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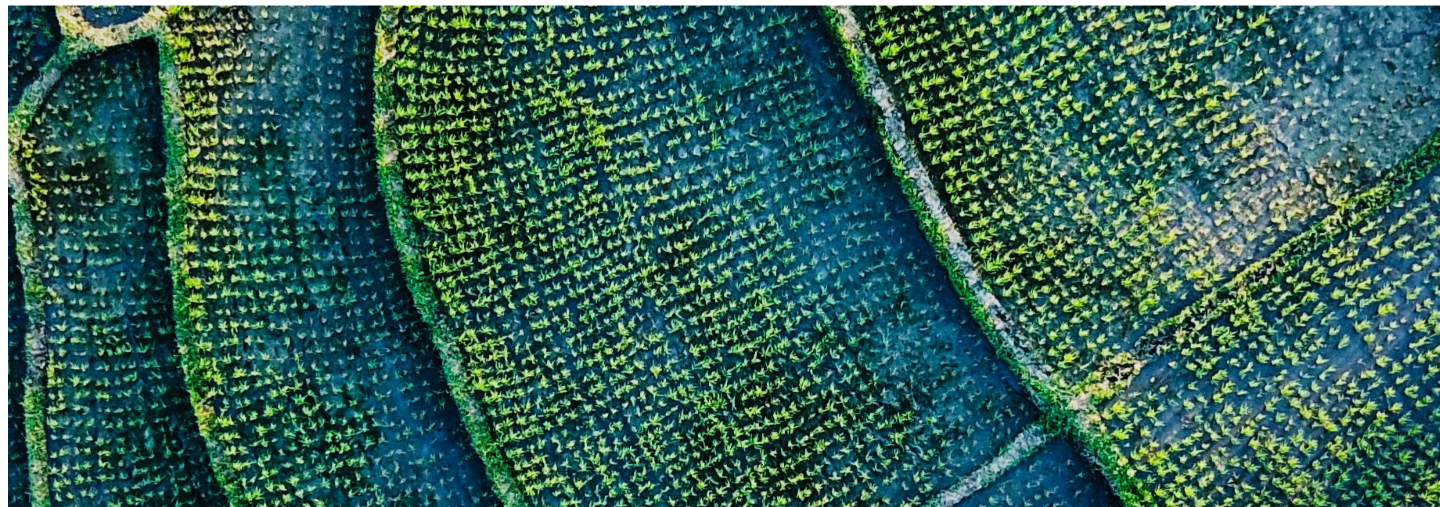


