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**MANUS CRANNY, BLOOMBERG:**

PIMCO, they're anticipating another corner of the market to do well. They're renewing the bullish bond forecast for the new year, writing, “Current valuations and an outlook for challenging economic growth, diminishing inflation. We believe bonds have rarely appeared more compelling than equities.” Geraldine Sunström and the team at PIMCO put the note out; Portfolio Manager. Now, Geraldine, what goes through Dani and I's mind, we're looking at this marvelous quote. We know that you've said this before at the start of the year, it didn't go so well. But what kind of hard landing do you need to see to deliver that outperformance of the bonds to equity spread? Good morning.

**GERALDINE SUNDSTROM, PIMCO:**

Good morning. Well, we don't think that you need a hard landing at all. The best predictor of bond return is the current yield and at the moment with yields where they are, even out on the belly of the curve in the US or other countries in Europe, the expected returns are looking good. If you have a bit of a harder landing than the market is pricing, then those returns will be even higher whereas equities- where the equity risk premium is at the moment will struggle to beat those types of returns. So- and even if inflation were to be quite sticky, you have quite a lot of protection for higher yield embedded in this type of carry at the moment.

**DANI BURGER, BLOOMBERG:**

Well, you're talking about the equity risk premium. If stocks are going to struggle Geraldine, in 2024, just how bad does it get?

**SUNDSTROM:**

We don't think there is going to be a hard landing. We think there's sort of a toss of a coin if we get a recession or not in 2024. So we're a little bit more cautious than consensus out there. But, yeah, so I think it actually, yeah, I forgot your question. Sorry, it's Friday!

**BURGER:**

Geraldine, honestly, I do the same thing all the time. Don't tell Manus.

**CRANNY:**

It happens everyday!

**BURGER:**

Don't tell Manus, sometimes he says stuff to me and I've forgotten what he said. But I wanted to know specifically about stocks. In these two scenarios, you've laid out in- We don't get a hard landing, maybe we do, it's a coin toss. How ugly does it get out there for stocks if we do get to that kind of landing?

**SUNDSTROM:**

No, I think earnings expectations for next year are still quite elevated. I mean, earnings see some acceleration of the economy, which is a sort of dichotomy versus our expectation of growth slowing down. So we think we're going to continue to see disappointment in terms of earnings consensus next year. That said, you know, it's not a hard landing if there is a recession, it's going to be a mild one. But you could definitely see a correction, multiples are pretty elevated, especially with the Magnificent 7. There are other markets which are much more fairly valued out there. And it's hard to see this market as a really big broadening rally beyond some secular area or tech-related area that are still seeing a lot of growth. So we're cautious, but we're not calling for a crash of the market.

**CRANNY:**

OK, so maybe a correction, a little bit of pressure on stocks, no dramatically hard landing. So let's translate that into credit. You're quite bullish on bonds. We know that, the belly of the curve. We've got that message loud and clear. Let's talk about the probability. Late cycle is where you say there is a 50% probability of a recession. If we are late cycle, and Dani and I were chatting about this yesterday, we looked at Moody’s this morning. They say speculative corporate defaults are running at 5%. Now, that's the highest since 2021. What we want to know is what kind of defaults cycle are we going to get in 2024? Where is that going to be most pronounced in terms of spreads? Do we blow out? And how aggressively do we blow out?

**SUNDSTROM:**

So we really recommend to go up the quality, be it in equities or credit, and stay away from the more cyclical, much more interest rate sensitive sector, which could have a hard time. The good news, though, is that during the very low interest rates, companies have turned out that debt pretty far out. So the wall of maturity is not necessarily going to come right here right now and is going to be much more gradual, especially towards 2025. So there's not necessarily going to be a big credit cycle like we're used to. Companies have been very clever during the very low levels of interest rates, but that's not a recommendation to go for junk credit. We really stay in a securitized part of the credit market, high-quality investment grade, and certainly not in sectors that are very sensitive to interest rates.

**BURGER:**

Geraldine, it's been a year of a lot of soul searching for the bond bulls. I know PIMCO and your team were among those that said bonds are back. You're not the only one. A lot of people got this wrong. Where did that soul searching lead you to? What do you think's been the biggest miscalculation this year?

**SUNDSTROM:**

Well, I think the transmission of monetary policy probably did not work as we thought. There were a lot more structural savings that were there. So the consumer was very resilient, mortgaged, or very fixed, rather than floating in many economies. And so if we feel that it's much more like a delay, things take longer to happen because of the series of supply, shock, and demand shocks that we have. But eventually, as time goes by, we do see things roll over. And of course, when you look at Europe, you see that we are flirting with recession. You see the data in the UK this morning. Those economies are a lot more sensitive to interest rates, and we see the result there. So the US has been a bit of an exception out there. But as time goes by, we will see where the convergence occurs. And we would think that the convergence is more likely to be towards more slowing in the US than acceleration in the rest of the world.

**CRANNY:**

So Geraldine, I mean, you've touched on the big news points this morning, slowdown in the UK, jobs data the USA, rising. But you are underweight in Japan. I'm just trying to close off this conversation this morning. I could be long the belly in the US, I could be long gilts, or I could be long in Japan. Where are you materially changing your allocation? Is it the big bond event that we're all anticipating in Japan? Your call across the three assets this morning?

**SUNDSTROM:**

We think that the risk reward in Japan, given the low level of yield, even though the yield curve control has not really been dealt with, is rather poor. So we prefer to be in those areas where there should be a harder landing and consensus be wrong. You actually do get protection. You do get diversification in your portfolio. And you can find this a lot more in the dollar block that could also be countries like Australia, which are, in our view, more sensitive to interest rates than the US in terms of an economy, or the UK for that matter. And a bit willing to go a little bit out on this curve because you don't really lose so much. The curves used to be very inverted. So going out in the belly of the curve was a costly exercise relative to the money market. But these days, curves are a lot flatter. So it's good to go out on that curve, get the real protection, because in the money market, you don't have this duration. You don't have this lever effect that will protect your portfolio.

**CRANNY:**

Maybe it's protection myself.

**BURGER:**

Yeah.

**CRANNY:**

I can't open the money market phone, Geraldine.

**BURGER:**

Well, I was going to say, I was going to say, you know, it's good news for Manus, because he's been struggling. The US literally doesn't recognize him as a whole human being. It's very sad. Geraldine, I'm afraid that's all we have time for. Thank you so much for joining us this Friday morning. Enjoy your weekend. That's PIMCO’s Geraldine Sundström.