Investment Strategy Insights

Monthly Views From Our Diverse Global Investment Teams

PineBridge® INVESTMENTS

Where Will Policy Rates Terminate?

Hani Redha, CAIA, Global Multi-Asset Portfolio Manager

October 2024

The Fed has finally joined the rate-cutting party with its 50-basis-point cut, cementing the global easing cycle. Yet beyond the short-term debates about 50-bp or 25-bp moves, investors must continue to assess the medium- and longer-term trajectory and destination for risk-free interest rates, the backbone of the financial system. The "neutral rate" of interest represents the equilibrium level at which the economy can grow sustainably without the risk of overheating or stalling. And while challenging to assess, it is a worthwhile exercise – particularly at this juncture, when markets have priced in several hundred basis points of cuts.

Since the pandemic, our assessment has been that the global economy has shifted to a "Balanced Growth" regime, characterized by higher nominal growth, interest rates, and investment activity compared with the "Stall Speed" regime that predominated between the global financial crisis (GFC) and the onset of Covid. The post-GFC era was marked by the lingering effects of a balance sheet recession, exacerbated by fiscal austerity. Consumer-driven deleveraging led to reduced consumption and investment, which in turn slowed productivity growth to just 1%. Strong savings, coupled with weak investment, led to extreme monetary policy responses amidst a liquidity trap. This was the abnormal (not new) normal.

After taking policy and rates to the lower bound amid the pandemic, the Fed unleashed an immense degree of monetary tightening, bringing us to a more restrictive stance relative to the neutral rate than at any time in the past few decades. Rates have started their descent, yet we see evidence that the neutral rate has risen somewhat in recent years, effectively due to abnormally large fiscal thrusts and an unprecedented wave of immigration. Accelerating productivity growth, along with higher investment activity due to the energy transition, supply chain restructuring, and higher defense spending, are also contributing to slowly rising neutral rates. The Fed's Summary of Economic Projections now estimates the nominal long-term policy rate to be 2.9%. We expect the short end of the yield curve to settle around 3% and the 10-year note to likely remain somewhat below 4%.

Europe's growth continues to fall behind that of the US due to structural factors, including stagnant productivity and slower population growth, which have not improved post-Covid compared to the US. As a result, we forecast a lower neutral rate for Europe than the US, at around 2%. While European growth is expected to rebound from recent lows, the pace and extent of this recovery will likely be modest. Additionally, fiscal constraints – driven by the need for countries with higher deficits to cut spending to adhere with the EU's 3% GDP fiscal rules – are expected to act as a further drag on growth. Mario Draghi's recent report calling for higher investment into innovation and productivity enhancement is precisely what we believe policymakers should be implementing; sadly, we have little confidence in a meaningful response.

A key upside risk to bond yields over the medium term is a revival of inflation, resulting primarily from runaway fiscal policy in the US due to politicians' inability to rein it in. While not our base case, the structural forces that are raising the neutral rate, along with unbridled fiscal policy, could also result in undesirable levels of inflation.

Though it is not observable directly, "neutral is what neutral does"; we will know it when we see it. Meanwhile, notwithstanding elevated rate volatility in the period ahead, we expect policy rates to decline from current levels but without terminating at the lower bound. Absent unpredictable shocks, we see no return to that abnormal.

About This Report

PineBridge believes that not only do differences of opinion make markets, but they also foreshadow substantial moves ahead as these differences are resolved. Once a month, investment leaders from our global multi-asset, equities, and fixed income teams meet to share their diverse viewpoints. This report reflects those discussions and debates by providing insight on the topic of the month along with snapshots of our asset class views and convictions across the firm.

Conviction Score (CS) and Investment Views

The Conviction Scores shown below reflect the investment team's views on how portfolios should be positioned for the next six to nine months. 1=bullish, 5=bearish, and the change from the prior month is indicated in parentheses.

Global Macro

Sam McDonald
Sovereign Analyst,
Global Emerging Markets
Fixed Income

CS 3.00 (unchanged)

US labor market growth has continued to moderate, with August nonfarm payroll numbers bringing the three-month moving average of job gains to just 116,000, down from 270,000 in March. But other labor-market indicators are more sanguine: a quits rate at 2.1% in July from 2.0% in June, no significant rise in layoffs, net worker flows stable and in line with historical levels in non-recessionary periods, hiring rates still outpacing job separation rates, and weekly jobless claims remaining broadly stable around the 230,000 mark. Nonetheless, while there has been a clear downshift in the direction of travel for the US economy in recent months, we retain our base case of a "Stabilization"/soft landing.

