

# Macro Perspectives

Recession, inflation and duration considerations



## Introduction



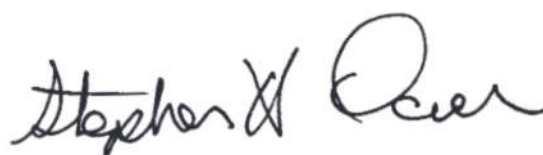
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From a macroeconomic perspective, 2022 centered around the actions of reserve banks around the world. While the fight against inflation continues into 2023, the discussions are more focused on recession and potential weakness in the US dollar. I recently gathered with some of our economists across the firm to discuss these topics—here are some of my key takeaways:

- **US inflation is trending lower, but the fight isn't over yet.** This contrasts with Europe, where inflation remains higher and has not peaked. Asia has generally seen milder inflation. Japan, for the first time in over 20 years, is experiencing inflation and positive real interest rates. Our economists disagree on how quickly and how far inflation will fall. The market consensus suggests US inflation will run at roughly 3% for the full year. Internally, we have a healthy debate on how quickly inflation will fall and whether it will get to the US Federal Reserve's (Fed's) 2% target.
- **Interest rates are near peaking.** In the United States, we expect the Fed's policy rate to rise to at least consensus expectations of around 5%, with the possibility of reaching 5.25%. Our economists disagree on how long the Fed will hold rates at the higher level. The implications for fixed income and equity investors are that the Fed is unlikely to provide a "Fed put" if the market has a correction.
- **How deep might a US recession be?** One could describe 2023's economic outlook as "the most-anticipated recession ever," with surveys of economic forecasters and market behavior in 2022 providing the evidence. Everyone seems to "know" the United States is going to have a recession, and everyone seems to "know" it will be mild. Whenever "everybody" thinks something, that type of herd mentality makes me nervous because often the herd is misguided. I gain some comfort from internal discussion and healthy debate among our economists, whose views on recession vary from the possibility of no recession at all, to a "normal" recession, which typically lasts about 10 months.
- **Time to consider increasing fixed income allocation.** Fixed income is now providing income again. Rates are near a peak, and 2023 may be a year of positive returns for fixed income. We see a general shift toward larger fixed income allocations no matter how one is currently positioned.
- **There's a quality bias when leaning into fixed income.** We believe investment grade and sovereigns are particularly attractive in this environment, with continued economic uncertainty perhaps providing opportunities on a selective basis in areas like high yield.

- **Opportunity outside of the United States.** This year, analysts expect US growth to come in below that of Japan—which has not happened for over two decades—while emerging and developed Asia overall will likely see higher growth than the United States. Meanwhile, Europe’s economy is doing better than many forecasts expected, due largely because of a mild winter.
- **Expect volatility.** While our economists agree that taking a long-term strategic view suggests taking on a bit more duration, there may be tactical opportunities within the fixed income markets.
- **Emerging markets may have tailwinds.** Both debt and equity markets in emerging markets are seeing favorable conditions. Relatively stronger growth rates combined with tempered inflation—and the potential the US dollar may have peaked—provides opportunities, particularly in Asia.
- **Asia generally, and specifically Japan and China, may provide new opportunities for active investors.** With a whiff of inflation in Japan, it is now facing different dynamics than during previous decades of deflation. Meanwhile, China is finally coming out of COVID-19 lockdown, which should help spur renewed consumption and improve global growth prospects.

These are my main observations as we lean into 2023. The rest of this piece explores some of these issues more deeply from the lens of the economists across Franklin Templeton. Read on for our latest Macro Perspectives.



### Wild cards: Worries and optimism

Here are some key themes our economists are watching closely.

#### US debt ceiling/budget deficits

Government deficits around the world have grown since pre-COVID. We are mindful of economic and market risk if the United States does not resolve its debt-ceiling limit. This could cause severe market volatility, and in the worst case, could lead to a ratings downgrade.

#### “Sticky” inflation

If the global economy is stronger than expected, and inflation proves more long-lasting, this could cause a very different monetary policy approach (tighter for longer) than the market is currently pricing in.

#### Growth in Asia and China’s reopening

With China beginning to reopen, growth dynamics could have some moderate inflationary impacts. The recognition that Asia’s growth rate is likely to outperform that of the United States’ is not without country-specific risks, but also creates opportunities for investors in non-dollar assets.

#### Europe, energy and war

Amid a milder-than-expected winter, Europe seems unlikely to face the type of severe downturn feared just a few months ago. The outlook can be considered fairly encouraging, but still represents geopolitical uncertainty, especially as the Russia-Ukraine war continues.



# Expanded viewpoints from the roundtable

## What flavor of recession?

It seems like the United States is headed toward the most-anticipated recession maybe ever, and that sort of crowd or herd mentality worries me a bit. Gene, what are your thoughts?

