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**SONALI BASAK, BLOOMBERG:**

Joining us now are PIMCO’s Jerome Schneider and Maureen O'Connor of Wells Fargo. Jerome, as someone who manages so actively along the curve, I want to ask you about the whipsawing of rates this week because we have had a 13 basis point move intraday from the top to the bottom. We are off those highs, but we are pretty close to them. How drastically are expectations changing moving into the end of the year?

**JEROME SCHNEIDER, PIMCO:**

I think that for the most part there's a couple of factors that play into the volatility we're seeing. Number one, we're still coming off the summer doldrums where people are trying to digest risk. We've had a tremendous amount of corporate issuance come into the market over the past week, which has to be digested. Some hedging effects to that, but we're also dealing with the recalibration of expectations not only of inflation, but also where the Fed's destination of a terminal rate might be. And that frankly means that the market is more data sensitive than probably the Federal Reserve at this point in time in terms of digesting this. One of the interesting things quite honestly is the fact that the market has been more or less going about the baseline risks to the expectations of the market, but also the tail risk, the probability of recession. So the fact that we're simply in a range and moving to slightly higher rates is reflective of the fact that the Fed has gotten data, which has been moving slowly toward their comfort zone, but not in their comfort zone. And that is simply a reflection that the market in and of itself might project a soft landing that may not necessarily come as quickly as the Federal Reserve might like.

**BASAK:**

We'll talk more about that landing in a second, but it's important to think through the expectations for corporations. The read through in the economy, Maureen, you work with so many issuers. How much risk is under the surface for them?

**MAUREEN O’CONNOR, WELLS FARGO:**

I think much like in the investor community, the question is when do we see peak rates? And when do we start to crest on the other side? And I think that's the question that a lot of treasurer and CFO level folks are trying to get their arms around right now. Is now the right time to be leveraging up your balance sheet, refinancing debt, funding acquisitions, digging into catbacks at these elevated rate levels? Or is this the rate environment we're going to be in for some time? And I think you're starting to see around the edges a little bit of acquiescing where companies are willing to extend duration a little bit across the curve, willing to lean in a little bit, recognizing that this higher for longer narrative is probably with us for some time. And a two and a half percent ten-year treasury yield is probably something of the past.

**BASAK:**

It's interesting to see the mid-year expectations for rate cuts next year still. Do you think the corporate issuers, Maureen, are having different expectations about rates lowering at all from here?

**O’CONNOR:**

I think you definitely saw it last year, right? Last year we were in the middle of a rate shock and the narrative was this is transitory. This won't last. We will be looking at materially lower rates at some point in the near term and you saw the duration of issuance get much shorter on the curve. You saw borrowers accessing the CP market in larger sizes. You saw borrowers accessing floating rate debt, bank level debt in larger size in an effort just to kind of bridge themselves to a lower funding environment in the future. And now you're starting to see that narrative shift a little bit. So while the market is definitely pricing in cuts for next year around 100 basis points or so, I think the overarching thesis that we're starting to get our sense of with our corporate clients is that that might not actually play out. I think there'll be some normalization in the curve, but I think in terms of term level interest rates, while we might see a little bit of relief, I don’t think anyone is forecasting a materially lower rate environment over the course of the next 12 months.

**BASAK:**

Now, how do these expectations change when you see the economic data come in, Jerome? Do you think that this supports the case for even higher for longer when the Fed is thinking about their calculus?

**SCHNEIDER:**

Yeah, for one, I think that we have to focus on the fact that the Fed is probably not as data dependent in the immediate sense as you might think. That will probably be articulated in terms of a hawkish pause, suggesting they’re going to remain vigilant but not necessarily act. We do expect that there's a possibility of additional rate hike at PIMCO later this year, but I think we are getting to that top end of the crescendo of the rate hiking policy sequence, which means that ultimately, we have to get comfortable with the higher rates for longer. Now, the second part of that sequence is how quickly inflation comes back down to the landing zone that the Fed wants of that 2% rate. And while we do think that core inflation, especially the more favored metrics that Jerome Powell likes, shelter, et cetera, we don't necessarily see that happening as quickly. So one of the reasons that we anticipate what we would call a softish landing at PIMCO is the fact that inflation figures will probably remain stickier than central banks would like for the immediate sense, which means some of that 100 basis point rate cut that's forecasted for next year might not actually come to fruition over the course of 2024 and 2025. So that friction, that reconciliation is something that investors can actually benefit from by being at the front into the yield curve. But at the same time, recognize that yields are very much more attractive across the curve compared to where we were 6, 12 months ago, given the recalibration of rates.