Consumers continue to be the most resilient aspect of the US economy. Retail sales in August outperformed expectations once again, up 0.1% month over month, while the net worth to disposable income ratio is near all-time highs. Given the moderating labor market, softening in average hourly earnings growth, and the drawdown in excess savings, the economy's propulsive force from consumption should eventually begin to slow.

As US inflation continues to moderate, falling to 2.5% in August, the Federal Reserve delivered a hawkish cut of 50 basis points (bps), emphasizing the "maximum employment" aspect of its dual mandate. The larger-than-expected cut highlights the Federal Open Market Committee's confidence that inflation will return to target given the labor market softening. The market continues to push for more rate cuts than the Fed dot plot, but the Fed is likely to remain data-dependent. The FOMC revised its 2024 GDP growth projection downward to 2.0% from 2.1% but maintained its projected growth for 2025 and 2026 at 2.0%.

We move China's regional conviction score up by 0.25 to 3.25 given ongoing weakness in the property sector and subdued consumer data. Deflationary forces are driving weaker fiscal revenue, and hopes of further fiscal stimulus in the short term are low. While exports and manufacturing remain the economy's bright spots, risks around the US elections may undermine this strength; China, Europe, and Mexico are expected to be the biggest losers if there is a red sweep in the US in November.

Rates

Gunter Seeger
Portfolio Manager, Developed
Markets Investment Grade

CS 3.00 (unchanged)

We have been long duration from 4.70% in the US 10-year all the way down to 3.70%. We maintain our neutral expression and would turn negative only on a run to 3.50%, which would tilt risk/reward to the downside.

When the Fed lowered rates by 50 bps, Chair Powell highlighted that this was a partial "catch up" to the rest of the world. He also signaled that the Fed has "recalibrated" its focus from inflation to full employment. We see this as the Fed presuming that inflation is indeed conquered and that the next policy rate moves will all be lower for the foreseeable future. While risk markets celebrated, the Treasury market remained unconvinced, since the 50-bp cut implies that the economy is about to slow or has already slowed. Signs of strength in price indexes or in retail sales will be met with concern. Strong inflation signals will be bad for risk markets and vice versa. If inflation does not rise in the next six months, the economy can achieve a soft landing and we will likely see more cuts to smooth out the bumps. If not, the Fed will have to "recalibrate" once again. With spending so great, we remain skeptical that inflation is gone for good.

Credit

Steven Oh, CFA
Global Head of Credit and Fixed Income

CS 3.25 (unchanged)

The start of the Fed's easing cycle with an outsized 50-bp cut signals that any economic deceleration will be cushioned by less-restrictive monetary policy in the year ahead. From a fundamental credit profile perspective, the outlook is favorable and would be supportive of a more positive CS despite a weakening trend. However, tight valuations in high yield (HY), which have dipped below +300, and in investment grade (IG) credit, now in the mid-80s, lead us to maintain a slightly defensive overall score.

While there is significant uncertainty arising from heightened geopolitical tensions globally and the upcoming US elections, the expectations for ongoing fiscal spending irrespective of the outcome should provide economic stimulus. Rather than a recession, there is more likely to be softness affecting particular industries and geographic regions.

Yield and carry should be the dominant driver of returns over the next 12 months, but given the compression in risk premiums, we would tilt toward lower-risk components while expanding diversification. Within asset classes, reducing risk isn't about getting ultra-defensive, but rather maintaining a beta exposure closer to 1.0.

Currency (USD Perspective)

Anders Faergemann
Senior Sovereign Portfolio Manager, Emerging Markets Fixed Income

CS 2.75 (unchanged)

Two-year US/Germany interest rate differentials have narrowed significantly in recent months, moving from 200 bps in April to 135 bps in September, undermining support for the US dollar. Rising concerns about a faster softening in the US labor market put the Fed on alert to increase its pace of monetary policy normalization, outpacing that of other central banks, and kicking off the cycle with a 50 bp cut cemented this market view.