**Gene:** The United States is not currently in a recession, so let's start there. Recent indicators from the Federal Reserve (Fed) point to near-trend growth for the last quarter, with drivers including healthy consumer spending, inventory building and some investment. But—and it's a big but—some sectors of the economy are looking like they are in recession. While there is still a possibility of a soft landing, our team believes the United States will enter a recession this year, likely in the second half, and put that probability at around 65%.

Our research shows that recessions typically last around 10 months on average, although no two recessions are exactly alike, so take that with a grain of salt. We forecast several distinct economic scenarios:

- A soft landing would avoid recession and be the best outcome—we think there is about a 35% chance of this occurring;
- We place a “normal” recession at 50% odds. This would feature sticky inflation in housing, wages and services; a broader cyclical downturn; and higher unemployment coupled with a Fed that is slow to ease rates given inflation volatility;
- We think a “deep” recession is less likely and see a 10% probability of this happening. Significant demand destruction, Fed overtightening, and a slow fiscal policy response would likely cause this scenario; and
- Finally, we see a stagflationary recession as the least likely outcome, with just 5% odds. Sticky inflation in housing, commodities and wages with slow (or zero) economic growth would characterize this type of recession.

Sonal, what recession odds do you see?

**Sonal:** My odds are lower—one in four. I'm not anticipating a US recession. I think we are going to get stagnant growth in the third quarter of this year, and in the fourth quarter, probably a negative number on an annualized basis, and maybe a small negative number in the first quarter of 2024. But I don't see a recession in terms of a very broad-based decline in economic activity. The reason is the US consumer. US consumers are alive and doing very, very well. As inflation comes down, which I expect, those nominal wage gains workers have seen will translate into real wage gains. Despite being a fixed income person, I would note what major airlines have been reporting—strong corporate profits amid a rebound in travel over the past quarter.

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Sonal Desai

US consumers are one of the strongest forces of growth across not only the United States, but across the world as well. China is also coming back online, which has positive implications for growth. I put these things together and I don't find evidence to back up this assumption that globally we're going into recession. Even Europe is unlikely to fall into recession because of a warmer-than-expected winter. The energy crisis that was anticipated and feared a few months ago hasn't happened so far. So, my view on recession is perhaps a bit contrarian. There is a lot of negative sentiment out there, but it's not translating into actual behavior. That's my take,



but I would probably wait until we see the February economic numbers to know whether the consumer is actually in any kind of pain. In terms of Fed policy, I do think we will likely see three 25 basis-point (bps)<sup>1</sup> rate hikes ahead.

**Mark, what's your take on the flavor of potential recession?**

**Mark:** This has been an unusual three years to say the least. And I always use the word “experiment” from the sense that the economy was down and out, almost in a depression. We saw extraordinary policy responses, monetary as well as fiscal. And because of that, we've seen a lot of dislocations. As we come back online and try to compare what's going on now to before COVID-19, perhaps 2018, 2019, it's difficult to apply probabilities. However, that's what we do. One of the reasons we believe in a diversified portfolio in 2023, even though that did not work at all in 2022, is because of some of the uncertainties that Gene and Sonal have highlighted. We would agree more so with Sonal than Gene when looking at the odds of recession.

Working with our economists, our base case is for the United States to avoid a recession—let's call it either side of unchanged. While we have observed inverted yield curves, we have also seen fed funds move up from near zero to 4.5% in a year of volatility. Financial conditions have been tightening, and when you put that all together and you look at the various components of the economy, we see unchanged or around zero in terms of economic growth. There are some stress points to the economy that are more interest-rate sensitive—like housing—but a decline in interest rates should provide some relief.

The consumer is behaving very well, and very importantly, incomes, job growth and savings have offered support—at least so far. All in all, our base case is that the United States doesn't have a deep recession. Our next highest probability is that unbeknownst to the Fed as well as other central banks globally, they are in the process of overdoing it. Real interest rates are as high as they've been for a long time. Policy is a big debate that we all have, and it seems that US fiscal policy is not extremely tight by any means, but is less than what we were used to in 2020 and 2021.

A lower probability for us would be a deeper US recession. The question we would ask is where is the stress in the economy? Where is the leverage? It's not always obvious as we go through the cycles, but nonetheless, we think a deep recession is a lower probability. Finally, in terms of our



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Francis Scotland

probabilities, a potential tail risk is that the economy is doing just fine, the consumer is doing very well, China is coming back online, and inflation proves to be far stickier than the market is pricing in. We put a fairly low probability on that outcome as we go through 2023, which would have a whole different set of policy implications, particularly for the Fed.

**And, finally Francis, your thoughts on recession?**

**Francis:** Fed Chair Jerome Powell has gone to great lengths to prepare the market, business and people for the prospect of a recession. He’s drawn on references to the Fed Chair Paul Volcker era (1979–1987) when it took a severe recession to break the inflation psychology that existed in the early 1980s. In my opinion, a comparison of that era with today isn’t appropriate. We’ve seen an 18-month pickup in inflation that has largely reversed and is well on its way back to 2%. There’s just no comparison with what we’ve gone through to what took place in the 1970s and the 1980s. But if the Fed persists in sustaining monetary conditions where they are, we will get a recession.

