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**LISA ABRAMOWICZ, BLOOMBERG:**

Meanwhile, stocks are heading for an eighth year of outperformance in a decade. Goldman Sachs believes that will soon end with illustrating, “The US equity market now has more concentration risk than other major markets. Investors should increasingly focus less on regional exceptionalism”. Joining us now, I’m so pleased to say, somebody with incredible insight, PIMCO’s Erin Browne. Erin, do you agree that US exceptionalism can only go so far and that it’s kind of running out?

**ERIN BROWNE, PIMCO:**

I actually disagree with that statement. I mean, you’ve seen a decade of US outperformance, but I think that’s been really justified by the fact that the US is a higher quality index. It has higher free cash flow generation than its European or other developed market, non-US peers. And in addition to that, in a market where you’re getting five, six percent yields on cash right now, cash-riched US companies stand to benefit from being able to invest that cash into decent yielding environments. So I think that the preference for quality, particularly in this type of cyclical environment is going to continue to outperform. And I think that the US is best positioned on a regional basis to take advantage of that.

**ABRAMOWICZ:**

There are a couple of questions embedded within this. Number one is how long can the US ride its tech wave, right? And that’s been a big question. There’s also this question of whether the US can get disinflation without incurring some more economic pain. Can we start on the latter, to begin with? Do you think that it is possible to get that disinflation that the Fed is seeking without seeing the kind of pain in the likes of Europe and elsewhere that’s transpiring?

**BROWNE:**

So you are starting to see inflation come down. I think the question really is, is it going to come down fast enough and far enough in order for the Fed to meet its objective of 2%. I think that you’ll likely see, you know, it’s probably a safe bet that you’ll likely see additional financial condition tightening, you know, at the end of this year and through next year, whether that’s through markets itself or through the Fed doing one more interest rate hike. And I do think that that will get inflation down, but it’s probably going to still remain sort of sticky in a high 2% range through the end of next year, which is I think going to be difficult for the Fed to really engineer any type of accommodation with interest rate cuts. So I do think that it’s a fairly fine line that the Fed is going to be facing next year, but ultimately we are seeing inflation come down. I don’t think you’re going to see significant economic pain in the US. You may see some retrenchment in growth, but it’s going to be a very low growth, not necessarily severe recession as we enter 2024.

**ABRAMOWICZ:**

Given that backdrop, our bright spot stocks are the pain trade for stocks to keep climbing because they are cash rich. They are able to capitalize on an economy that’s not sinking dramatically, and frankly are in pretty good positions, especially with their tech leadership.

**BROWNE:**

So I think you’re going to see real differentiation emerge as we move through 2024. You saw some of that this year, you’re going to continue to see it next year in terms of differentiation between the high quality stocks and their lower quality stocks. Right now, stocks are competing against a yield rich environment on the fixed income side, which is yielding you north of 5% on cash, and so that’s a difficult environment for equity investors as a starting point. So for companies that aren’t delivering with respect to earnings, with respect to sales, and with respect to free cash flow, there’s another alternative out there right now on the fixed income side. It’s a safe haven asset. That said, I think that high quality companies that are able to generate growth and free cash flow will continue to do well in 2024, because I don’t think we’re going into a recession, and if we do go into recession, it’s going to be a fairly mild one. And so in that environment where you have slow growth, but not necessarily severely negative growth, but stocks that are able to generate good returns, good earnings are going to continue to do well. So I think you really have to pick your spots as you enter next year.

**ABRAMOWICZ:**

As you pick your spots, and it is selective, I’m curious how you’re allocating, given the fact that the ballast of bonds has shifted, and that the ballast of stocks has become more idiosyncratic.

**BROWNE:**

So I think that particularly good quality, high investment grade, fixed income instruments, I think, should continue to do well. Agency mortgages, I think, look very cheap. Even non-agency mortgages, structured products, also look relatively attractive in this environment, as does high quality fixed income broadly. Some equities, I think, also look attractive, but where we’re really staying away from are equities that are really dependent on an easy interest rate environment. Some stocks like the homebuilders, like consumer autos, have done really, you know, decently well this year, particularly the home building sector, but yet, you know, an 8% mortgage rate is going to really start to bite next year. And so I think that those are the stocks, the ones that are consumer facing, but also highly dependent on easy credit. Those are the stocks that I think are under-formed. You know, broadly speaking, I think the equity market will have sort of low sort of to flat growth next year in terms of the total equity to return, but I think you will see real differentiation between, you know, those stocks that can internally generate its own growth in cash flow versus those that are really dependent on an easy financing condition, which are going to be hurt, I think, you know, even more so next year.

**ABRAMOWICZ:**

Within the credit sphere, you’re talking about some of the more interest rate sensitive on the equity sphere. In the credit sphere, there’s been a lot of befuddlement about why we haven’t seen more pain. Former Fed Governor Jeremy Stein was quoted in a Bloomberg piece today saying, “if you had told me two years ago that the Fed would hike by this much in a short time, I would have said that they would leave dead bodies littered across the corporate credit landscape.” A lot of people would have agreed, is that deferred delayed or just put off indefinitely?

**BROWNE:**

I think it’s a little bit of both. I think firstly, you’ve been in an environment with over a decade of super low interest rates, where corporates have termed out their debt. And so you haven’t seen, you know, significant debt maturities coming due over the last couple of years. And I think as a result of that, you know, companies have been able to hold in there. If you look at interest rate costs in the US, they haven’t, you know, increased in terms of the aggregate share of the corporate balance sheet that much. And corporations that are cash rich have actually been able to take advantage of this high interest rate environment and reinvest their cash flow into, you know, higher yielding money market funds or, you know, cash funds. And so as a result of that, you haven’t seen corporate credit pain. You also haven’t seen household pain either, because similarly, households have been able to term out their debt structure through the 30-year mortgage, which is why you’re seeing a different outcome in the US with respect to, you know, non-performing loans versus other more interest rate sensitive economies. That said, there’s only so long that this can last. And so you are seeing cracks in the leveraged loan market. You are starting to see some cracks in the floating rate market, as well as the, you know, more just stressed high yield market. I think that those are going to be more idiosyncratic stories. We don’t have a significant debt maturity wall until the end of this, of this decade. And so I think by and large, corporates that are, you know, investment grades should hold on and be okay.

**ABRAMOWICZ:**

Erin Browne, thank you so much, as always, for your insights.