

TRANSCRIPT: EPISODE 292

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[INTRODUCTION]

Staci West: Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. This week we explore the current state of the global macro economy with nuanced perspectives on interest rates, inflation, fiscal policy, and monetary policy.

James Yardley (JY): I'm James Yardley, and today I'm joined by Eva Sun-Wai, one of the managers of the M&G Global Macro Bond fund. Thank you very much for joining us today.

Eva Sun-Wai (ESW): Thank you for having me.

[INTERVIEW]

JY: So Eva, yours is a global macro fund, so let's start with the macro economy. It's been an interesting year: where do you see where the world is now and where are we going? What is your sort of broad macro framework at the moment?

ESW: It's definitely been an interesting year. I think when I look back at the end of 2022 and we had lots of 2023 forecasts coming out, we had probably a lot more doom and gloom I think, the consensus was more for a recession or slowdowns to start hitting western economies towards the latter part of this year; we knew that hiking cycles were kind of in the middle and we were likely going to see those come to an end, but the impact of them was really unknown.

And we've now had a year where actually economies, especially in the US, have held up pretty resiliently. In the US especially, we have still that debate on soft landing versus hard landing, it's difficult to know if that recession is actually coming. And I think markets have grappled with that in the bond space in terms of what that means for interest rates, what it means for inflation what it means for fiscal policy as well as monetary. And I feel like this year we've very much seen three phases of higher yields in developed markets.

Phase one being higher inflation expectations, so higher inflation breakevens, which is market expectations of inflation. Phase two was more falling breakevens, falling inflation expectations, and we had flattening of curves. So, we had very inverted yield curves whereby the front end was yielding more than the long end, which is historically a sign of recession. Phase three seems to be

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steeper yield curves, so we have more term premium being priced into the long end, which is essentially investors demanding higher yields for taking on longer dated borrowing, which is ...

JY: If we just explain that to the listeners ... Traditionally I guess you'd expect to be compensated for being invested in a longer bond [**ESW:** Yes]. So, any year bond, say a two year bond, has historically should have a higher yield, I guess, and that's what you are talking about when you're talking about term premium there, isn't it? [**ESW:** Exactly.] But recently the yield curve has actually been inverted the other way, so you're getting a higher yield on your 2 year bond, say, relative to your 10 year, and - as you say - that's historically a sign of recession and yet that recession hasn't come yet.

So, I guess, where are we going now? Are you in this higher-for-longer camp and that we have to keep these interest rates much higher and that we're in a new era now from where we were a few years ago, or do we now see inflation and rates fall back to where they were?

ESW: Yeah, I think the higher-for-longer narrative has really gripped markets for a long part of this year. Personally, if you're talking about the opposite of lower-for-longer, we're actually talking about higher-for-shorter, and I think that's more the camp that I'm in.

We are a little bit more hard landing, a little bit more recessionary in our expectations. In my view, if you hike over 500 basis points in the space of about a year, a year and a half, you will likely see pain in the real economy. In my view, the transmission mechanisms are clearly quite slow, and I think when we talk about the US, if we think about one of the key ways in which that is transmitted into the economy, it's through the mortgage market.

In the US, you have a much longer average length of maturity, lots of maturities in the US are 30-year fixed compared to the UK or you know, we are looking at Sweden at the beginning of the year, which has an average of about a year and a half, so much, much shorter, and you started to see house prices drop off in Sweden much earlier in the year. It's not just through house prices obviously, but one of the main mechanisms in which economies slow down, is through that mortgage market.

And you would assume if you're starting to see people need to take out new mortgages or need to refinance and not want to, and therefore, you know, stay where they are, that limits economic activity, it limits all the extra things you have when you move house: you are not then buying a new car in your new environment, you are not buying new furniture, you are not spending money in a new place. So all of those, there's lots of multiplier effects that come through that limited economic activity.

If we look at the UK - we've been looking at a lot of calculations - it's actually estimated that less than half of the pass-through has happened from higher interest rates into the mortgage market, and considering less than half - and we have much shorter mortgage terms, so that makes me think that

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there's still more pain to come here - over half, which makes me think there's probably the majority still to come in the US.

It's clear that the timing has been, you know, very uncertain, but in my view, if you hike that aggressively [and] that quickly - in an economy that is not used to it, right? We are not used to higher levels of interest rates than we've seen in recent decades, we've had lower for longer for a long time - so, in my view, that the economy is being very resilient, but I think it's all a little bit optimistic in my view.

JY: Interesting. So, how are you playing that then when it comes to the portfolio? Does that mean that you expect interest rates to fall faster in the UK and Europe and therefore do you prefer, say, gilts over treasuries?

And are you also playing currencies in that respect as well as a separate question after that? I mean, does that mean you expect the dollar to be stronger if rates are going to have to be higher in the US?