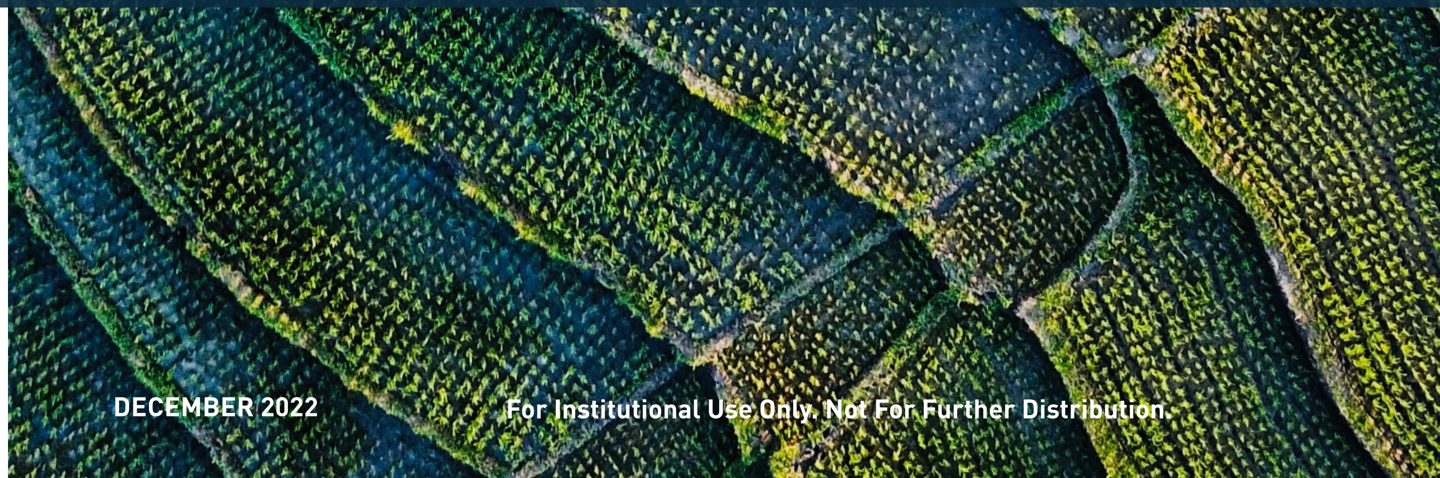
GLOBAL BOND TEAM

Medium-term Views & Outlook

Over the next 12 -18 months-is inflation likely to persist?

Will the Fed continue to tighten? Is a recession inevitable?

See what our Global Bond team thinks.



DECEMBER 2022

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Inflation

The result of this "keep vs. sell" evaluation enables Inflation is running hot as prices that were repressed by the pandemic rebound to more normal levels. We expect inflation to decelerate as labor markets and demand take a hit. We also acknowledge stickiness in shelter (US) and services prices, which may prevent a sharp rollover in price pressures. We see a low probability of a sharp, organic deceleration in inflation, though we acknowledge that this scenario is possible if we see significant goods deflation and an earlier- than-expected rollover in shelter. The Fed started a cycle of tightening at the March Federal Open Market Committee (FOMC) meeting, and has since turned more aggressive in response to stubborn inflation. In the US, the team expects a recession starting in early-2023 because of the many shocks to the economy, particularly aggressive Fed tightening. As a result, we believe we are beyond the year-over-year peak in headline and Personal Consumption Expenditures (PCE) inflation. European inflation is not yet decisively retreating in our view, which keeps pressure on the European Central Bank (ECB) and Bank of England (BOE). European recession is a consensus call at this point given the Russian gas cutoff and energy issues for households and businesses. The invasion of Ukraine and resulting sanctions have pushed up energy prices, food prices, and commodity prices. This ultimately means a higher and delayed peak in inflation, with average year-over-year inflation for 2023 sustaining above US levels. The process of building greater energy and supply chain resilience in the West combined with currently tight labor markets imply headline and core inflation are likely to recede slowly, and remain roughly 1% above central bank targets in late 2023, in our opinion.

Interest RateExpectations

Our above consensus expectations for inflation yet below consensus expectations for growth in the US and Europe would be consistent with a rise in yields followed by reversal to levels slightly above market levels - resulting from the late Q4 2022 global bond rally. In the US, we see policy rates rising an additional 100 basis points in 50-25-25 increments in the three Fed meetings starting in December, followed by a pause from March to September before rate cuts commence. Risk is for an even higher upper bound than 5.0% Fed Funds if the economic contraction and resulting labor market loosening is more delayed than we anticipate. Given that the Fed may be more hesitant to cut rates and support growth compared to previous recessions, we could see a lengthy period of yield curve inversion. We believe the inflation premium in the UK is being underpriced, and the BoE may turn more hawkish. Prospects for a Labour government should enter over a medium-term horizon, which in turn could prompt expectations of more fiscal actions and open room for the BoE to maneuver policy rates further. We believe these pressures may combine to lift yields at least 50 basis points higher from late 2022 levels. A strengthening inflation picture continues in Europe and is being met by a cautious ECB as the strong downside idiosyncrasies, given war, energy shocks, and a weak China doesn't help. As elsewhere, labor market dynamics and core inflation versus target rather than private sector economic weakness may dictate ECB actions. In our view, this should keep upward pressure on yields to levels back near the 2022 highs through much of 2023.