And, you can see the underbelly of the labor market beginning to shift here. Temporary employment is already contracting. Average weekly hours have now fallen back to below pre-pandemic levels. Average weekly earnings grew only 3% over the last year, which is a dramatic retreat from post-pandemic levels. All of that suggests the wage disinflation the Fed is looking for is already in the pipeline. In addition, Harvard University’s high-frequency economic tracking service tracks job postings data—the data show there’s been a dramatic change in the job market in the last two months.

Job postings, according to this metric, went from 20% higher than January 2020, as recently as early November, to 22% below January 2020 levels, as of the end of last year.<sup>2</sup> So that seems to rhyme with the weakness in average hourly earnings, which was posted in the last jobs report, as well as a lot of the job layoff announcements that we’re seeing in the newspapers from large marquee-type corporations. What’s missing so far has been a pickup in unemployment insurance (UI) claims. But what history shows is that when UI claims start to pick up, it coincides with a rise in the unemployment rate. And all of that happens very, very quickly, and it’s not reversible—by the time that arrives, it’s too late.

So, the question becomes will the Fed react fast enough? Given their history and their anxiety about maintaining their inflation credibility, my personal belief is that they probably are not going to react fast enough. There will be another “oh my God” moment, just like there was last year, but in a different direction. So, do I think that the Fed’s going to react fast enough? No.

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## Are markets correctly pricing inflation?

**Sonal, it looks like the consensus view is for US inflation at about 3% year-over-year in 2023. Do you agree? What’s your view on inflation and interest rates?**

**Sonal:** I think 3% is optimistic. A few points. First, macro policies are still pretty loose, which might sound strange when we’re looking at a US central bank that’s been raising interest rates. But the United States is looking at a fiscal deficit this year, which is probably going to be around 5% of gross domestic product (GDP). Social Security checks have gone up close to 9% this year, and those go out to about 70 million Americans—that’s about a third of the adult population.<sup>3</sup> And, keep in mind, the Fed’s balance sheet is still huge.

Second, the market has taken a great deal of comfort from the fact that wages are moderating—as it should. Having said that, the Fed Bank of Atlanta’s latest Wage Growth Tracker showed overall wage growth of 6.1% in December, with wages up 7.7% for job switchers, and up 5.5% for people who remained in their jobs.<sup>4</sup> And unit labor cost growth was 5.2%–5.3%.<sup>5</sup> Historically, the Personal Consumption Expenditures Index (PCE) has mapped into unit labor costs, and the December reading was far above the Fed’s 2% inflation target. So, we’re talking about US unemployment at close to 3.5%, a US fiscal deficit of around 5%, and wages still growing.



Meanwhile, markets are anticipating a Fed “pivot” in the near term, but I think some people are suffering from what I would consider a recency bias. They regard the current Fed tightening cycle as being transitory, but I would note that after the global financial crisis (GFC), the Fed spent more than 10 years fighting deflation—the dog that never barked. It threw the kitchen sink at the problem in terms of easing, because the GFC was such a terribly large and meaningful event. I think these last few years of substantially above-target inflation will probably lead us to a multiyear period where the Fed keeps rates higher than the market is currently anticipating.

**To summarize, you think the federal funds rate will rise to 5% or 5.5% and that the so-called pivot toward easing won't happen quickly. If the equity market is wrong in its current view and then sees a correction as a result, are you saying it's unlikely the Fed will come to the rescue?**