ESW: I think we've actually got to a point now where, because we've seen bond valuations get to such high levels, across the board I think there's a lot of opportunity not just in the UK and Europe, but treasuries, you know, aside from the recent rally we've had in November, we were hitting 5% in long dated bonds, which is pretty remarkable considering the backdrop.

And so for us, actually, we like US treasuries as well as gilts and bunds [bonds issued by the German government], but we want to be selective. And so as I've said, we are positioned for more of a hard landing scenario, but we want to keep room to continue to add duration if we see the higher-for-longer narrative continue to take hold and we see yields creep higher. I think we've probably seen the peak now, but I think we're likely to perhaps see a bit of consolidation into ranges as opposed to continued sharp rallies that we've seen over November. Especially going into kind of the Christmas season where liquidity drops off, you'd expect probably these bonds to trade more in a range as opposed to continue a very, very strong rally.

But in 2024, I'd expect markets to start pricing in rate cuts a little bit more. I think we're not far off, you know, we're sort of pricing in Q2, Q3 across a couple of markets - I don't think that's unreasonable. Some people think that's too soon. I think that will probably end up happening. You also have to consider fiscal positions, governments and central banks, I don't think are that comfortable with rates this high, given they have refinancing to deal with.

And to answer your currency question again, yes, we do play currencies and we, again, want to remain selective. So when I say we're more hard landing, we're not positioning for complete doomsday. Complete doomsday positioning would be max long duration, would be long dollar, would be absolutely no risk assets. And I don't think we're there yet, I don't think markets are there yet, and I don't think valuations are there yet across the board. So, we have room to add more duration and we do have exposure to other currencies and those where we believe there's still value.

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Emerging markets is a good example whereby we have de-risked on a portfolio level, but within emerging markets there are still very high real yields whereby that means inflation-adjusted yields, which are very attractive in certain emerging markets because they hiked prematurely to developed markets, so they got inflation down quickly and rates have remained high. That means the carry you are getting from the currencies - so, imagine you put your money in a Brazilian bank, you are being paid very, very well in interest rates to hold that foreign currency.

So, there are some elements of the market that we still like and so, we are not completely positioned for doomsday but we are being more selective in where we are taking risk at the moment. And as you said, this fund is a macro fund, it's very flexible and so we can do that in a variety of ways; through government bonds, inflation linked bonds, credit, emerging markets, derivatives. So there's, you know, lots going on under the surface, but broadly the funds have begun to de-risk.

JY: And so where are you in terms of government bonds versus corporate bonds? I mean, are you preferring govies at the moment then? Have you taken down your corporate bonds or maybe your high yield weight?

ESW: Yes. If you look at corporate spreads at the moment, we're seeing pretty tight levels. I don't think we're at max tightness, but we are seeing in my view, quite un-compelling spread levels for the economic backdrop. The difference is though, if you look at the all-in yields, you are seeing very attractive all-in yields in the credit space, especially in investment grade.

So, high yield we don't have much exposure to, because we don't believe that, you know, going into a recessionary environment, we want to be holding high yield. But certain investment grade names: if you look at a corporate bond, it's comprised of an underlying risk-free rate and the corporate spread on top. You look at spreads versus the government bonds of course, but at the moment so much of that yield is being driven by the underlying risk-free rate, that the all-in yields are very, very attractive. So given the spreads aren't as attractive, we would prefer broadly to hold the government bonds, so hold the underlying risk-free rate.

But where we believe there are certain industries, sectors, individual issuers that can weather a recessionary environment very well, we want to take advantage of those all-in yields and clip the carry from those bonds. And that's where, at M&G, we have a very large credit research team and that resource is super valuable in this kind of environment. So where we see value in corporate bonds, we will hold them, will buy them. But broadly, if you look at what's comprising that all-in yield, government bonds relatively look more attractive in my view.

JY: And do you have a strong view on bonds versus equities at the moment? I mean, where are we with bonds now? We've had this incredible bull run for 30 years and now a really painful period for the last few years. Can bonds really work as an asset class going forward? And do you have a view of them versus equity currently?

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ESW: I mean, I won't speak to equity because obviously I'm a bond investor and I'll probably embarrass myself, but I do think we're entering a phase where the prospect of bond returns outstripping equity returns in 2024 is a real possibility.

If I look at six month US government bonds versus the S&P 500, if you compare earnings yields on both, we're actually seeing higher yields from six month treasuries than from the S&P 500. Now naturally there is a duration mismatch there. You would have to assume that you were re-rolling the six month bond every six months at that same yield to get the same overall return. But broadly, what it's showing is to essentially buy a risk-free asset, a six month T-bill, you are getting paid more than the 500 largest market cap corporates in America, which is pretty wild if you really stop and think about it.

