PineBridge® INVESTMENTS

Can Commodity Prices Spoil the Rate-Cutting Party?

Hani Redha, CAIA, Global Multi-Asset Portfolio Manager

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Commodities are in focus as oil and copper prices move another leg higher this year, and even iron ore, one of early-2024's laggards, is starting to rebound. Heightened geopolitical tensions in the Middle East, as well as the ongoing Russia-Ukraine conflict, have also contributed to the rapid rise in commodity prices.

Shifts in commodity prices can have important implications for the global market by influencing economic growth, inflation, monetary policy, and the cost structures of many companies. So can commodity prices conspire to prevent central banks from beginning their interest rate easing cycle?

It's important to set the context for recent moves in the oil market. Structurally, oil supply is plentiful. OPEC+ producers are sitting on ample spare capacity, and US oil production is near record highs and rising. This excess supply fundamentally acts as a "shock absorber" for prices, limiting their ability to remain high even if they spike temporarily due to geopolitical flareups. Saudi Arabia is key here. The country is targeting a desired price range to meet its fiscal spending needs while also preventing excessively high prices that invite acceleration of the "green transition." The only words that would signal a change in mindset by the Saudis would be "market share," yet we believe such a pivot to be unlikely given the supply glut they currently face.

Furthermore, the demand side for oil remains somewhat challenged. The pandemic led to a significant drop in demand, and weak China growth is contributing to a sluggish recovery. Furthermore, as the global energy sector moves toward decarbonization and peak oil demand, the long-term demand outlook becomes increasingly complex and potentially subdued. Given current fundamentals, we expect oil prices to remain range-bound between $80 and $90 per barrel over the coming months.

Industrial metals have also risen sharply in recent months, driven by resilient global growth that is bolstering demand and concerns that production disruptions could create supply constraints. In addition, signs of a revival in Chinese demand continue to support metals, with the latest purchasing managers' indices indicating an expansion in factory activity in March, accompanied by early signs of recovery in global manufacturing and property sectors. But there's significant dispersion of fundamentals across various key metals.

Copper, in particular, has performed well, supported by supply disruptions due to the shutdown of the First Quantum Cobre Panama mine, compounded by lower-than-expected production forecasts from various companies. This structural supply shortage is expected to persist, while demand is supported by green transition initiatives and a post-pandemic pickup in activity. In contrast, steel faces structural oversupply, and weakness in China's property sector – which we expect to persist – is a formidable headwind to demand. Lithium also faces oversupply from previous investments, now exceeding demand, leading to elevated inventories across the supply chain. A significant turnaround for lithium is likely contingent upon the conclusion of the destocking cycle. Overall, copper is the main exception within the metals markets in terms of facing structurally rising deficits (which support prices) in contrast to surpluses elsewhere.

Rising commodity prices have sparked concerns about higher inflation and the possibility of delayed monetary policy easing. However, we expect the impact to be less significant than many anticipate. For example, various analyses suggest that a roughly 10% increase in oil prices could raise global headline inflation by around 30 basis points and core inflation by just 5 basis points over a 12-month period. Given the Fed's primary focus on core inflation, we expect the influence on its monetary policy to be minimal.

In short, elevated commodity prices are unlikely to significantly affect global core inflation or substantially change the monetary policy outlook in most economies, unless prices rise materially from here. We view the latter as unlikely due to plentiful supply capacity across most major commodities. Inflation may still spoil, or delay, the rate-cutting party – but commodity prices won't be the culprit.

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

Ilke Pienaar
Head of Sovereign Research, Global Emerging Markets Fixed Income

CS 2.75 (unchanged)

Despite a significant lowering of expectations for interest-rate cuts in the US this year, financial conditions remain loose, hovering about one standard deviation from their long-term average. Nevertheless, disappointing first-quarter GDP, which grew by a much lower than expected 1.6%, adds credence to our forecast of a slowdown in the second half of the year. The Fed's excess reserve account is depleting fast, the household savings rate is back to its long-term average, and on a rolling 12-month basis, government expenditures once again track below revenue, for the first time in over a year. Additionally, job growth has stalled year-over-year, according to household survey data. Election risks also play into the lower-growth outlook, with the halting effect it can have on immigration depending on the outcome.

Against this backdrop, and despite upward surprises in the first quarter, increases in the Consumer Price Index (CPI) should settle down to the Fed's desired rate of 2% by early 2025, with Personal Consumption Expenditures (PCE) reaching that level in the third quarter of this year. The US dollar is appreciating on a year-on-year basis, credit is still contracting, notwithstanding its most recent bounce, and rental surveys point to ongoing disinflation in the shelter component of CPI.

Markets are now pricing just one rate cut for 2024, which is a likely undershoot of what is more likely to be two cuts before year-end, with a start in July. With the world's other big central banks set to ease this year (with the exception of the Bank of Japan), and with an assist from more stimulative fiscal policy, global growth is generally robust, with global purchasing managers' indices (PMIs) in expansionary territory for the first time since mid-2022.