**Sonal:** Correct. The market believes the “Fed put” is there, but it doesn't exist. That's my biggest concern.

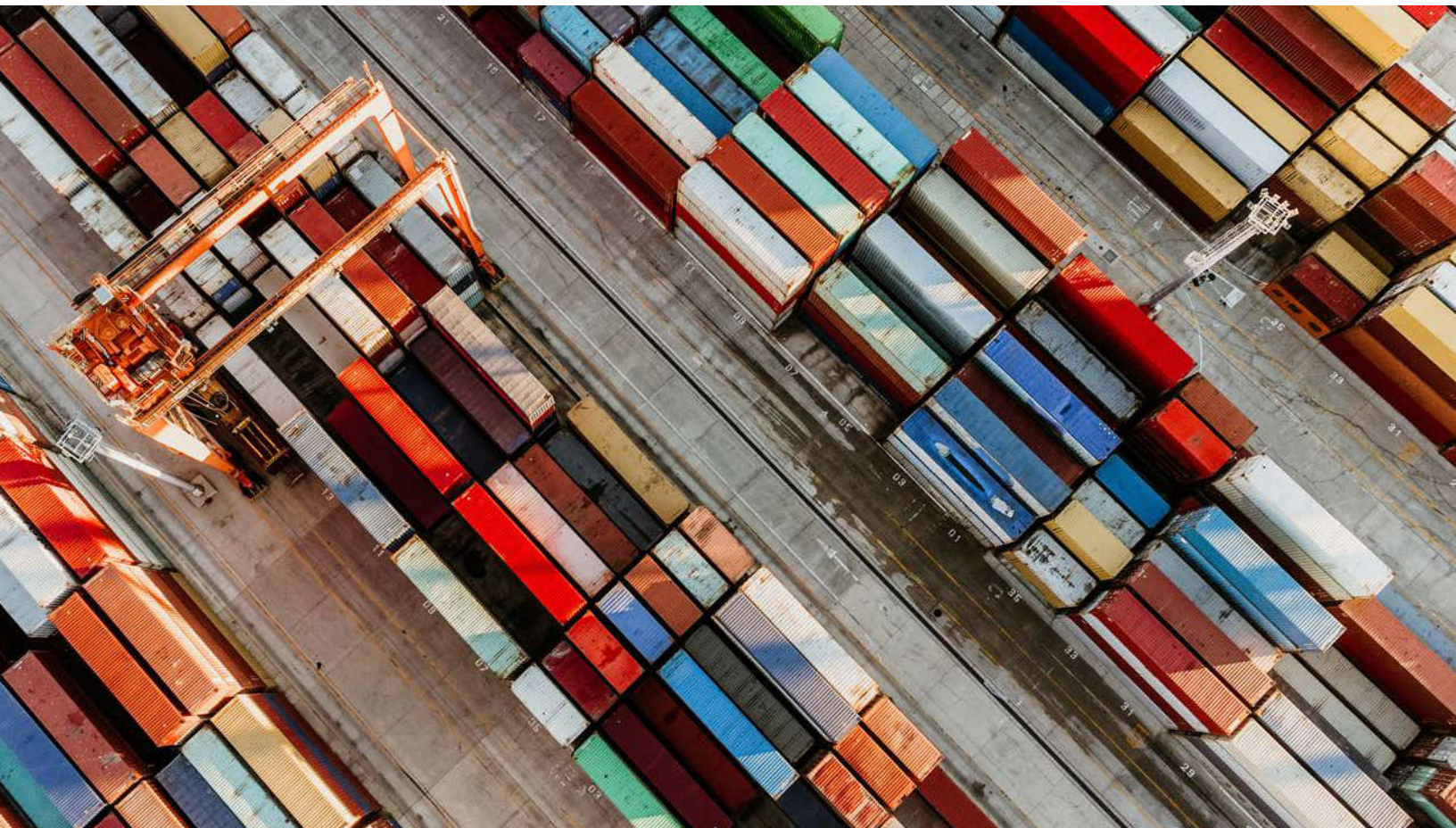
**Mark, let's turn to you and Western Asset's view. What is your outlook both for inflation and rates? Any concerns?**

**Mark:** The forecasters on the team are talking about the possibility of US inflation at around 2% year-over-year by the end of this year. If you look at the fixing—here I am talking

the near-term inflation swap<sup>6</sup> market—if you look at the pricing on the headline Consumer Price Index (CPI), it's somewhat surprising to many, in the fourth quarter of 2023 on a year-over-year basis, we're 2% or below. It's the first time in a long time the pricing or fixing on CPI is below our forecast.

Obviously, oil and energy are very important components of inflation, and oil is currently around US\$75–\$80 per barrel. Things could change radically. But if we do end up with year-over-year inflation declining from over 6% in 2022 down to 2% toward the end of 2023, as the market seems to be anticipating, that's consistent with our view.

How do we get there? Certainly, the commodity side plays a part as it relates to headline inflation. But whether it's rents, autos, medical or other services, we are seeing overall downward pressure in inflation on the goods side, on the manufacturing side. It is a bit slower on the services side. When we look at the inflation numbers and our expectations for 2023, we are optimistic that we will see a quick retrace-ment. The worry is that the 2% inflation scenario is now priced into the marketplace; there is a disconnect between the market expectations and the Fed's expectations. That's where the debate gets extremely interesting.





**“When we look at the inflation numbers and our expectations for 2023, we are optimistic that we will see a quick retracement. The worry is that the 2% inflation scenario is now priced into the marketplace; there is a disconnect between the market expectations and the Fed’s expectations. That’s where the debate gets extremely interesting.”**

Mark Lindbloom

**Can you elaborate a little on that disconnect and your outlook for monetary policy?**

**Mark:** The Fed, the European Central Bank (ECB) and most other central banks have been talking very hawkishly. They are concerned that we are in an environment similar to the late 1970s and early 1980s when inflation was more buoyant and sticky than the post-GFC period, for a variety of reasons. Fed Chair Jerome Powell and other Fed officials have talked about how they’re not going to ease up the current tightening cycle quickly—essentially saying they are going to get to restrictive territory then hold rates there nearly all year. The market doesn’t believe them. The market is seeing the fed funds rate rise to 4.75% or perhaps 5%, while the Fed has been signaling 5.25%. So, the market expected—and got—a 25 bps hike at the February policy meeting, but there is anticipation of a pause—wherein the Fed can stop and assess the data. And, then assuming the economy is on a path of weakness and lower inflation, the thinking is there will be aggressive easing as we get into the latter part of 2023. At Western Asset, we are generally in line with the market for the near-term outlook, but there is an internal debate within our team regarding duration and the yield curve. We aren’t quite as sure about what happens in March. Most importantly, we think the Fed’s focus is on employment data. While a lagging indicator, earnings and wages have been very, very slow to turn. For the Fed to really shift and pause, we need to see that fall into place.