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Likelihood of a Recession

We view a recession as inevitable, but the timing remains uncertain. The downturn includes the US and other major economies slipping into recession by the end of 2022 (globally) and winter 2023 (US). Timing and scale are partly uncertain due to the benefits of a tight labor market, lagged pandemic recovery influences, and savings levels helping to provide a partial cushion against declining real incomes. Global manufacturing and services Purchasing Managers Index (PMI) fell into contractionary territory in October signaling broad-based slowing. Companies are losing pricing power and margins will decline as a result. We are waiting for the profits plunge to drive risk appetite down further. It hasn't happened this earnings season. We believe earnings will likely contract in 2023. A collapse in profits is a necessary condition for a recession. Downturn remains our highest probability scenario given yield curve inversion, worrying leading indicators, weak PMIs across the globe and continued policy tightening. Recession risks in Europe are extremely elevated, China's recovery has stalled (though news over the past few weeks has increased optimism with some adjustments to zero covid policy but none that leave room for near-term relaxation. Cases are spiking to very high levels). While exact timing is less certain, our conviction in forecasting a US recession is growing. We anticipate the contraction starting in Q1, lasting three quarters, to be followed by a shallow recovery.

We think spreads are at risk of leaking wider, and despite interesting all-in yields in investment grade credit we think patience on adding to portfolio credit profiles will be rewarded. We are in the middle of another bear market rally based off of current spread forecasts. In this downturn scenario we would expect to see financial conditions continue to tighten, spreads leak wider, and the dollar remain stronger for longer. We still have trouble forming a bullish argument for Broad FX within our downturn base case. We view FX valuations as out right cheap but the Fed is indicating that they will stay the course - whether other central banks decide to waffle or not. The US Dollar ultimately prevails in that environment. As our probability of US recession has increased, and with tentative signs of wage inflation peaking, we have shifted our duration strategy from defensive towards neutral. Consistent with Fed and ECB speak, we think it is too early to position for a benign wage and service price environment that allows a full pivot away from the policy tightening direction.

POSITIONING

Given the geopolitical landscape as well as the current macroeconomic backdrop, we are maintaining a relative credit exposure (or 'credit beta') at the lower end of our typical allocation range. We reduced credit beta in late 2021 as all-in yields of longer maturity credit bonds did not compensate for the combined risks associated with the changed monetary policy backdrop and advancing stage of the credit cycle. Currently, we believe valuations are attractive as yields and spreads are higher, which provides additional carry. However, an uncertain global economic backdrop with downside risks remains front and center. We are anticipating further economic deterioration as central banks continue aggressive monetary policy stances to curb inflation. We are maintaining a sufficiently cautious credit risk stance to leave room to add more should a harder economic landing produce excessive spread widening versus true risk of credit. We continue to monitor markets closely and have plenty of liquidity in the form of cash, treasuries, and short corporate bonds to capitalize on any market dislocation as we move into the 2023 calendar year.

