

Audio Transcript: Yield Curve Dynamics and the Case for Duration September 8, 2023

Katie Klingensmith [00:00:01] Hello, everybody, and welcome to today's conversation at Brandywine Global, Around the Curve.

Katie Klingensmith [00:00:11] I'm Katie Klingensmith, and I am delighted to be joined today by Anujeet Sareen, who is a portfolio manager on our flagship fixed income portfolios here at Brandywine Global. There's always a lot to talk about, and especially today with Anujeet. We're going to dive into what's going on with the Treasury curve. What's driving it? What we like? Why? The risks? There's a lot to unpack. So actually, just to get a started, Anujeet, this year, we've seen quite a bit of movement in yields. What would you say was the biggest single driver?

Anujeet Sareen [00:00:42] Sure. So, Katie, I'd say if we focus, I mean, yields have moved around throughout the year, right? They fell in the first quarter. They've risen certainly since the spring lows. So, if I were to focus really on the last few months, and why yields have hit the yield highs that we've seen, I'd say the major reason has just been the resilience of US growth. You know, the Fed has hiked rates, as you well know, 500 basis points, and yet the economy has essentially accelerated in the first and second quarters of this year. And I think it's making people question whether the Fed truly is restrictive at its current interest rate. And perhaps the economy can not only withstand higher interest rates, maybe we should have higher interest rates, given the performance of the economy so far. So, I'd say it's growth resilience. I think there are some, they might talk about, you know, I think some fiscal largesse. And excess Treasury issuance is a factor. But I think ultimately that, too, is a consequence of excessively easy fiscal policies, which are supporting, you know, stronger growth. So, ultimately, I think it's about growth.

Katie Klingensmith [00:01:52] So, that's a happy story. And I know we can spend this conversation and many more talking about what we expect of the Fed. Just Cliff notes, how do you think the Fed is interpreting this perhaps more positive than expected growth data?

Anujeet Sareen [00:02:07] I think they're probably a little surprised at this stage. I think there's a lot of ruminations at the Fed on what is the neutral rate. They've hiked rates this much. And if you think the Fed is restrictive, right? If you think that whatever is neutral for the Fed, that they're well above that at this stage. The consequence of that is that growth then should be below trend. Right. So say, for example, the right neutral rate for the Fed is 3%, or even 4%. Well, the Fed is well north of five. The economy should be growing below trend. And the fact that it's not, I think is making the Fed scratch their heads a little bit saying, okay, is this because what we think is restrictive is really not that restrictive? Or, and I think this is really the question at the moment, or is it they just need to be more patient to see the lags of monetary policy flow through, and they'll be validated next year to say, okay, we did tighten enough. Things are slowing, and we don't need to do any more.

Katie Klingensmith [00:03:08] Clearly, we'd all love to see this higher trend growth, the Fed included. But inflation is the other piece here. What do you see right now in terms of the way inflation is trending in the US?

Anujeet Sareen [00:03:19] Yeah. So I'm going to frame this question really from, sort of, the two perspectives that I think exist on inflation at the moment, right? One perspective is that inflation is a wage-price spiral phenomenon. And if you look at wage growth, it's still

pretty high. You're seeing headlines of unions still getting some pretty big pay raises. And that's a reason to be concerned that inflation is actually going to stay elevated for longer than the Fed might expect. Larry Summers is perhaps one of the biggest proponents of that view. The alternative view is that inflation has been largely a function of some really excessive monetary and fiscal policies two years ago. We're not doing that anymore. And so inflation is normalizing almost regardless of the growth rate and tightness of the labor market. And that's more the view that I subscribe to. And I think there's some evidence to support that. If you look at inflation, it really split into two components: CPI, ex-shelter and then shelter inflation. If you look at CPI, ex-housing, essentially, or ex-shelter, that's fully normalized. That's growing at 1% year over year. Looks like, you know, we're back to what we were pre-COVID. Shelter inflation, of course, though, is still pretty elevated. But that's a lagged version of what's happening in the rental markets. And if you look at the rental markets today, they've actually slowed quite a bit. So, it's just, there's a bit of a catch-up on that aspect of CPI to unfold. So, I would contend that inflation is actually in a very significant way already normalized, and that's very encouraging to me in that we're no longer pursuing the irresponsible policies that generated it, and the economy is rebalancing in a very healthy way.

