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**KATIE GREIFELD, BLOOMBERG:**

Joining us now, I'm thrilled to say we have PIMCO’s Tony Crescenzi and Bank of America's Meghan Swiber joining me on set on a Friday. So it must be my lucky week. And we're of course meeting before the Fed meeting next week. And Tony, getting away from how many more hikes are left, it seems like July is baked in at this point. How long might this Fed be on hold?

**TONY CRESCENZI, PIMCO:**

Well, the view of rate cuts flies in the face of Paul Volcker, the legendary Fed Chair, and his idea of keeping at it. Of course the title of a book he had. Chair Powell over a year ago said that one of the three lessons of history is to keep at it to sustain the higher rate of the Fed funds rate in order to keep the downward pressure on inflation. The Fed doesn't want to make the mistakes that have happened historically, which is to cut rates prematurely. So you should expect the Fed to keep at it for some time until it's clear, and by clear we mean through inflation expectations that the job is done because the inflation data alone won't cut it. The Fed has to feel that households are confident that the inflation rate will be down over the long run too.

**GREIFELD:**

And Meghan, Tony brings up Paul Volcker. So let's talk about Ben Bernanke because we actually heard from the former Fed Chair this week. He weighed in on the next move saying that it looks very clear that the Fed will raise another 25 basis points at its next meeting. It's possible this increase in July might be the last one. And Meghan, if it's July and done, how does that work itself through the Treasury curve? How are you thinking about opportunities at the short end versus the long end?

**MEGHAN SWIBER, BANK OF AMERICA:**

Sure Katie, great question. So what we see born out in history is that you really want to be buying the last hike of the cycle, particularly further out the curve. So we do think that going long tenses when we're nearing the Fed's final hike makes a lot of sense. You usually see the 10 year rate rally around 100 basis points or so in the 12 months after the Fed's delivered that final hike. Markets right now are only pricing about a 10 basis point rally or so. So we think that those long positions are well-served but important to be putting them further out the curve. Because when you look at what's priced into the front end, and Tony was just making this point earlier, there's a lot of question marks around how long the Fed is going to stay on hold. But the market's pricing a full 25 basis point cut by the first quarter of next year. So we do think that there's more room for the curve to invert further. We like being long further out, but we do think that ultimately the cuts priced in right now are largely overstated.

**GREIFELD:**

And I want to get to the message that the yield curve is sending, but you bring up duration. I'm glad you went there because we actually got the annual investment letter or one of the investment letters from former PIMCO CIO Bill Gross and he wrote that “with inflation back to 3% or so and the Fed nearing the end of its tightening cycle, it would appear to many that a new bond bull market is about to begin. But while I think that the 10 year at 380 may have peaked at 4% for 2023, a bull market is not in the cards.” So Meghan, you've got Bill Gross on the other side of the trade. Tony, where do you fall?

**CRESCENZI:**

Well, we would agree with Meghan. In fact, 90% of the time, since 1978, core bonds, those with duration, let's say, of six and a half years average maturity in the sevens or so, have outperformed cash, T-bills and such, 9% of the time, by an average of three percentage points over three year rolling periods. So looking back, three years from now to today, it's likely that these long end maturities will fare well. And so it's a fool's game to some extent to keep playing the T-bill money market game. Blink and you may miss the next big bond rally, so the time is now for total return styled investing to get the gains that Meghan suggested could occur because a move of 70, 80 basic points or so on a 10-year instrument means a lot in terms of price gains. And you never know when that'll happen and for what reason. And so now is the time, and his history suggests it, when the Fed is about to be done with its rate hike cycle, call it a few months. That's the time to be investing in longer maturities. With stand, we would suggest the volatility that that could bring in the interim because you can't time a diversifier as bonds are. And so we would suggest being weary about doing so.

**GREIFELD:**

So it sounds like the opportunity of cost of cash is very real right now.

**CRESCENZI:**

And speaking over the long term, because, well, this is quite attractive and you do want some liquidity, but you've got to be sure that you're getting a return for that liquidity. In short-term fronts, such as those that we have managed by Jerome Schneider, for example, the carry, the yield to maturity is in the zone of over 6% or so. But you want to be sure that you can part with the liquidity to get those yields, but we think there's always some, for many investors, I should say, ability to part with liquidity to get that extra yield closer to 6%.

**GREIFELD:**

And I do want to get back to the yield curve because that's really been one of the big stories in the market, that extremely stubborn inversion that we're seeing. And what it's actually signaling, Meghan, I was reading your notes and this stuck out to me: “the deeper curve inversion doesn't necessarily mean that recession risk is higher.” Talk to us what you mean by that and what this curve actually is suggesting.