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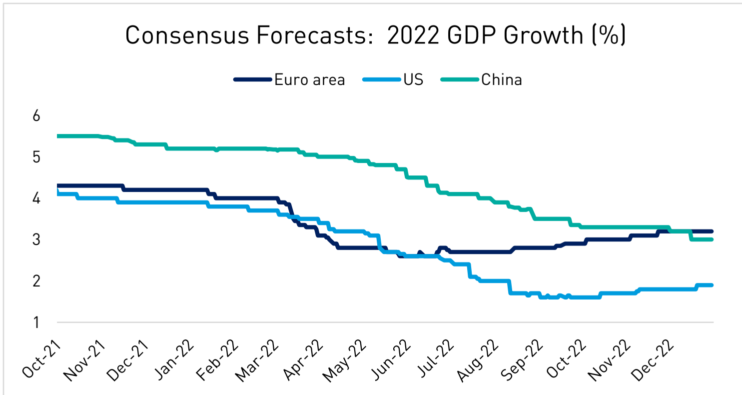
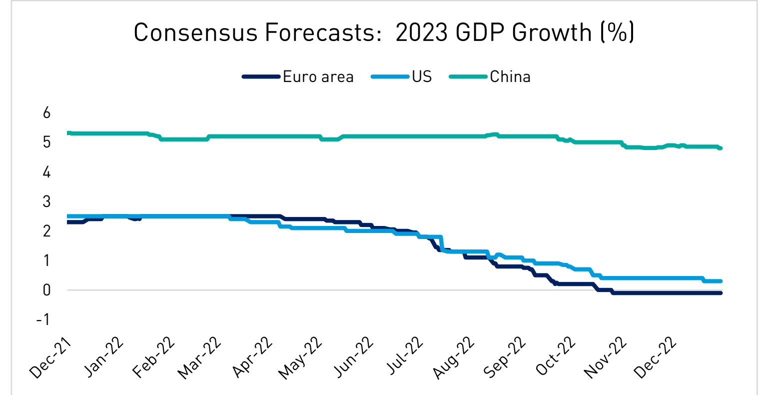
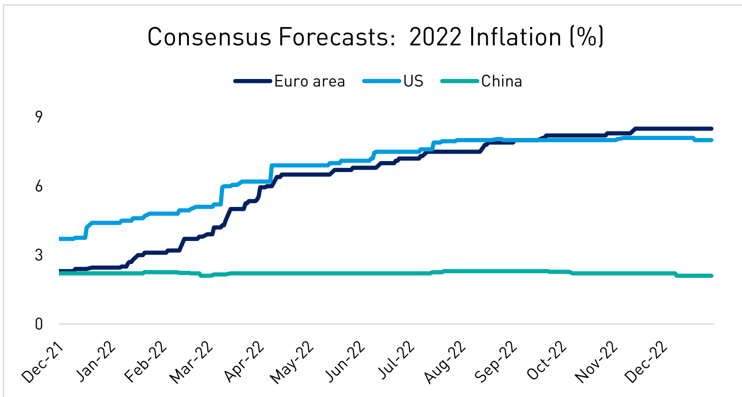
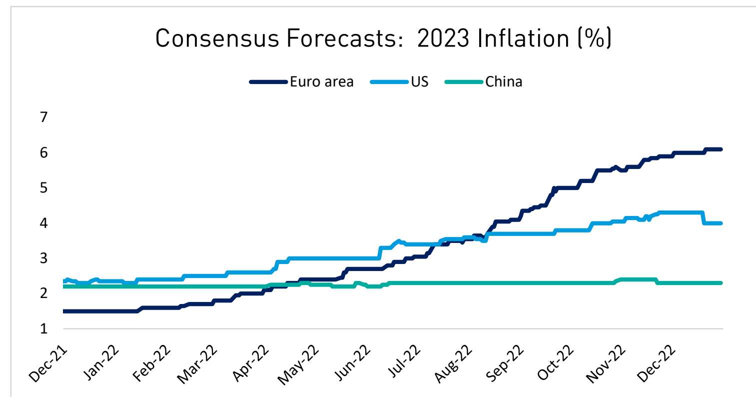
Consensus Forecasts for 2022 & 2023

DOWNSIDE RISKS TO GROWTH & UPSIDE RISKS TO INFLATION REMAIN DOMINATE CONCERN









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Past performance is no guarantee of future results.

AUTHORS

GLOBAL BOND TEAM

Disclosure

Past market experience is no guarantee of future results.

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Any investment that has the possibility for profits also has the possibility of losses, including the loss of principal.

Diversification does not ensure a profit or guarantee against a loss.

Commodity, interest and derivative trading involves substantial risk of loss.

KEY RISKS: *Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Non – US Securities Risk, Currency Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Prepayment Risk and Extension Risk*

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