**BASAK:**

We know that things will come fast and heavy after the Labor Day holiday, but next week is pretty much a doozy. You have the Fed, you have the BOJ. When you think about the relative story of the United States, Jerome, how complicated does that make your job?

**SCHNEIDER:**

Yeah, it makes it complicated because not only are we weighing geopolitical factors and economic data factors, we’re weighing other factors from central banks. In fact, obviously this week, we are not only considering the hawkish pause to come from the Fed, but the dovish hike that happened at the ECB. The Bank of Japan clearly is in play. And we're dealing with various factors of globalization and effectively deflation, which might have longer term effects within the economic sequencing. What I think is important is to recognize the fact that there will be a need for a little bit of higher degree of flexibility, not only within portfolios that we manage, but also from issuers perspective, from investors perspective, to understand that the transition period might not necessarily be as smooth as people would expect. And there could, in fact, be aftershocks to liquidity, to market conditions, to pricing of credit that happened as we digest this economic cycle that perhaps isn't necessarily as soft landing as people might expect over that period of time. So these are a myriad of factors. In addition to other factors later in 2024, the election, et cetera, which come into play that might weigh on markets.

**BASAK:**

There is this idea of front-running, not only economic data, but to your point, key events, the elections, the Fed decision. At what point here does the actual data itself become a bigger concern, Maureen? How much are you concerned about liquidity in particular?

**O’CONNOR:**

Well, in the credit markets, the markets have almost never felt as liquid as they do right now, right? And certainly we are at a high point in terms of just the appetite for primary product. You'll see dips in liquidity, certainly over the summer months and the end of August in particular. You'll see dips in liquidity as we close out the year. But in terms of the available cash and the technical landscape in both the high-grade and high-yield markets, it's basically never felt better. We've had a robust primary pipeline in the last couple of weeks in both markets, but it's going to taper off as we move into the end of the year. So I don't expect that narrative to really change. The election is obviously on our radar screens. It's not getting much airplay in my market. It's so far off, it might as well be a decade off at this point. So I'm sure as we get closer, we're going to start to see a little bit of noise around that. But to your point around how issuers position around that, a lot of companies just want to get in front of it, right? Derisk it. You saw that this month. There was key inflation data this week. There's obviously a pretty critical Fed meeting next week. So the month was very front-loaded. We had a really big last couple of weeks. And we'll have a quiet couple of weeks to end the month as we navigate through some of those releases.

**BASAK:**

It's amazing how much nervousness has really ticked up in conversations. Jerome, when you think about the idea of data becoming much harder than expected, this idea that the soft landing might not come as soft as you would think, in that scenario, where do you go?

**SCHNEIDER:**

Yeah, what we think about is being a little bit more defensive. And while we reflect that there are liquid markets at this point in time as Maureen suggests, we also paint a more cautionary tone that some of this liquidity could evaporate as you get tighter liquidity conditions as excess reserves are removed from the system, et cetera. So we are on a path where we have to be very focused on liquidity and more importantly, this has probably been never a better time in more than a decade to actually have higher amounts of liquidity for defensive purposes from a corporate perspective and not really worry about the impact to performance, meaning the drag from higher cash balances, the drag from additional liquidity isn't as consequential. In fact, it's quite beneficial at this point in time. So if you're a corporate CFO, if you're a treasurer, you're going to think about the defensive mechanism of having higher cash balances and a liquidity profile which favors higher cash balances, not just today, but over the course of the next one to two years. We're seeing that also on the investor side where cash management has become a real focus. But I think the focal point here is that given the uncertainty of if it's a soft landing or otherwise, the tail risks are something that's relatively undervalued, meaning there is prudency to be had in being more defensive at this point in time, given the optimistic outlook that generally the market is possessing right now.

**BASAK:**

Our thanks to PIMCO’s Jerome Schneider and Maureen O'Connor of Wells Fargo.