**Francis, what is your view of inflation right now in the United States?**

**Francis:** Well, the short answer for me is: the direction is down. I don’t think there’s a lot of dispute about that anymore. The real question is: are we going to 2% or are we going to hit 3% to 4%, and then level out? My view is we’re going to go to 2%, maybe even lower. As you know from a lot of the conversations we’ve had in the past about the outlook and this particular topic, our view has been shaped by the idea that this isn’t a normal business cycle. We’re living through the normalization of the economy following a disaster brought on by the pandemic, the lockdowns, and the various reactions to both.

To recap briefly, we had the biggest bust in history. The authorities reacted to it with historic reflationary stimulus on a scale we’ve never seen before. As a result, we experienced the sequence of inflation rolling through asset markets. We had asset market inflation. Then we got commodity market inflation. We got real estate inflation, and ultimately, we got inflation in goods and services itself.

In late 2021, the Fed started to get nervous that inflation might not be transitory after all. They really started to get nervous when they saw this reflationary impulse roll into wage inflation. Then, they pivoted. They shifted the narrative from “it’s transitory” to “it’s structural.” And the shift really felt like they were panicking over the realization that they got it really wrong, and they needed to catch up in order to preserve the inflation credibility.

So, what’s happened since they made their pivot? It’s been a bit like watching a movie in reverse. In a word, we’ve seen a lot of deflation. Stock and bond prices have fallen, commodity prices have retreated, and real estate prices have started to decline. Additionally, in the second half of last year, price inflation retreated a lot. The data—looking at both headline and core CPI—is pretty convincing, indicating that the peak in inflation was mid-2022. It’s fallen a lot in the last six months, and likely to keep falling.<sup>7</sup> It should fall all through this year. And my own view is it’s going to be 2% or less by year end.

**That’s very compelling, Francis, and it seems there are a number of market indicators that also suggest that inflation could be coming down. But the Fed doesn’t really seem to have that view. What’s going on?**

**Francis:** It’s hard to tell what the Fed believes at times—especially after underestimating inflation so badly last year. The Fed’s inflation fighting credibility is really on the line

this year. At the December Federal Open Market Committee (FOMC) meeting, what was really interesting was every single FOMC member believed that interest rates had to go higher this year, notwithstanding this declining inflation rate that I just mentioned that was playing out all through the second half of 2022. So, the Fed shifted its view on inflation from transitory to structural concerns almost at the peak of the price-inflation cycle in the middle of last year. Now, it's really focusing on how tightness in the labor market and how sticky wage inflation might prop up service sector price inflation. However, we know from the yield curve that the market believes that in last year's panicky effort to correct its wrong and get ahead of inflation that they overshot equilibrium. The yield curve's inverted. It's been that way for a while now. Even in the Fed's own summary of economic projections, they have an equilibrium fed funds rate at 2.5%.

So, the market's saying the central bank is overdoing it. Conditions are very restrictive. It's not just the yield curve. If you look at the money supply, we've seen an unprecedented contraction, in nominal terms, in M2;<sup>8</sup> and, the contraction in money supply in real terms is as severe as it was in the 1980s. These conditions are what the yield curve is picking up. Inflation's not going up as long as money growth stays this weak. If you look at risk assets, risk assets have been rallying lately. Risk assets are finding optimism in the inflation developments. But because the Fed sees financial conditions as part of the transmission mechanism on inflation, Fed Chair Powell has kept up his sort of hawkish rhetoric. They reduced the pace with the 25-bps increase in February, but there's still no discussion about the case for lower rates.

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## Growth and inflation outside the United States

**Michael, let's look more globally. What's your outlook for inflation and growth outside the United States?**

**Michael:** It's a challenging time because there's a lot of variance when looking at different parts of the world. In Europe, inflation is currently running higher than in the United States. It is only beginning to peak on the headline inflation numbers, and the core numbers (excluding food and energy) are still in an upward trend, whereas in the United States, both inflation measures have been trending down. It's a question of how quickly they trend down. Energy was a much bigger factor in Europe, and wage negotiations were a very significant contributor to some of Europe's inflationary dynamics.

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Michael Hasenstab

Asia looks very interesting. The core Tokyo CPI, which comes out a little earlier than the national CPI, rose 4% in December, the highest level since the 1980s. While it does tend to differ from the national reading, it's an interesting signal in that Japan is seeing some different dynamics. Many investors had written off Japan because for decades it struggled with a deflation liquidity trap. So, I think it is an interesting dynamic and has important implications for growth and for currencies.

