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**SCOTT WAPNER, CNBC:**

Let's bring in Erin Browne now of PIMCO to expand our conversation. Welcome back. It's good to see you. What do you make of what Liz (Young) had to say and how you assess this market as we approach the final stretch?

**ERIN BROWNE, PIMCO:**

So I see the world a little bit differently than Liz. I think if you thread a needle through the economy, it's holding up okay. Yes, you’ve seen significant central bank hikes, but at the same time, when you look at financial conditions, they've eased pretty significantly since the third quarter and they're really back at the lowest levels that we've seen year to date, absent a brief blip over the summer. And so you're starting to see financial conditions ease. Yes, the unemployment rate has risen, but it's risen on the back of an expanding labor force. And so when you look at the employment to population ratio, it's actually done very well. And so all of this I think is really supporting a stronger consumer. On the margin, there are cracks. And I do think that you will see dislocations in certain segments of the economy, but I think what's really distinct about what we're seeing now versus prior slowdowns or recessions is that you're seeing these mini cycles, these mini inventory correction cycles, which are affecting maybe one part of the economy, but the rest and the whole of the economy is holding in pretty decently well. And I think that that's really going to be the story continuing into 2024, where the equity market will do just fine, but you will see dislocations in certain pockets of the market, which will materially underperform.

**WAPNER:**

What does “just fine” mean in terms of the kind of return that somebody can expect in the new year?

**BROWNE:**

So you're not going to see the same explosive growth that we saw in the third quarter, where GDP growth was 5% on an annualized basis. You're probably slowing something into the mid two percent range next year, which is about trend, maybe slightly below trend, but still in positive territory. And that creates an environment where GDP growth can be sort of high single digits. So I think that the returns next year are going to be lower than we'll experience this year for the aggregate S&P 500, but still in positive territory.

**WAPNER:**

What if the Fed cuts? What's that going to mean, right? We always say don't fight the Fed. Well, it hurts you on the way up when they're hiking. Doesn't it help you on the way down when they're cutting?

**BROWNE:**

So I think that the market right now is a little overexcited about the potential for Fed cuts. The market right now is pricing in three cuts by the end of next year, and a continuation of those cuts at a more accelerated pace as we move into 2025. And they're really expecting that the market's going to start cutting in June and do one-a-quarter thereafter through the end of the year. I think just given the fact that we're not expecting a significant recession, you're not expecting a significant slowdown, there is a dislocation right now between what the fixed income market's pricing in, which is three rate cuts next year, and what equities are pricing in, which is 15% year on year earnings growth in the fourth quarter of next year. Those two don't really align. So I do think that the Fed is probably likely to be disappointed relative to what's priced into the market with respect to rate cuts and that they will be fairly gradual in their rate cuts next year, just because inflation is going to be slow to come back down below the 2% threshold. We’re probably not likely to experience that next year or until very late in the year.

**WAPNER:**

So if returns are going to be okay, they're not going to be negative, right? We're going to do okay, just fine, those were your words. What's the composition of that going to look like? Is it going to be like it was this year where it's still the top heavy names because of concerns that persist about the economy and growth? If you expect on one hand that growth is going to be slower from a GDP standpoint, then aren't I going to want to just stay with those names that I've danced with to this point?

**BROWNE:**

I think that's true. I do think that the large caps will likely outperform. They're going to have better access to public market liquidity, better market, better free cash flow generation. Small caps, particularly ones that are really leveraged to the lower income consumer or really have high balance sheet leverage are probably going to continue to underperform, just given the fact that rates are still quite high and borrowing costs are still quite prohibitive for those companies. But I do think that you'll start to see certain pockets of the market, like the tech sector I think will continue to be a leader next year. Homebuilders, consumer autos, I think will start to roll over. Homebuilders in particular have been a star performer this year, but I do think that that's going to become increasingly difficult. And largely speaking, you kind of want to stick with the winners of this year. January is always a reversal month. I wouldn't get scared, but beyond January, I would stick with your winners because I think that those companies that are up in quality, that are able to generate free cash flow in absence of a high GDP environment are likely the ones that are going to be winners next year as well.

**WAPNER:**

The old proverb, dance with who brung you. That's essentially what Erin is suggesting. Does that composition of the market look like that as well to you?

**LIZ YOUNG, SOFI:**

If I had to make the bull case right now, no, I would want there to be more participation from other parts of the market. And if we're going to try to be consistent through, all right, cuts are going to start, the Fed starts cutting because they want to, because they can, they want to normalize, that would actually indicate that we went from late cycle and we're trying to transition back to early cycle without a recession, which again, I would say possible, not probable, but if we're transitioning back into early cycle, that's where you usually see leadership from things like small cap, the cyclicals, the typical cyclicals, industrials, energy, financials. So I would expect those to start to come up, where we talked about this all year, will the bottom line of the rest of the market come up to meet those magnificent seven.

**WAPNER:**

Do you think that’s going to happen or no?

**YOUNG:**

Well, if it were a bull case and we got back into early cycle behavior, those laggards should come up to meet the top ones, but that's not my base case right now.

**WAPNER:**

Erin, what about you, this idea that these lagging places in the market, and maybe the biggest question mark of all are the small caps at this particular time. How do you feel about those?

**BROWNE:**

So I don't think that we're going to be in an early cycle environment next year. If we were, I agree that early cycle environment's small caps tend to be the ones that outperform, but I actually think that this is going to be almost an elongated late cycle environment next year, where we're not tipping over to recession, we're staying in a low growth environment, and in that type of environment, you really want to own quality. You don't want to own the junkier credits or the small caps. And so to me, I think it's going to continue to be an environment where small caps, which have less liquidity and oftentimes less access to credit, they're going to continue to be constrained and have to continue to underperform.

**WAPNER:**

The other idea, Liz, is that if the labor market doesn't roll over, maybe we're not as late cycle as some want us to believe we are. Because if the labor market holds up, then theoretically, consumer spending is going to hold up. The economy at large for a two thirds discretionary spending economy is going to hold up. Maybe we're not as late cycle as some want us to believe.

**YOUNG:**

In which case, it would be an elongated late cycle, right?

**WAPNER:**

Unless we're just not nearly as late cycle as some want us to believe we are, right?

**YOUNG:**

Maybe. I think we're also just used to an unemployment rate that's so low. That's not a normal unemployment rate. A frictional or sort of regular unemployment rate in the economy is four, four and a half percent. The average is actually above 5%. So, I think we're just so used to it being so low that it's uncomfortable if it rises above four. It's not necessarily indicating that we're in a recession, though. We've got some wiggle room.

**WAPNER:**

Erin, last point to you, the other idea being that you definitely want to stay in the US versus other areas of the world, Europe included.

**BROWNE:**

That's absolutely right. I think Europe is having challenges, and I think that European growth is slipping. Look at the data that's coming out of Germany as an example. I think that that's going to be a much more challenging market for positive equity returns. And so, the US, which typically screens as up in quality anyway, is definitely going to be where you want to invest. Europe has done well the last couple of years. I think this next year is going to be the US's chance to really outperform and shine.

**WAPNER:**

All right. I appreciate it. That was fun. Erin, thank you. We'll talk to you soon