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**JONATHAN FERRO, BLOOMBERG:**

Let's have that conversation right now with the brilliant Pimcoes, Andrew Balls. Andrew, wonderful to catch up, sir as always. Investors worldwide at the moment seem to be embracing the idea of a soft landing. Do you and the team still see a recession stateside?

**ANDREW BALLS, PIMCO:**

So I think- we think the most likely outcome is a recession. But there have been promising signs in the data. So you could certainly have a slowdown but without the formal recession. I mean, the interesting thing is, we think that you're going to have to see slower growth and some greater weakness in terms of the labor market in order to get inflation coming down next year towards the Fed target. So still our expectation of the rise in unemployment and the kind of magnitude which would normally be associated with having a recession, yeah.

**FERRO:**

We seem to be in this sweet spot at the moment where inflation trends start to look disinflationary, where unemployment remains lower; 3.5 percent, payroll growth remains decent. Do you think that sweet spot can last beyond the next couple of months?

**BALLS:**

I mean, I think, yes, I mean, I think the decline in terms of inflation is promising in the US. Hopefully it's a leading indicator for Europe where we're a little bit behind. But there's not a lot of indication yet of greater labor market weakness. But we do think you have the lagged impact over the next few quarters of all the tightening we've seen. And it's been a very, very rapid rate cycle from the Fed. We think that the impact of tied to credit conditions from the regional banks and the US play into this as well. So yeah, more likely than not that you have a recession over the next few quarters.

**FERRO:**

Let's turn to the Federal Reserve. In your secular outlook in the last couple of months, Andrew, you and the team mentioned that this Fed would tolerate “two point something”. Can you tell me the difference between “two” and “two point something”? How big is that difference?

**BALLS:**

So I think, and it's something that my colleague Rich Clarida has talked about a lot. For the Fed to think about easing policy rates over the next year, year and a half, they're going to see- clearly, they're going to need to see inflation coming down from where we are now. And you know, once you get to “two point something", I mean, at that point you can start to think about rate cuts over time. And there's a question, you know, an uncertainty about quite how the time frame for getting from three, three something down towards two point zero. And this may be something where the Fed is willing to be a little bit patient. But once you get down below 3%, you know, that's near enough- we think; for the central bank that they'll be then thinking about the other side of the, the, the dual mandates as well, you know, this, this recent period, you know, clearly the focus has been wholly on inflation, just given where we have been.

**FERRO:**

Are you making the argument that Andrew that may be the window for cutting might be closer than people anticipate?

**BALLS:**

I don't have any big disagreement with the way the market's pricing. I think the time frame for next year looks reasonable. I think there's two big sets of risks around the baseline outlook. One is is inflation, stickiness. The other one on the other side is greater than expected weakness in the economy. And I think over time, as you get more confidence in terms of the inflation outlook, including getting below 3%, then clearly the focus for the Fed, I think also the focus for markets will be more on the, on the growth risks to the, to the equation. So I don't have any particular disagreement with the way that the market is pricing now, but as you get more, more data, if you do get better indications on the inflation side, then I think the growth risks will come to be, you know, clearer and more focused.

**FERRO:**

Can we push that through the bond market currently with the 10-year at 382? Are you and the team saying that's a buy here?

**BALLS:**

So I think that the level of yields looks pretty attractive for the next few years. I think the outlook in terms of returns looks very attractive for high quality bonds. And if you look at the yields you're getting on, on high quality bonds funds, and then compare that to, to expected equity market returns. And I think it looks very attractive. And then the second thing is with policy rates at this- at these levels, we've just been talking about the potential for Fed rate cuts over time. You do have that, that, that real room for policy easing and that, that room for bond portfolios to, you know, provide a diversification versus equities in your, your overall asset allocation. So I think the level of yields in the US looks attractive. We, you know, at PIMCO,, we've been generally adding a bit more duration in our portfolios over time.

**FERRO:**

Andrew, where does that leave the shape of the yield curve? Because currently, the two-year versus ten-year is negative 101. That's deeply inverted on a historical basis. How are you anticipating that's going to evolve in a month and quarters ahead of us, given what you anticipate is going to happen with growth?