If we look at the rest of Asia, we did not see the same magnitude of inflation that we saw in the United States or in Europe. It was a lot more moderate, and lagged, because COVID-related policies greatly restricted the opening of economic activity. While inflation in the United States has been on a clear downtrend in recent months, there are still some moderate upticks in Asia, but the magnitude is different. It's at much lower levels generally throughout the region. With China beginning to open again, growth dynamics there could have some moderate inflationary impacts, but for good reasons.

In Latin America, some countries saw inflation readings surge earlier and faster than in Europe or the United States—hitting double-digits. It necessitated some very aggressive central bank activity, which did occur. And now in many cases we've seen that inflation trajectory change to inflation coming back down. So, the key takeaways looking globally at inflation are that Latin America is generally on a decelerating path, and that Asia is slightly accelerating, but the terminal level will likely be a lot lower than what we witnessed in the United States and what we're seeing in Europe.



## Quality and duration decisions key in “run” toward fixed income

**Gene,** you’re looking at multi-asset portfolios, trying to make some decisions in terms of positioning. What is your thinking right now?

**Gene:** The inflation outlook and commensurate policy response, and the equity and bond market reactions to these variables, have largely influenced changes to our asset allocations from 2022 until now. We look at inflation as being both a cause and a symptom of underwhelming market performance in 2022, and it’s really changed the calculus for all risk assets over the past quarter: for equities, fixed income and everything in between. We think the Fed, and most other central banks, have really set the economic context over the past year, given the tightening of rates in response to higher-than-expected inflation. We believe that’s going to continue, and we’ve already seen the negative impact inflation had on equities last year.

But perhaps the reset in bond yields has been a stronger force driving allocation shifts. Consequently, bonds overall offer a much more favorable risk and return tradeoff against equities than we’ve seen at any point in recent memory. We characterize this asset allocation preference as not so much about running away from equities, but rather, running toward fixed income. Last year it was challenging to eke out return from fixed income, and it was a pretty disastrous year in terms of portfolio-level returns. So far, that’s not looking to be the case this year. Over the last couple of quarters, we have shifted our strategies from being at one point overweight equities to now overweight fixed income, as equities continue to track the economy and resulting policy response.

As I mentioned, we believe a recession is ultimately looming on the horizon and we are monitoring the situation very closely. Should “recession” go from concern to reality, this will likely have profound implications on asset allocation, and not just at a high level *between* equity and fixed income, but also *within* equity and fixed income sectors.

**Sonal,** Gene mentioned that from an asset allocation point of view, he’s “running toward fixed income.” Can you share your thoughts on duration and where you think there are opportunities now within fixed income?

**Sonal:** Historically, I’ve always been pretty pessimistic about the outlook for fixed income, but I do think this is a great point in fixed income—that I completely agree with Gene on. Markets have recently seen huge daily swings in basis points,



so it makes abundant sense to shorten your duration, but you have to do it tactically. If you can be tactical, I'd say it's a good time to be invested relatively short to benchmark indexes because I have very little doubt that we're going to see selloffs, we're going to see the market react to the Fed, perhaps to actions out of Japan.

We've had a strong start for fixed income in the first three weeks of this year, which in my view, makes it an excellent time to actually stay a bit short duration because that's not going to last. Having said this, the areas where I am most bullish would be investment grade, which seems fairly boring but offers good yields currently around 4%–5%. This implies some duration, but is an area that should be able to weather a mild recession. I'm also looking at high-yield credit, which in an absolute way is delivering much higher yields. There will be volatility, but if you can ride out the next 18 to 24 months and are very selective, I think it's an excellent time to enter the market. Over the past several years, investors had to go to the alternatives space, or private credit to see the types of returns that we are currently getting in liquid public markets on the fixed income side. I would reiterate that it's great time to be an active investor, because you want to try to avoid those pockets of extreme weakness. At this point, I'd be a little more hesitant in the floating-rate space, because you have to be extremely careful with interest rates continuing to go up.

Lastly, emerging markets are looking at decent fundamentals, and fabulous valuations in terms of starting points in hard currency as well as local currency. I think the US dollar probably has gotten pretty much toward its topmost level, especially as we continue to see changes from Japan. I think this sets us up nicely in the emerging markets space.

**So just a quick summary, you would be a little hesitant entering duration in the short term, but it's a good time to move into fixed income and especially in some of the spread type products?**

**Sonal:** I'd say that's fair, but on the other hand, I'm not saying don't go into duration at all because certainly if you just want to put something somewhere and forget about it, you're getting better returns right now than you have in a long time. I would note that short duration Treasuries in some ways are giving you better returns than anything on the long end given the inversion of the yield curve, which I don't think is justified.

**Francis, there's a lot of uncertainty and a lot of competing forces. Given that, where are you seeing opportunities in duration right now?**

**Francis:** I think, generally speaking, it's pretty constructive for adding duration. The problem is that the long end of the yield curve is held in check to some extent by the Fed's stubbornness at the short end of the curve—especially given how steeply inverted the curve is right now. Fed policy historically is notoriously schizophrenic, it goes from tightening to easing, often without a lot of transition—this Fed in particular has this characteristic. So, I do think there's going to be another, as I said, “oh my God” moment at the Fed, much like there was last year when they pivoted from maximum stimulus to hitting the brakes. I think that moment will come this year, but it may take a labor market dislocation. And clearly, as that arrives, that will be a big plus for fixed income when it happens.