Katie Klingensmith [00:05:03] So that is Anujeet optimistic on the direction of inflation. We know that the Fed has been anxious to ensure that inflation is truly under control. What are they going to need to see to be able to at least keep rates on hold?

Anujeet Sareen [00:05:18] I think probably the two main things they are looking for are the two main things that drive their mandate. Right? Their mandate is price stability and full employment. And I think they are taking solace in the fact that, notwithstanding the actual growth rates in the economy, those two areas are slowing. The labor market, as we just saw on Friday, continues to moderate. Employment growth has certainly taken a downshift from where it was earlier this year. Unemployment did tick higher this past month as well, and the leading indicators for wage growth are also pointing to a further slowdown. I think the Fed takes solace in that. And then I think the other thing that they're going to keep continuing to track would be certainly the actual inflation data. You could parse it a few different ways, but I think they're generally encouraged by the developments there. They're not yet at a point where they can declare victory. But still, they've said they're data dependent, so they'll wait to see more of that data materialize.

Katie Klingensmith [00:06:16] What's the risk that the Fed keeps rates too high for too long?

Anujeet Sareen [00:06:20] I think that's a very real risk. They are at some level inherently conflicted because they are data dependent. But data dependent on policies that have long and variable lags. So, the Fed must at some level, has to at some level take a view on, okay, what we've done today will have this impact 18 months from now. And so, you cannot be fully data dependent if you're the Fed. And yet, nevertheless, they seem to be. Right? They're very much focused on the latest inflation prints. I think they do feel there's a degree of uncertainty that's making them be, I think, more shorter-term focused. And I think that does raise the risk that they've raised rates too high, or they'll keep them there for too long than the economy can ultimately withstand.

Katie Klingensmith [00:07:14] Switching back a little, you mentioned fiscal policy. We saw real Treasuries sell off after the Fitch downgrade. And that downgrade focused on long-term debt sustainability and our ability to address it politically. Are you concerned about the downgrade and the reasons for it?

Anujeet Sareen [00:07:32] I'm not really concerned about the downgrade. I don't think that it substantively changed investment decisions out there. But I think it is relevant insofar as it highlights what is an issue, which is that the US government is running a very large fiscal deficit, and that deficit got larger this past year. There are a range of reasons why that's happened. Some of it had to do with some of the fiscal packages passed towards the end of last year before the change in Congress. That's partly, you know, leading to a larger deficit this year. And there are a couple of other reasons that are driving it. Nevertheless, though, the fiscal deficit is really quite large, and it's gotten worse over time. And I think that is cause for concern. I think that is something investors are thinking about in terms of what kind of risk premia is appropriate. Should real yields be higher now to compensate investors for the fiscal, sort of, irresponsibility of the US government? So, I think it is playing a role. I wouldn't say it's more important than growth and inflation dynamics, but I think it is having an impact on, sort of, essentially, bond risk premia. You are you are taking on a Treasury that's borrowed a lot of money and will have to borrow quite a bit still in the years ahead.

Katie Klingensmith [00:08:52] That is one contributing factor why we saw yields move up. You mentioned early on that you really thought that the change in growth outlook is probably the biggest driver of this move up in Treasury yields. What's next in terms of growth, and what's driving it, especially in context of what's going to hit the yield?

Anujeet Sareen [00:09:13] So, thinking about, kind of, where the growth resilience is coming from. Right? It's really coming from the private sector. And the two specific sources would be household consumption, particularly through July was quite robust. We would argue that was supported by pretty reasonable improvements in real income growth this year. Right? Inflation's come down faster than wages, and that's certainly helping support some consumption. But the savings rate is also very, very low. That reflects a high degree of optimism or some latent fiscal support that households are still working through. We think that's largely exhausted by the end of this quarter. So, we think households will have to be a little bit more careful and likely return their savings behavior, maybe not quite to what it was pre-COVID, but certainly a higher savings rate than what it is today. And that will lead to some moderation in demand. And then meanwhile, the labor market is slowing, and we think that will slow further. And that should also, we think, ultimately, lead to more moderate consumption. The investment side, I think, is the more challenging piece to figure out, to be honest. On the one hand, again, it's the weaker profit growth in the fourth and first and second quarters of this year would suggest, along with a number of surveys, that investment spending should be more muted in the second half of this year and early next year. But there are a couple of important offsets. One, of course, is the tremendous focus on generative AI and the investment spending that that's generating. And then secondly, the fiscal support to building semiconductor plants and green technology. Those are offsets to, I think, some of the survey data that you're seeing.