While financial markets have been quick to price in an additional 200 bps of Fed cuts by the end of 2025, we believe this overstates the downside risks to the US economy. Our base case remains one of "Stabilization" or a soft landing, yet the rate of change in the US economy has removed an anchor for US dollar strength. Consequently, we have adjusted our 12-month EUR/USD forecast higher, from 1.0500 to 1.1000.

Contrary to the sluggish eurozone data, markets have taken the ECB's gradual approach to monetary easing at face value, causing the perceived policy convergence between the Fed and the ECB to bolster the euro. While we don't see any immediate catalyst for the euro to strengthen further, only short-term technical flows and broader positioning favor some type of reversal at this juncture.

Unwinding of the carry trade in July was triggered in part by the sudden, sharp appreciation of the Japanese yen. Positions have cleaned up since, and as the structural market narrative for the yen has made a complete 180 in parallel with a reversal in the interest rate spread, it has provided a newfound impetus for the yen to strengthen – possibly beyond our current 12-month USD/JPY forecast of 145.00. US recession concerns, however, appear overstated, suggesting the US dollar leg of the trade has run its course for now. Near-term political uncertainty in both Japan and the US warrant some caution on volatility, yet FX volatility generally continues to be low, suggesting currency markets will broadly adhere to recent ranges.

Emerging Markets Fixed Income

Chris Perryman
Corporate Portfolio Manager and Head of Trading, Emerging Markets Fixed Income

USD EM (Sovereign and Corp.)
CS 3.00 (unchanged)

Local Markets (Sovereign)
CS 2.50 (unchanged)

The macro environment for emerging markets (EM) remains favorable. Domestic demand proved more robust than expected in the year's first half, preventing a slowing of growth momentum, and normalization of growth thus far in the year's second half continues to support EM assets. Our expectation for commodity prices is also optimistic for the asset class.

EM spreads in September reversed their August spike following the weaker-than-expected non-farm payroll number for July, which sparked concerns over a significant slowdown in the US economy. Markets have calmed and strong US retail sales data have increased confidence in a soft landing. We expect that a Fed intent on further rate cuts and a soft landing in the US will be positive for EM assets in terms of performance. Along with robust growth momentum, we continue to see EM fundamentals as healthy. We expect that the market will remain selective, favoring EM names where good policymaking and credible fiscal/monetary policies support the overall credit profile. Additionally, the market will differentiate between those EM names that are successful in implementing reforms and those receiving ongoing funding from international financial institutions and other external sources.

The Fed's 50-bp cut raises the possibility of further inflows into the asset class and increases the likelihood of reopening market access for some lower-rated countries, which have been priced out so far. We should expect those remaining names with issuance needs to come to market before the US election. In the corporate space, EM fundamentals remain resilient. The second quarter was broadly neutral to slightly positive. Valuations have been mixed, but the supply side technical picture remains very solid. As with sovereigns, September saw heavy supply.

Investor attention is now increasingly shifting toward the US elections and their ramifications for the macro environment. With valuations remaining balanced, we believe that high carry and robust fundamentals should continue to offer support for the asset class.

Multi-Asset

Sunny Ng
Portfolio Manager, Global Multi-Asset

CS 2.75 (-0.75)

With the risk of a hard landing now approaching 50%, we dialed back our risk to stabilize portfolio values, moving our score to 3.0 from 3.5 at mid-month and then adjusting it again, to 2.75, following the FOMC meeting, to embrace a slightly higher risk posture in response to the Fed's accelerated easing measures.

When the Fed went into its July meeting, the trailing three-month run rate for payrolls was hovering around 200,000, with a high and rising portion of that coming from government-funded jobs. The Fed's indecision in July, at a time when we saw employment risks rising, led us to derisk to 3.5. Only several months later, payroll's three-month run rate had stepped down to a pace approaching 100,000. Small businesses, which employ half of the US economy according to the National Federation of Independent Business, saw profits breaking to the downside. This backdrop was what we expected when we took down our score. Since then, while firings still haven't risen, hirings have stair-stepped down at a pace that, if continued, could have ended up morphing into firings by year-end. After Fed Chair Powell broke away from data dependency and the need for unanimous decision-making – not only by making a 50-bp rate cut but also by adjusting Fed dot plots from cuts of 125 bps to 200 bps by the end of 2025 (another break from past soft-landing playbooks) – we quickly nudged up our score to a slightly risk-embracing 2.75. While the bond market had priced in cuts of 300 bps, it has been prematurely overpricing cuts quite consistently for the past 18 months. Finally, however, the Fed was coming their way, and by doing so pre-emptively, it lowered the odds of recession.

