of step like the Bank of Japan, but big picture, I think these rate cuts are really on their way. You've seen it already for quite a few emerging market economies and even some developed market economies like Switzerland and Sweden. And I think all of that together with this energy shock dissipating can give us more conviction that these rate cuts really are right around the corner.

Keegan: Thank you, Katharine, again, for the update on the latest shifts across central bank monetary policy. So Guillermo, we've just heard that, you know, for the first time in the post-COVID era, we're set to potentially see a shift to easing across central banks. And then maybe a difference in the sequencing of those policy eases. And you're tasked with the not-so-envious job of interpreting the implications of this on asset price dynamics globally. So how are markets reacting to this shift and what are you seeing in terms of price reactions?

Guillermo Felices, PhD, Global Investment Strategist: Yeah, thanks for having me, and yes, so Katharine was exactly right when she said that some of the major Western central banks are ready to cut. You can see that on this slide. Inflation has made a lot of progress in the case of the US, the UK, and the Eurozone. And what I think is interesting here is, you know, how the prospects of those cuts are, you know, are evolving. So the market has formed different views in terms of, you know, how these central banks may proceed. And, of course, it's pricing that at quarterly rates markets. So on the next slide, what I would point out is that the first set of differences, if you want, among these central banks is the timing. So the first cut is expected to take place in the Eurozone. So markets are pricing in the first cut in June. Then the Bank of England will follow according to markets in August. And then the fed would follow those two by cutting in November according to markets. And that's what you can see on the left-hand side. The probability of a June cut is really elevated in the case of the ACD but not so much, for example, in the case of the [inaudible]. Now the second area of differences in the way the market is interpreted in pricing these cuts, is that the market is pricing in deeper cuts in Europe this year than in the US. So on the right-hand side, what you can see is that the market is expecting two to three cuts by the ACD and by the Bank of England. But in the case of the fed is actually expecting less than two cuts this year. And then the final point I would make is that from mid-April onwards, basically what you've seen is that the market is also adjusting to the latest incoming data. So activity data in the US has been coming in a little bit weaker relative to that in Europe and this has meant that US yields have actually fallen a bit, kind of bit more than in the Eurozone. So that's also reflected in the relative interest rate differential across regions.

Keegan: That's great, and given the likelihood of these upcoming cuts is increasing and, you know, almost priced to near certainty. Can you tell us what that means for financial assets and how the various asset classes are likely to perform?

Guillermo: Sure. So look, for broader-based markets, at least so far, this is a comfortable environment. This is comforting because the prospect of cuts against this backdrop of, you know, slowing but still resilient growth generally in the US, in the Eurozone, even in the UK. You know, this is actually supportive of risk markets, of credit spreads, of equity markets. Now from a cross-asset point of view when the fed pauses and embarks on trend cycles, generally that's good for bonds and good for equities when it comes to returns. But I think we need to consider two scenarios here. The first one is similar to our base case where we expect basically gradual cuts by the fed, by major central banks, as growth and inflation ease. And typically in that sort of environment, equities and bonds deliver positive returns. But the volatility associated with bonds tends to be lower than that, you know, for equity. So typically, in a risk-adjusted basis, bonds stand out. But when this is a little bit more complicated is, you know, in a second scenario where you have deeper cuts which is not what the market is expecting now but it's a, you know, it's a risk. And the likelihood of recession, you know, it increases. So typically in that sort of environment, you have more aggressive cuts. Typically, you have risky assets selling off and bonds rallying and delivering, you know, a very impressive performance. So if you go to the next slide, you will see that typically when you have this sort of, you know, negative equity performance. Typically bonds outperform in cutting cycles or when the central banks are on hold relative to cash and to equities. So in other words, you know, bonds give you, you know, these very nice kind of property of being a very effective shock absorber.

Keegan: Thanks, Guillermo, and maybe if we take a step back and move away from some of the more, you know, recent market reactions to these upcoming cuts and think about a longer time horizon. How should a long-term investor think about bonds just given today's starting point yields?

Guillermo: Yeah, look, so bond yields have adjusted higher. So if you look at the next slide, you will see that, you know, bonds are back at, you know, very interesting levels. In the case of the US, 4.5% or so. And we refer to, you know, these new, high level of interest rates as basically the bond market being back at the strategic buy zone. So that's typically good because it means that your bond returns over, you know, a number of years tends to be quite high. Actually, you know, if you look at the sort of returns that you get say, you know, over ten years. Typically the [inaudible] return that you get is not very different to the starting level of yields at the beginning of that ten-year period. So on the right-hand side, you can see, you know, three or four different, you know, periods where essentially when we have high bond yields. Typically the return that you get after that is actually not very different. Then the final point to make is that, you know, cutting cycles by central banks, you know, typically act as a catalyst for, you know, this, you know, valuing bonds, so for opening value bonds. And that's exactly what we're, you know, what we're likely to see in the next few months.

Keegan: Thank you, Guillermo. So maybe in closing, turning to our summary slide here, we've heard more on the increasingly wide range of economic indicators across advanced economies. And the implications these may have for a potentially diverging path of central bank policies moving forward. Fed officials are still entangled in a balancing act and it's the latest bout of hotter than expected inflation prints. While some earlier sciences points you at a potentially softening labor market here in the US. The UK and the ECB, on the other hand, appear to have managed more significant progress towards their inflation goals while growth in both the core and periphery was robust in the first quarter. Given all this, the market is now expecting that it'll be the ECB and the Bank of England leading in the path of policy action with large probabilities of cuts already priced as early as June. As these policy cuts quickly become a reality, bonds appear attractive relative to cash given the performance we've observed during historical cutting cycles. And with rates sitting at levels not seen in over a decade, we continue our mantra that yield is destiny. So thank you, again, to the panel for joining the conversation today and thank you all for joining.

IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of May 23, 2024.

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