Rates

Gunter Seeger
Portfolio Manager, Developed Markets Investment Grade

CS 3.00 (-0.20)

The market continues to be very difficult, delivering many "out-of-consensus" outcomes. We have recently seen the longest inversion of two-year and 10-year Treasuries in US history – exceeding the 429-day inversion crafted by Paul Volker in 1979-1980. In the past, long inversions have slowed the economy, and most have led to a recession. This time, however, we have experienced surprisingly strong resilience in employment, housing, equity values, credit spreads, and retail sales. Other unusual signs include the disappearance of the flight-to-quality trade that we used to see in the US, a decline in oil prices despite a seemingly broader war in the Middle East, higher US yields, and the S&P 500 remaining above 5,000. In Japan, immediately after the central bank raised interest rates in March and ceased being the last practitioner of negative interest rate policy (NIRP), the yen fell to 154 per dollar from 150. Since then, Japanese T-bills have traded more negative than before the hike. Near the end of April, the ratio of the US Treasury curve to Fed fund futures (WIRP) is pricing in 1.6 rate cuts for 2024 versus the six it had priced in at the end of January, while the US dollar as measured by the US Dollar Index (DXY) has grown stronger, rising from 101 at the start of the year to 106.

Credit

Steven Oh, CFA
Global Head of Credit and Fixed Income

Credit 3.25 (-0.25)

Recent stronger-than-expected economic data, particularly elevated inflation, has reset market expectations with respect to Fed easing for the year. Unlike prior months when spreads tightened as yields rose, there was a correlated pullback in both rates and spreads in April. The net result is that both spread and yield valuations have improved. Our CS has therefore improved closer to neutral. Recent economic data, however, has not led us to alter our fundamental economic outlook, and we continue to believe market expectations regarding Fed easing were overly optimistic. With the European Central Bank (ECB) poised to move forward with its rate easing and the US less certain about a start date, a policy path divergence is a likely outcome as we enter summer.

In the high yield market, spread widening has helped push yields squarely above 8% once again. With floating-rate loans holding up better due to the technical dynamics created by the year-to-date surge in CLO issuance, we are becoming more neutral between high yield and loans as well as closer to neutral in our views between investment grade and high yield. With the ECB easing and the Fed potentially holding off longer, combined with reasonable spread differentials, European credit is looking marginally more attractive.

Currency (USD Perspective)

Anders Faergemann
Senior Sovereign Portfolio Manager, Emerging Markets Fixed Income

CS 3.00 (+0.25)

While short-term factors are supporting the US dollar, positioning and valuations suggest the US dollar may already be pricing in most of the positive tone. US exceptionalism, terms of trade, and widening yield differentials all favor a stronger US dollar. Adding to that positive view, geopolitics tends to benefit the US dollar as a safe-haven currency. Therefore, we have kept our 12-month euro/US dollar forecast unchanged at 1.05, in line with our view that the global macro outlook best resembles our “Stabilization” scenario, in which the US economy slows down without entering a recession and inflation moderates sufficiently for the Fed to cut three times over the next 12 months. Market perception that the Fed may initiate its rate-cutting cycle after the US election and later than the ECB is subject to second-quarter US data releases that show similar strength to the first quarter. We still see evidence of a two-speed economy in the US, with private payrolls and full-time jobs showing weakness compared with strength in part-time and government-based jobs, including those in education and health. Still, the combined forces of immigration flows and fiscal spending are bolstering US consumer spending, leading the push for US exceptionalism to be extended.

In Europe, we see the ECB having a clearer path toward cutting interest rates three or four times over the next 12 months, starting in June. Inflation is moderating, and while parts of the eurozone are seeing signs of economic recovery, Germany and France are lagging.

Countervailing forces between higher oil prices and the Bank of Japan exiting yield curve control undermined the Japanese yen in April. While the yen is significantly undervalued on a historical basis, bond flows have yet to reverse to provide support for the currency. Japan’s Ministry of Finance has increased its rhetoric around intervention to support the yen but has yet to pull the trigger.

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)

As first-quarter results come in, we remain neutral, with some sectors surprising on the upside and others facing challenges. In Asia, the outlook for the gaming, semiconductor, transportation, and Thai refining sectors is improving, while the outlook for Chinese and Hong Kong property and Korean non-bank financials, steel, and petrochemicals is deteriorating. In Central and Eastern Europe, the Middle East and Africa (CEEMEA), we see positive signs in real estate, oil and gas, and financials and industrials, with challenges facing infrastructure and metals and mining. In infrastructure names, the deterioration was more in dividend policy than operational performance. In Latin America, positives have been seen in consumer goods and real estate, while oil and gas presents challenges. In our global macro scenarios, we raised our “Stabilization” scenario to 70% from 60%, kept “Maintain” at 15%, and reduced “Recession” to 15% from 25% on US data showing a slowdown will take longer to arrive.