The Fed has now begun derisking this situation by offsetting shorter-tailed lags and activating them to work on the upside. Financial conditions improved as we approached this first cut, and they should now bring forth wealth effects to upper-end consumers for the next six months. Less affluent consumers will soon see relief from the high interest rates on their credit cards and auto loans, as will small businesses, whose floating-rate bank loans will become more manageable. Housing will begin coming off the floor. The odds of a recession are falling once again, with a soft landing becoming more likely.

Global Equity

John Song
Research Analyst,
Global Equities

CS 3.00 (unchanged)

Equity markets are at a turning point in the wake of the Fed rate cut, signaling a shift in focus from inflation control to broader economic support.

In the technology sector, the prolonged downturn is driving layoffs, with IT spending sluggish and recovery in demand for PCs and smartphones weaker than expected. While tech is still facing challenges, the outlook should improve as we move closer to 2025. Industrials are in a similar situation, having experienced two years of destocking and PMI readings below 50. However, there are signs that demand is stabilizing, positioning the sector for a stronger 2025. Healthcare faces a similar scenario, with destocking, although demand seems to have pulled back slightly over the last quarter due to weaker spending from pharma.

In financials, pressure on net interest margins will persist as rates fall, but declining rates should support loan growth. While commercial real estate remains a slow-moving problem, it is now viewed as being more manageable, and office foot traffic at retail locations in September approached pre-Covid levels. In the consumer sector, inflation continues to affect lower-income households the most, leading to cutbacks in spending on essentials. Discount retailers are feeling the pressure from weakened consumer demand, while sectors focused on those with higher income remain more resilient.

Global Emerging Markets Equity

Taras Shumelda
Portfolio Manager,
Global Equities

CS 2.50 (unchanged)

Emerging markets reacted well to the Fed's rate cut, led by risk assets, such as tech, China, and Turkey stocks. However, the rate cut alone will not be enough to sustain positive performance; upward earnings revisions are needed.

In China, GDP growth has been disappointing and is getting worse, but tech stocks are pricing resilient growth, which may prove too high given that smartphone and PC demand is not yet rebounding. In Korea valuations remain attractive, with good investment opportunities, especially among the exporters. At the same time, we have trimmed some of our AI-related exposures in Korea and Taiwan as valuations began to look stretched. In India, many high-ticket discretionary purchases, such as cars and travel/lodging, are cooling off. On the other hand, global demand for IT services seems to have bottomed out, and management commentary has turned cautiously optimistic.

Investors remain negative in their sentiment toward Mexican equities, especially after the fast-tracking of a multitude of constitutional changes. Corporates indicated that recent political reforms should not affect their business in the short term. Mexican stocks are at attractive valuations, although it is probably too early to add to this market. The Brazilian central bank has raised rates by 25 bps, as expected. Since Brazil's banks are comfortable with the quality of their assets, the rate hike should not have a big impact on their businesses. In EMEA, a large Polish internet platform beat earnings estimates but gave weak guidance, not dissimilar to a Chinese internet giant. Investors need to keep an eye on similar pressures at other internet platforms.

On the portfolio level, we are adding to financials and are funding it with consumer discretionary and chip manufacturers.

Quantitative Research

Haibo Chen, PhD
Portfolio Manager and
Head of Fixed Income
Quantitative Strategies

We improved our conviction score, driven by curve steepening of 20 bps and a credit spread that has barely moved. Our global credit forecasts are negative, and our relative model favors EM over developed markets (DM). In DM, our model favors REITs, banking, electricals, and financials and dislikes transportation, consumer goods, and energy. In EM, it likes consumer goods and tech, media, and telecom, and it dislikes transportation, pulp and paper, and real estate. Our global rates model forecasts lower yields except for Japan, Switzerland, Norway, and Australia and a steeper curve globally except for Japan. The rates view expressed in our G10 model portfolio is overweight global duration. It is overweight Italy, New Zealand, Belgium, and the UK; it is underweight North America, France, and Germany. Along the curve, it is overweight the six-month, 10-year, and 20-year and underweight the two-year and five-year.

All market data, spreads, and index returns are sourced from Bloomberg as of 23 September 2024.

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pinebridge.com

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