**Mark, let's turn to you and Western Asset's view of duration.**

**Mark:** There are risks to the growth question, just given where we are in the economic cycle and what central banks are trying to engineer. That causes us to believe that duration, which has been a benefit for this bull market over the decades, and which worked miserably in 2022, will work better in 2023. Therefore, we do want some duration. I think to Sonal's point, you can be tactical about that. Remembering, for example, June into July of 2022, we saw a vicious rally in the market where 10-year Treasury notes came off by 90 bps, moving from around 3.5% on June 14 to around 2.7% on July 29.<sup>9</sup> That turned out to be a really good selling opportunity. But we think it is different now from an economic, monetary policy, and most importantly, an inflation point of view. Perhaps the market has moved a little too quick. It's important to remember that in fixed income, it's all about yield. We haven't seen these yields in Treasuries and investment-grade corporate bonds in 20 years. The pie is getting bigger. I think the people are allocating to fixed income away from other sectors just given the expected risk-adjusted returns.

So, from a duration point of view, we think it pays to be long. One of the things that we like to look at is the consensus of the market—where the forwards are. Where is the one-year forward, where is the Treasury curve? And if you look at twos through 10s, the answer as of now is about 3.3%. It's substantially lower on the short end of the yield curve and only a little lower in 10-year Treasury notes. We think that's

about right, and the bigger discussion we have from a macro point of view is more on the yield curve than it is on the overall duration, but we do want to hold duration against some of our favorite spread sectors or our risk sectors in a broad-based portfolio.

#### What risk-spread sectors have opportunity?

**Mark:** Given the uncertainty over growth and the valuations we now see, I think many investors are surprised at where investment-grade corporates, high-yield bank loans, emerging markets structure, munis, etc. are currently trading. They've done very well at the start of the year. What we have tended to do is to increase the investment-grade sectors, investment-grade corporates—for example, Treasury plus a spread—but the absolute yield is pretty darn attractive. We feel that that is a good place to be. We don't dislike high yield and bank loans, but we want to be a little more careful there from a quality point of view.

On the structured side, we favor mostly shorter durations going up the capital structure. We find AAA non-residential, commercial real estate asset-backed securities very attractive. Given the uncertainty surrounding what's happening with residential areas of the housing market, and commercial real estate in particular, we need to differentiate between what's happening in the office and industrial sectors. And then finally emerging markets, as Michael has pointed out, we see some very, very attractive opportunities there.

#### Gene, what are your thoughts on duration and also for investors looking at moving from equity into fixed income?

**Gene:** In terms of fixed income duration, right now we're just a touch longer than our benchmarks, but not by much. We are not looking to go long duration today, and we're also fairly concerned about the shorter side as well given the trajectory of interest rates going forward within fixed income. We are carefully looking at the shape of the yield curve. We are also cautious on floating-rate loans (bank loans), that's not somewhere that we're concentrating on right now, or high yield. High yield is interesting because it looks like the longer-term implications are quite favorable, but we're very concerned with the short-term and volatility over the next six to 12 months. So, we're relatively negative on high yield over that shorter horizon. Elsewhere, we've become less constructive on Japan and China. But the overall story for us is relatively duration-neutral, we're certainly interested in

**“In terms of asset allocation, I think it really comes down to one's time horizon. Right now, crafting a durable portfolio with a five- or 10-year time horizon requires a different mix than if you're looking to be more tactical, in our view.”**

Gene Podkaminer

the higher yields coming off of Treasuries, looking at investment-grade favorably, and skeptical right now of some of the higher-spread sectors.

In terms of asset allocation, I think it really comes down to one's time horizon. Right now, crafting a durable portfolio with a five- or 10-year time horizon requires a different mix than if you're looking to be more tactical, in our view. The former may see a healthy allocation toward risky assets, while the latter may lighten up on equity exposure in order to fund investment-grade fixed income. Let me start with the longer term first—high yield and equity have characteristics that are very similar in the long term. High yield has probably the most exposure to economic growth of any fixed income sector out there. One can argue that high yield is as close as you get to an equity substitute within fixed income. Over the long-term, we see a very robust return for high yield compared to investment-grade bonds and cash. But over the shorter term, if an investor is worried about recession and wants to meaningfully reduce their exposure to the economic growth factor, or avoid volatility, high yield is probably not where they should be looking. Generally, the relative safety of sovereigns and investment-grade bonds would better align with their concerns. So perhaps for right now, bypassing some of those higher-spread segments in the interim, as volatility passes.