Multi-Asset

Amien Johaadien
Research Analyst, Global Multi-Asset

CS 2.80 (unchanged)

Given persistent US inflation and the robust labor market, recent Fed commentary signals diminished confidence in an imminent easing cycle. The Fed has added that if higher inflation persists, it is prepared to maintain the current level of restriction for as long as needed. Despite some speculation about potential rate hikes, we disagree. Excess core CPI inflation is primarily driven by shelter and car insurance costs, both of which are expected to decline as rental calculations mechanically adjust and car insurance costs gradually unwind. Moreover, the Fed remains focused on boosting supply, supported by a rapidly growing US labor force from increased immigration along with productivity gains. This should bolster its confidence that inflation will gradually return to target levels. The critical question now is when and by how much rates can be cut. In our view, cuts will be fewer than what markets had priced in but are still on the horizon.

Though the slope of our Capital Market Line is still not signaling outright caution, nor that investors are being paid particularly well for taking on risk, our nine- to 18-month outlook for the direction of fundamentals (our second criterion for dialing risk up or down) has improved. With odds falling for a recession and continuing to rise for a soft landing, cash flows are now expected to inflect higher. We also now expect quantitative tightening (QT) to end sooner, leaving markets still flush with supersized pandemic-injected liquidity. Previously, we had expected QT to continue until markets were at least facing neutral liquidity conditions.

Global Equity

Ken Ruskin
Director of Research and Head of Sustainable Investing, Global Equities

CS 3.00 (unchanged)

Equity markets lost some momentum in April as the third consecutive stronger-than-expected CPI report triggered a reassessment of the Fed's willingness to cut rates. At the same time, geopolitical risk has increased, raising the price of oil and leading to outperformance by energy stocks.

First-quarter reports are expected to evidence good earnings growth, as consumer spending remains strong. US tech and AI-driven spending also will drive earnings strength. CFOs remain confident in their companies' prospects and are increasingly confident in the US economy. Supply chain de-stocking is expected to impact certain areas of the industrial economy. Geopolitics, election-related policy uncertainty, and the path of interest rate actions remain risks, meaning that limiting macro/factor risk versus the benchmark is as important as ever.

Global Emerging Markets Equity

Taras Shumelda
Portfolio Manager, Global Equities

CS 2.50 (unchanged)

We expect first-quarter earnings to be lower than the expectations held at the quarter's start, perhaps setting up for fewer disappointments in the future and even some earnings-per-share upgrades. The market remains skittish as a no-US-rate-cut scenario, while not a consensus, becomes more popular.

In China, the solar sector shows signs of bottoming and contracts are picking up. E-commerce platforms saw strong activity during the January-February New Year period, but March sales slowed as forecast. Platform retail demand, however, seems stable. Tech names in China and elsewhere in Asia delivered an in-line performance, but after large upgrades companies are hard-pressed to beat expectations. In India, banks report robust retail deposit growth in their preview first-quarter reports, allaying concerns about margin pressure from the higher cost of capital. Consumer-facing companies are reporting an improvement in demand.

In Latin America, 11 of 18 sectors reported year-over-year revenue growth in the fourth quarter of 2023, led by utilities, car rental and logistics, and retail. Domestic retailers in Brazil began to bounce back, especially in the fast-fashion space, as government initiatives have caused cross-border apparel shipments to drop precipitously. Financials with exposure to consumer credit should benefit from lower rates, supporting margins in the cost of funding and net interest, and improving asset quality. In EMEA, there have been no notable changes since last month.

Investors continue to exhibit a lack of conviction in bottom-up fundamentals, but as some sectors and regions have sold off, volatility seems to be subsiding. Geopolitical and top-down factors continue to have a disproportionate role, but lower stock valuations help soften the impact. In our investment decisions, we try to look past such factors as much as possible and focus on companies with strong and improving business models, quality management, sound financial structure, and proper adherence to ESG values.

Quantitative Research

Qian Yang
Quantitative Strategist, Fixed Income Quantitative Strategies

Driven by credit spread tightening of 7 basis points, we have improved our US Conviction Score. Our global credit forecasts are negative, and our relative model favors emerging markets (EM) over developed markets (DM). In DM, our model favors capital goods and banking and brokerage, and dislikes electric, utilities, and natural gas. Among EM industries, our model likes infrastructure and industrials and dislikes real estate, transportation, and diversified industries.

Our global rates model forecasts lower yields and a steeper curve globally. The rates view expressed in our G10 Model portfolio is overweight global duration but divided within regions. In North America it is overweight Canada but underweight the US; in Europe it is overweight Belgium, Spain, and Italy and underweight France and Germany; and in Asia and Oceania it is overweight Japan and underweight Australia. Along the curve, it is overweight in the two-year and 20-year and underweight in the five-, 10-, and 30-year.

All market data, spreads, and index returns are sourced from Bloomberg as of 24 April 2024.

About PineBridge Investments

pinebridge.com

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 31 March 2024, the firm managed US$168.2 billion across global asset classes for sophisticated investors around the world.

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