**BALLS:**

Yeah, so I think it's, it's been a long period of inversion. Off the back of this inflation shock, we've had this policy rate shock. I think over time, and if you look into the forward rates, you see the normalization of the curve over time, as the Fed is able to cut rates over time. So in our portfolios, you know, over time, I think we will have a bias to have curve steepening positions in the portfolios. I don't think there's any great rush to put that on myself because we, we, you know, very clear indication that the Federal Reserve will hike rates next week, and they, you know, may well go again after that.

**FERRO:**

So that's the Treasury market and the prospect of a downturn in economic growth. We need to turn to credit as well. High yield spreads, Andrew, are so, so tight. Near the tightest of the year currently, at about 380 basis points. I just wonder whether you're anticipating a pick up in defaults if you're looking for a downturn in growth and how you'd be positioned in credit currently?

**BALLS:**

So if you, so back to the king of the outlook, the baseline of, you know, the possibility of a soft landing, you know, probably more likely, a shallow recession. I don't think that has to be too problematic for credit in that baseline if we get there. The problem is the risk cases around this. If there's inflation stickiness, if the Fed is forced to go more, I think that could be quite disruptive for risk assets and high yield. And in a downside growth case, if the impact of the Fed tightening is more than, you know, we market PIMCO or the consensus is pricing in, I think that's problematic for credit as well. So given the tightness of credit, I think it makes sense to be a little bit underweight here. And there's other alternatives. There's other ways of earning spread without that exposure to corporate credit. I think agency mortgages look quite attractive in the US. And I think, you know, more broadly, there's a set of mortgage-related securities you can buy in the US and globally that look attractive. So I think that's offering, you know, better risk reward at the moment compared with corporate credit. And then, you know, back to the level of 10-year yields for treasuries and the yields on high-quality bond portfolios, I think, you know, sticking with IG, sticking with investment grade credit, you know, seems perfectly sensible here. You don't need to go down in quality or liquidity, I'd say, because the yields you can get with high-quality bonds now are really, you know, really quite attractive.

**FERRO:**

The focus, as you know this morning, is not just on the Fed next week, not just on the ECB, but also on the BOJ. We're reporting that the BOJ isn't going to move away from your curve control anytime soon. Andrew, if we did get a reset of policy at the BOJ and forgive me for the “what if”, but I am trying to work out what the scenario analysis might be from a place like PIMCO. If you're back away at the BOJ, how are you thinking that spills over the European bond market, spills into treasuries? Is it just a wholesale drop of bonds abroad and Japanese investors return home? Like, what happens if the BOJ backs off?

**BALLS:**

So I think there's a range of outcomes. You want to start an argument at PIMCO, this is a pretty good topic. So there's some of us, and I would be in this camp, but I think that the BOJ move is very well telegraphed over time. It's expected that they will move away from yield curve control over time. And compared with the rate shocks we've seen in terms of the Federal Reserve, the European Central Bank, et cetera, it's hard to see why this should have such a big impact in terms of global markets. There's another camp, though. And this is often people who are working on the hedge fund side of the equation where real sensitivity to spill over effects from the BOJ move. So I think we'll see how this plays out over time. My view, and if you look at the move in December, when they started this process, there were no big impacts in terms of global financial markets. So my expectation is something that's well expected should not have too big an impact. And then with JJBs, I mean, we are probably at a somewhat artificial level here. You would expect yields to be a bit higher. You see this with the swap market, if they were to move away from YCC. But I don't think we'd expect very, very significant moves. And yes, as a Japanese investor when you're based in Yen in particular. I think over time, you'll want to see Japanese institutions owning more, being a bit closer to home. But again, the interest rate shock we've seen the levels of yields available, say, on European assets. I think for the market to absorb any shift from the Japanese investor base away from Europe, say, I don't imagine this would be something that would be too difficult to be absorbed.

**FERRO:**

Andrew Balls, thank you, sir, for the outlook on the Fed, of fixed income, the BOJ at the end there too. The PIMCO Global Fixed Income, CIO.