Western Asset

Webcast Summary

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The Fed and Liquidity Markets: A Time to Wait and See

Inflation has come down over the past year and we think the Fed is nearly finished raising interest rates. The consensus economic outlook has shifted from pessimistic to optimistic, pushing yields up. But we expect slower growth ahead due to tight financial conditions. For the economy overall, we still expect a soft landing absent any unforeseen issues, and the US dollar may weaken after surging to high levels. With yields now at attractive levels, bonds have reverted to their traditional role to once again provide portfolio diversification for investors. Given this environment, we see opportunity to find value in some areas of EM and structured products.

Here are some key takeaways.

Market Review

- Bond yields have risen significantly this year despite improved inflation and a stabilizing Federal Reserve (Fed), driven mainly by growth expectations' shift from pessimistic to optimistic.
- The US dollar appreciated substantially through the end of 2022, reaching rich valuation levels compared to history and fundamentals.
- The Treasury's extensive debt issuance program since the resolution of the debt ceiling issue earlier this year, combined with other factors including the market's economic outlook, has caused recent volatility in long-term yields. But we believe this should subside over time.
- Energy prices spiked earlier in 2022 due to geopolitical tensions, acting as a tax on consumers, but have since moderated to provide some relief.
- The consumer has remained resilient so far, dipping into savings to maintain spending despite high inflation eroding purchasing power and impacting real incomes.

Fed Policy

- With inflation coming down, the Fed can afford to be patient before taking further action, engaging a "wait and see" attitude to determine how the economy responds and evolves.
- T-bill issuance has seen decreased usage of the Fed's Reverse Repo Program (RRP) by money market investors. This is not seen as a systemic risk, but reflects the relatively higher yields T-bills are currently offering compared to the RRP rate.
- The RRP continues to be an important component of the Fed's policy toolkit and ensures yield stability in the overnight repurchase markets.
- The Fed has been unequivocal that moving to a higher inflation target is not under consideration, while remaining committed to bringing inflation down to its 2% target over time.

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Inflation

- Inflation has improved significantly over the last year, with core Personal Consumption Expenditures (PCE) down to 2.5% year-over-year from 5.5% a year ago.
- Supply-chain issues have resolved, the labor market has rebalanced and wages have come down—all factors that should contribute to lower inflation.
- Lower inflation over the past year is consistent with stable to lower bond yields, not the rise that has occurred.
- Further labor market improvements on job growth, wages and participation would help rein in inflation, though more progress is needed.

Portfolio Positioning

- Duration overweight positions have been challenged by the rise in yields, though credit-sensitive sectors of the market benefited from solid economic growth.
- In both broad markets and liquidity portfolios, our expectations around the likely trajectory of interest rates are that we are close to peak levels and cautious duration extension is appropriate.
- Our portfolios emphasize high-quality spread sectors while seeking to generate excess income, another source of returns this year alongside duration and value opportunities.

Outlook

- We expect US economic growth to slow from the solid pace of recent quarters amid restrictive financial conditions.
- While a recession is not expected, we think the risk of a harder landing increases the longer rates stay elevated.
- After surging to rich valuations, we expect the US dollar to moderately depreciate back toward fair value.
- While nominal borrowing levels and the impact of "higher for longer" rates are expected to drive spread widening in certain sectors, and drive relatively higher levels of default at the lower end of the ratings scale over time, this is not evident among the issuers with whom Western Asset liquidity portfolios invest.

Q & A

- We expect the Fed to hold rates at the current, high, restrictive level through year-end, with possibly only one more hike in early 2024 before pausing as they assess the impacts of tightening.
- On the yield curve, we have added exposure on the front end with the Fed nearing the end of hikes, but still see value in the back end given high valuations.
- Geopolitical risks like slower China/Europe growth are headwinds for the US, while Middle East energy tensions could raise oil prices and hurt consumers.
- The consumer has drawn down savings to maintain spending levels despite high inflation and stagnant incomes, but this will be hard to sustain over the long term.
- We think the tight labor market has made good progress at rebalancing supply and demand dynamics and lowering wage growth.

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