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### Asia's role in driving global growth

**Michael, let's turn back to China, which recently announced the weakest economic growth it's had since 1976, barring the first year of COVID in 2022.<sup>10</sup> China's population doesn't seem to be growing like it used to. What is your outlook for China, which has so often been an engine for global growth?**



**Michael:** I would make a couple of points in terms of the short-term dynamics, but also the long-term structural evolution of China. For decades as China has grown and become a bigger and bigger economy, it is natural and expected that the rate of change will slow. That being said, last year's severe lockdown amid zero-COVID policies really plunged that growth to an exceptionally low level. China's growth rate was around 3% for the full year 2022, less than half of what it saw the year prior. Now we are seeing an amazing pivot where zero-COVID has been lifted and there is a full opening up of the economy across the board. This has led to virus surges and then immunities—a very accelerated path of working through COVID-19 compared to many other countries but reopening is underway and will lead to a resurgence in domestic economic activity. This will have some spillovers globally, whether it's Chinese tourists traveling to other countries or further easing of supply chains that were still sticky. I think that is a meaningful positive that's happening pretty quickly.

That said, China will not likely have the type of growth surge it saw post-GFC, where there was incredible stimulus and demand for commodities globally and into China. So far,

policymakers have indicated a lot more caution. There has been an acceleration of stimulus to the real estate market, and openness to stimulate monetary and fiscal policy, but of a lot lower magnitude than we've seen before. So, we see some acceleration in growth, but not the double or even high single-digit growth of decades past. Those days are behind us.

**So, Michael, you are probably one of the great investors over the last 10 years to spot the growth of emerging markets.**

**What do the next five or 10 years look like for global growth, in your opinion?**

**Michael:** It's not just about China, but if China could grow 4% to 5% over the next couple of years, given the size of its economy, the magnitude of that additive demand effect globally would be very meaningful. It's an open question whether China can do that. There are always geopolitical risks and other things that could affect that outlook, but barring those, it does appear that's manageable. I think the bigger question is about the economic model 10 years out.



Also, as Sonal mentioned, everyone thought Europe would face energy shortages this winter amid the ongoing Russia-Ukraine war, but because of factors such as warmer-than-expected weather, that hasn't occurred. So, Europe seems unlikely to face the type of downturn that had been feared a few months ago, and I think the outlook can be considered fairly encouraging.

When I think about pockets that can shine, I think about Asia. According to the latest International Monetary Fund forecast, GDP growth in the United States is seen at 1.4% this year, and Japan's at 1.8%.<sup>11</sup> Japan has not been in a position to outperform the US for over a decade. It's a real meaningful adjustment. And emerging and developing Asia is looking at close to 5% growth this year. For the United States and Europe, maybe recession or no recession, we can debate that, but there is a downshift. That does not mean that growth everywhere is imploding, and Asia is one of the bright spots.

that range—this seems to have taken away a big support element for the dollar. The recognition that growth in Asia is likely to outperform that of the United States' is not without risks, but it seems likely Asia will have relative growth outperformance. And, the United States is still running these big fiscal deficits, and the debt ceiling debate keeps coming up, because the United States is spending a lot of money and still has a huge import bill.

These issues are going to present investors with opportunities though. The pie is opening and there are different parts of the pie for investors to diversify with. I'd say one sliver of that is the non-dollar space. If people believe that the dollar is at a peak and has already started to decline, we think the non-dollar space is exciting. It's not without risk, but valuations point to that as a good opportunity.

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## Currency considerations: moving away from US dollar-assets

**Michael, you're really obviously looking at things more globally. How do you look at currencies within the context of this discussion?**

**Michael:** There are big geopolitical risks out there that can alter these central scenarios, and certainly in the currency space there is no certainty. But we are seeing some pretty big opportunities in non-dollar assets right now. We've started to see the dollar's strength ebb over the past month, although these sorts of moves won't necessarily be in a straight line. It's not a uniform dynamic when looking at the US dollar versus various countries, so we have to be nimble and constantly adjust between countries, between regions. But generally, with fed funds getting close to a terminal rate—we can debate the exact number but we are getting close to

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### Endnotes

1. A basis point is one hundredth of 1%.
2. Source: Opportunity Insights Economic Tracker, Harvard University. As of December 30, 2022.
3. Source: US Social Security Administration, Cost-of-Living Adjustment (COLA) Information for 2023.
4. Source: Federal Reserve Bank of Atlanta. The Atlanta Fed's Wage Growth Tracker is a measure of the nominal wage growth of individuals constructed using microdata from the Current Population Survey (CPS) and is the median percent change in the hourly wage of individuals observed 12 months apart.
5. Ibid.
6. An inflation swap is a contract used to transfer inflation risk from one party to another through an exchange of fixed cash flows.
7. Source: US Bureau of Labor Statistics, Core and Headline CPI. As of January 12, 2023.
8. M2 is a measure of the money supply that includes cash, checking deposits, and other types of deposits that are readily convertible to cash such as CDs.
9. Source: US Department of the Treasury.
10. Source: Hannam, P. "China's economy slows sharply with GDP growth among worst on record," *The Guardian*, January 16, 2023.
11. Source: IMF World Economic Outlook, January 2023. There is no assurance that any estimate, forecast or projection will be realized.

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