**SWIBER:**

Sure Katie, so I think that when we look at recession probability models, for example, they largely take into account the shape of the yield curve, the very deep inversion that we're seeing. And if you look at those, that would suggest that recession risk is elevated right now. But what the curve inversion is telling us and what the curve tends to get right is anticipating Fed policy action. So the curve inversion is really telling us this message, this expectation for the Fed to be cutting. But the Fed can be cutting for different reasons, right? So in recent cycles, the Fed is cutting alongside the downturn that we saw following the pandemic. It's cutting during the global financial crisis, but the Fed can be cutting this time. And what the market's actually reflecting is cuts alongside inflation moderating very quickly. So certainly we've gotten a lot of good news on this in recent inflation prints. But the market's pricing, not only this perfect storm of inflation falling right now, but that continuing over time. And the Fed operating at a policy rate, as aggressive as they are right now, 5% after they deliver this next hike, ultimately will become more restrictive at a lower inflation rate. So what are used for them being able to cut alongside moderating inflation, which we think is really the message that the curve is telling us right now, not so much these cuts alongside a material growth downturn.

**GREIFELD:**

So in a way, just to draw this point out, it sounds like almost what you're saying is that the fact that the curve is this inverted is in some way an endorsement of the Fed's policy and the path.

**SWIBER:**

Absolutely. And I would say that the one thing that Powell can look back on and really see a lot of credibility on is the inflation market. And five-year break-evens, which are the Fed's view into how the market’s reading these longer-term inflation expectations that Tony mentioned, they've been consistently pricing the Fed being able to hit that 2% target over the long run, even alongside a lot of volatility in spot inflation. So there's a lot of credibility the market is giving the Fed right now.

**CRESCENZI:**

Katie, I was going to say, and I agree with Meghan, that it's the confidence in the Federal Reserve that it will keep inflation down, do whatever it takes, if you will, that is causing it, in part. Secondly, this is what's called the term premium effect, which is the impact of Fed policy in the bond purchases that it made in the past on yields. Consider, for example, the Federal Reserve holds $2.5 trillion worth of mortgages. It has $5 trillion worth of treasuries. It took a lot of bonds off the shelves several years ago during the pandemic. So go to those shelves today. There are fewer items on those shelves, so the prices are naturally higher. As the Fed puts some of those items back on the shelves, the term premium, the additional yields you get for going out. The yield curve will start to rise, and so that will begin to affect yields. But the biggest factor, I can say and agree with Meghan, is the confidence in the Fed, a view on future rate cuts in terms of where yields are eventually going. It's another message to investors to not wait too long in adding duration to turn toward total return style investing, income style investing, anything where you can get the capital gain and high quality assets.

**GREIFELD:**

So there's five different points that I could dig into that are interesting. But Meghan, you also made the point that it's not just a recession that would cause the Fed to cut. We're in restrictive territory now. I don't think that's controversial to say and just getting out of restrictive territory will require some rate cuts. So Tony, I have kind of a difficult question. Where do you think neutral is in this economy?

**CRESCENZI:**

The PIMCO view since 2014 is that the neutral rate is somewhere between zero and a half point above the inflation rate. So call it two and a half or so. It may be evolving. There's a debate about the impact of demographics, for example. We know that 1957, I've mentioned this fact before, it's the biggest birth year of the last century. So that means fast forward 65 plus years later, the big wave of retirement is the biggest wave in history. It's reducing the amount of labor supply and this will continue through 2030, pushing up wages and that could have an impact for all we know on the neutral rate. Secondly, there's this movement worldwide to invest in defense and to invest in the brown to green energy transition, et cetera, supply chains. All that might raise spending and reduce the saving glut that has kept interest rates down could also boost productivity, which can have an influence and upward influence on the neutral rate. So the jury's out, but we're sticking with the idea that it's lower than historical. And that'll keep yields low and the yield curve probably reflects that.

**GREIFELD:**

And we don't have much time left, but I'd be remiss if I didn't mention that it's not just the Fed next week. Of course, we have the ECB and the BOJ as well. And Meghan, when you look at that line up, where do you think the most risk for surprise comes from? Which region? Which

central bank?

**SWIBER:**

That's a good question, Katie. I think ultimately the message that we're hearing across all central banks right now is this commitment to data dependence. So central banks right now are also pretty limited in terms of how much they can ultimately shock the market because so much of the path forward here is really going to come down to the data. We're going to hear that from the Fed next week. The story is going to be a lot more about the focus around what they're ultimately going to do next. And at the end of the day, the Fed needs to be able to push back against some of this easing and financial conditions that we've seen following CPI, the relatively muted reading that we've recently gotten. So all of those things together do lend itself to central banks needing to keep that expectation out there for potential adjustments higher in overnight policy rates.

**GREIFELD:**

All right, a lot to look forward to. This is a great preview. Thank you so much.

**CRESCENZI:**

Thanks.

**GREIFELD:**

Our thanks to Meghan Swiber and Tony Cresenzi.