Katie Klingensmith [00:11:09] How are you thinking about fiscal policy right now in terms of where yields are going?

Anujeet Sareen [00:11:14] Yeah, I mean, my sense is that there was, undoubtedly, some support for fiscal policy through the first half of this year. I think that's starting to fade. We are going to restart the student loan repayments in the next month. So that's going to start to mitigate some of that effect. And so as we head into the election next year, I think fiscal policy becomes much less of a tailwind to growth than it has been.

Katie Klingensmith [00:11:43] In terms of savings, when we came out of the COVID lockdown period, there was obviously a lot of accumulated savings. You mentioned that the savings rate is a lot lower. But that aggregate savings part of it, how much is that playing?

Anujeet Sareen [00:11:56] Yeah. So, there's a number of different ways to measure this. But if we think about the excess savings that was created partly because of the fiscal transfers and partly because, you know, folks couldn't spend money like they would normally in 2020, that excess pool of savings does look like it's being depleted. I mean, it should exhaust itself, you know again, by the end of this quarter. That's in nominal terms. In real terms, you could argue it's just about gone already. Right? because inflation has eroded the value of that savings. There really isn't much left at this stage. Now, does that mean that it's subject to fall off a cliff? Not necessarily. I mean, it should mean that people become a little bit more focused on saving more of their current income. But, you know, their net worth is in pretty good shape, right? Equity prices have done reasonably well. Home prices have done reasonably well. So, I think people are feeling pretty confident, which is why the savings rate is so low. But nevertheless, to your question, I think that excess saving is largely gone, and it should lead to somewhat higher savings and, therefore, a little bit more modest consumption.

Katie Klingensmith [00:13:07] So, a lot of different factors driving growth, a lot of different factors driving inflation. What do you really see could be the catalysts for moving yields lower from here?

Anujeet Sareen [00:13:16] So, I think it'll be, my guess is at least, sort of, three different forces that converge. One would be a continued moderation in inflation. I mean, the one perspective, although I didn't mention this earlier, but if you think about inflation also strictly as a monetary phenomenon, money growth is contracting this year. And to the extent that money growth matters for inflation, it's possible that the Fed overshoots their inflation target to the other side at some point next year where inflation goes well below two. So, that certainly could be a catalyst for lower bond yields. I think the second catalyst is that we are coming up on that lag of monetary policy. The Fed started hiking rates in March of last year. It takes about 18 months. It could take up to two years, maybe two and a half years to fully play out or fully feel the effects of what the Fed has done. Well, that should start to intensify now over the coming quarters. So, growth growing below trend would certainly be a second catalyst. And related to that, growth being below trend would be associated with weaker employment growth. So, if we started to see the unemployment rate tick higher into the first half of '24, I think that certainly would help bond yields perform. The last piece would be, you know, a financial event of sorts. Now, those are always hard to anticipate and predict. But what we saw, I think, in March with the regional banking system, I think while that was not a systemic issue in the end, I think some other area of the financial markets or economy gets exposed because they borrowed too much. Now they've got to pay a lot higher interest rates. I think that's still a risk that sits out there, and that could also be a catalyst for lower yields.

Katie Klingensmith [00:15:02] How much is quantitative tightening right now driving dynamics in the yield curve?

Anujeet Sareen [00:15:07] Yeah, it's a good question. It's really hard to pin that down. I think it's worth thinking about in the context of just fiscal policy. So if, or the deficit rather. So the Treasury is issuing a lot of bonds, and the Fed is selling a lot of bonds. So there's a lot of supply that's hitting the market together, and that's surely playing some role on the

level of bond yields. Again, I don't think it's the primary driver. Ultimately, if there was real concern about this, the curve would be a lot steeper than it is today. Right. Because that's where risk premium, you know, you express that through a buyer's strike on long bonds. The curve is still reasonably flat. So I think it's still more of a focus on the overall term structure, which is more a function of the variables we just discussed, growth and inflation.