So, in my view, valuations for bonds are just very, very attractive. You are very cushioned at this point. We're talking about, oh well what if we don't have a recession? What if the soft landing continues? What if rates continue to creep higher? It's very hard to time that exact entry point and when you expect a pivot in the market or a pivot in central bank policy or in market views, but broadly, you are very cushioned at this point. If you're buying bonds at 5% here higher than equity indices, you are giving yourself a decent amount of protection.

JY: And what are the other big themes going on in the portfolio at the moment? I think you usually have around four to six themes. So, what are the main ideas?

ESW: Yep. As I said, broadly de-risking, but still being selective across credit and emerging markets. Sitting slightly long duration now across your core markets. I think one of the key themes that is pretty uncorrelated to the others, is our view on Japan.

Japan is a space where, when I talk about developed market economies, I'm sort of talking ex Japan because they're in a completely different monetary and economic landscape. We don't like Japanese duration, we do like the currency, which I'll talk about in a minute, but broadly, we think the Bank of Japan still has quite a way to go in terms of adjusting monetary policy. And even if they don't adjust monetary policy, even if they don't exit negative interest rate policy, your downside of not holding those bonds is pretty low given earlier in the year we had the 10 year [bond] at 25 basis points; we had front end essentially negatively yielding, so not holding those bonds, your downside is very, very limited in case those bonds were to rally, they have a floor right? For us, we do.

I went out to visit Tokyo in April, met with officials, met with the Ministry of Finance, et cetera, and it was quite clear that they were very uncomfortable with the prospect of more sustained domestic inflation in Japan. But, if you look at the underlying data, that prospect is still very real. It has stagnated slightly, but broadly, if you look, at service sector inflation, if you look at underlying wage negotiations, that sort of thing, we are seeing more sustained inflation in Japan.

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We also have the prospect of a weaker currency - that potentially imports inflation. We also have the prospect of higher oil prices and that sort of thing is bad for Japan because they're a big importer of oil, et cetera. So they're under quite a bit of pressure.

We have started to see some tightening of policy through yield curve control. So, they have currently been pinning the 10 year point of the curve, and they do that by essentially buying the bonds to keep yields capped, and they've been doing that for a while at the 10 year. They've started to relax that so we've seen a widening of that band so the tolerance level of the 10 year yield has got higher. That has helped the currency a bit, but not enough. And we think going forward, they will likely either completely abolish yield curve control - they probably have to do that before they exit negative interest rate policy in our view.

And so going forward, we do think there is the possibility for higher Japanese bond yields and a stronger currency. So, that is the position we have on that is quite different and quite uncorrelated to the rest of the kind of themes in the portfolio because it's very reliant on the domestic Japanese economy.

Having said that, it's hard to have completely uncorrelated themes but, for example, if the Fed were to cut, that would probably be yen positive because you'd have a weaker dollar. So, you know not everything is uncorrelated, but broadly that view is based on potentially higher sustained inflation in domestic Japan.

JY: And heading into 2024, I mean you've indicated you are more in the hard landing camp, I mean, are there any other strong views you have or anything you are looking out for in particular next year?

ESW: I think the talk of the last couple of months has very much been fiscal positions of governments and central banks. I think that dynamic is going to be very interesting. You know, we have essentially much higher levels of debt to GDP than we've had in the past. And that didn't matter so much in the past because interest rates were perpetually low so, governments could continue to refinance at very low levels and it didn't really matter if they were pushing up their balance sheets and pushing up debt to GDP. We're now in a phase where we have higher debt to GDP levels - I mean Japan is again an outlier here because they're at 250%; broadly, in developed markets, we've sat around a hundred in most economies - and you know, we're coming up to a year when we have refinancing and we have to think about the debt loads of governments and markets have reacted very positively to the US for example, coming out and saying, actually we're going to borrow a bit less than we thought we would next year. And that's been market positive.

But broadly, the fiscal positions of central banks and governments I think will be a very interesting dynamic to watch next year because what's the alternative? They either need to improve growth, which they can't do if they are cutting taxes or cutting spending to try and improve those ratios. We are still not back at target for inflation so we don't think central banks are quite in a position to start

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cutting to boost that growth. It's quite difficult for governments to inflate away their debt to GDP. So, I don't think it's massively problematic because governments and central banks always have tools and things they can use and ways they can refinance. But I think the fiscal versus monetary dynamic is a very interesting one going forward.

JY: Definitely something to keep an eye on. Well, thank you very much for joining us today, Eva. It's always great to hear from a macro specialist, and that was a really fascinating discussion.

ESW: Thank you for having me.

SW: M&G Global Macro Bond is a 'go-anywhere' bond fund. The team of managers use their considerable skill to take a view on macroeconomic conditions, and combine this view with their stock-picking ability to create a portfolio that should benefit from both long-term trends and short-term tactical investments. To learn more about the M&G Global Macro Bond fund, please visit FundCalibre and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.