Katie Klingensmith [00:16:04] So, we talked about quite a few short-term cyclical factors, but also some long-term structural factors. I think we're getting asked more and more in the marketplace has the equilibrium for the 10-year shifted? What do you think?

Anujeet Sareen [00:16:15] Yeah, it's a good question. Important question. So, if you look at the inflation-linked markets, the TIPS market, real yields range between, kind of, minus one and zero for much of the last decade. And if you look at where yields, that's rather minus one to plus one. If you look at where real yields ranged prior to the GFC, it was between one and three. We'll we're now 2%. So, I think one of the questions that's being discussed in the marketplace is, okay, maybe that post-GFC period was just an unusual period of balance sheet recession. You just had to have super-low real interest rates. But that period's done. Balance sheets are fixed. And so maybe we're going back to the pre-GFC world, in which case real yields range between one and three. And right now we're two. So perhaps we're in the middle. Perhaps at the peak of the cycle where actually will go to 3% real yields. You add 2%, 2.5% inflation on that, you could get 5, 5.5% 10-year yields. That would be one view. I would suggest that, I think, that's unlikely. And it's unlikely because the economy is already showing that to you in the ways that matter. If interest rates are restrictive, we would start to see it in certain places. Well, certainly if you look at mortgage applications for new home purchases, right, they're in the doldrums. They're at the weakest level in two decades. That's telling you interest rates are hurting. If you look at bank lending growth. And by the way, not just banks tightening lending standards, but banks telling you whether they're seeing demand for credit. Both are really weak, which tells you, again, the level of interest rates is having a deleterious effect on the economy and private sector decisions. So, from our perspective, we contend that the equilibrium real interest rate has likely shifted up. But we're already at a level that's causing, we think, downward pressure on the economy. And, therefore, we think it's more likely the case that we're peaking around these levels at a 2% real interest rate.

Katie Klingensmith [00:18:32] Given all of these different factors and indicators, where on the curve would you find most attractive?

Anujeet Sareen [00:18:38] The yield curve, of course, is still pretty flat and inverted in certain parts of the curve. And so, as we think forward into next year and the likelihood of a slowdown that would have the Fed sort of reversing course from where they are today, that would be a world where the curve is likely to steepen, particularly if we still have a lot of bonds that have to be financed on the longer end of the curve. So, we think it is appropriate to be moving down the yield curve and buying exposure closer to the intermediate part of the curve in 5-year bonds, 10-year bonds, more so the 30-year bonds to.

Katie Klingensmith [00:19:16] Alright. So, this is a great big other topic, but I just want to get a quick summary. How would you put the dynamics of the US yield curve, the Treasury curve, in context of what's happening globally? And what might that mean for flows in and out of the US and for the US dollar?

Anujeet Sareen [00:19:35] Sure. So, I'll answer this, there's a cyclical component to this and a structural component to this. The cyclical piece would be there's certainly been concerns that as the Bank of Japan has lifted the cap on their bond yields, removing yield curve control, that higher Japanese yields would also lead to higher Treasury yields as less capital would come from Japan. I think there's concerns about that. But I think the offset to that is that the Chinese economy has been really weak, right? China is more of a source of disinflation, if not deflation today. So, I think the global forces on the US yield curve are probably muted at this stage. I think the longer-term concern is really, I think, a structural shift, particularly by the BRICS, to diversify out of US dollar reserves into other assets, gold in particular. But I think, given how the US responded to Russia and really excluded it from the financial system because of the Ukraine war, I think there are other countries that longer term worry that if they end up in a situation in conflict with the US or even indirectly in conflict, that they'll also be shut out. And therefore they are taking steps to protect themselves. And that means that they want to rely less on the dollar as a transactional, as a reserve currency than they have previously.

Katie Klingensmith [00:21:07] Well, thank you so much for covering so much ground today, Anujeet Sareen, and for being part of the Around the Curve podcast series at Brandywine Global. Thank you, everybody, for listening.

Anujeet Sareen [00:21:16] Thanks, Katie.