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**SONALI BASAK, BLOOMBERG:**

Joining us now, Debbie Cunningham of Federated Hermes and PIMCO’s Tiffany Wilding. Tiffany, when you look at the volatility just in the two-year alone, let alone along the curve, how much risk is there still in short end rates?

**TIFFANY WILDING, PIMCO:**

In our recent Outlook piece for 2024, we titled it Navigating the Descent, because inflation has come down quite a bit from peak levels. Eventually, the Federal Reserve and other central banks will be cutting, but the path to getting there, and then ultimately, the pace thereafter, is probably going to be a bumpy road. And I think that the recent volatility that you've seen in the front end is a clear example of that.

**BASAK:**

Deborah, how do you think about even moving along the curve here? Because you saw just a couple days ago, the five-year really take a drastic leg down in terms of yields you were seeing, a huge bit into that five-year portion of the curve. Is that still a place you would be buying or how much risk do you see as you start to move along in duration?

**DEBORAH CUNNINGHAM, FEDERATED HERMES:**

I think there's more risk than the market is willing to accept at this point. And I agree with Tiffany, and ultimately, what that means is volatility is going to continue to abound. I'm not quite sure why the market rallied post the FOMC this week. I mean, Jerome Powell seemed very clear. March was off the table, and now the numbers that support that from an economic perspective are coming to fruition. And so finally, for the market, it's like getting cold water thrown on it. But quite honestly, I think it was over zealous for a good portion of the month of January already. And my expectations would be for the rest of this quarter and probably even the rest of the first half, you're going to see some ups and downs that are pretty substantial in the market.

**BASAK:**

Well, Deborah, double down there. How do you navigate? Where do you buy or sell to position for that reality?

**CUNNINGHAM:**

Well, I think you have to look at the time frame. If you're looking at true cash, things that you need from an operating basis today, tomorrow, and next week, that stays in short-term securities, that stays in money market funds, that stays in very liquid available funds on a given day without really principal risk associated with them. If you're talking about something from a strategic or a core cash basis that will likely not be needed until maybe the end of this year, the second half at some point, or maybe even into 2025, then I think you're very safe navigating out into the next aspects of the curve, whether it's micro short or ultra short, one to two-year type of space. But I wouldn't do it with cash that you are worried about from a principal perspective over the next couple months.

**BASAK:**

When you think, Tiffany, just about how shocking and conflicting some of the data has been, just how strong jobs have been, just today alone, in its report, do you reposition to capitalize on the direction of travel here as market expectations change?

**WILDING:**

Well, so I think that any good risk manager has to think in terms of scenario planning. And although the rhetoric has certainly been that a soft landing, the probability of that is increased, and we don't necessarily disagree with that, Chair Powell himself even said that the balance of risks are looking more balanced. But nevertheless, there's still risks out there. And I think the fact that growth in the United States has been so strong relative to its past history in the second half of this year, but also relative to its developed market peers, which have really stagnated, and you're still seeing very strong trends within the labor market. A labor market that's even maybe inflecting a little bit higher here, then you have to be a little bit worried that inflation could reaccelerate. Now, of course, in 2023, you had good supply side news that resulted in inflation coming down despite all that demand that we had. But that might not be the case in 2024. As we've argued, you can't go to heaven twice. Those supply side gains might have run their course. So I think you have to be cognizant of re-acceleration risks, but of course, on the other side of that, the issues with New York Community Bank, and obviously, what we know in CRE markets, you have to be cognizant of those downside risks as well.

**BASAK:**

Debbie, follow up here on this idea of re-acceleration of inflation. It's not just hot jobs, it's wages too. How much does that pose a risk into the coming months as the market recalibrates any potential for a rate cut?

**CUNNINGHAM:**

I think wage inflation, I think housing inflation, those are things that continue to run very hot. They've come down. The acceleration has certainly slowed, but they're still rising. They're not decelerating at this point. And I think there are substantial concerns that those will offset what have been gains from an energy sector from a supply side perspective in 2023, as we go out into the first half of 2024 and re-acceleration is quite possible. I think the confidence level that Chair Powell continued to emphasize at his press conference this week needs to be addressed.

**BASAK:**

You just think about the re-acceleration of expectations, not just about a March rate cut, the idea pretty much going away in markets, even a May cut. You had the odds drop from more than 90% down to about 66, 65% in the market today. Tiffany, how likely do you think a May cut will be at this point?

**WILDING:**

I think the thing that we've been saying is that we always thought March was a little bit too early, but nevertheless there's a lot of data between now and May. We do think inflation will continue to, on a year over your basis, decelerate. We'll think it’ll get into that two-point-something zone that we think the Fed would be eventually comfortable with cuts. So taking everything into consideration, our baseline view is still that mid-year is still a reasonable expectation, which is consistent with where we think the Federal Reserve officials are at this point. And then every other meeting type of pace after that is kind of reasonable. But as I suggested, as I emphasized, there's certainly scenarios on either side of that case. It's something that the markets are going to be trading. Markets are all about the balance of risks, not just the baseline. So as I mentioned, navigating from here until May will probably not be an easy journey, but for right now, at least that's our kind of baseline, more of a mid-year or June timeframe.

**BASAK:**

There was a lot of discussion about cuts, but Debbie, there's also a lot of questions about the Fed's own balance sheet, what it looks like, the impact on markets.How much will the Fed be able to take their gas off the quantitative easing cycle into more of the quantitative tightening before you would see any type of a taper tantrum, rather?

**CUNNINGHAM:**

I'm not sure that it would be considered quantitative tightening just to reduce the amount. If you look back at when the process began, they kind of ramped it up over the course of six months. There's the likely potential and possibility I think that they do the same thing on the downside. I think the fact that it was emphasized that they really haven't had the discussion on QT yet, that they would be looking at the March meeting for a more fulsome overview of how it was impacting the market and whether or not it truly was having any kind of impact on the liquidity in the treasury markets. Certainly, that would be at odds with what they're looking to achieve. I think we're looking at something that is a first half, maybe beginning of second half item, but I don't think it's something that is going to happen with immediacy.

**BASAK:**

How do you think, Tiffany, that this would start to impact the market? We're already seeing this pushbow between tighter and looser financial conditions, but if you think about tightening in the way that it could impact the banking system, you yourself mentioned in your community bank earlier, are there more strains to be had with the advent of a tightening cycle?

**WILDING:**

Well, our take on the community bank issue is that they were under-reserved for the potential losses that could occur within their CRE portfolio and they wanted to shore that up. I certainly think there are other smaller regional banks that are also probably under-reserved, so this is probably not the first piece of bad news that we could get on the regional banking sector. I think you have to be cognizant of those kinds of risks. We know that there's a recession happening within the CRE market, within the office market, but it's just the question of the broader spillovers into the economy, which we think will be manageable because many of these banks, those properties are still paying and they don't have to mark to market unless they have to roll over the debt. So I guess overall what we would say is that from that perspective, certainly we could see a little bit tighter financial conditions, we think it's going to be manageable. On the QT angle, the thing I would emphasize is really two points. The first one is the Fed, I think, has been very clear that even if they start cutting interest rates, they can still continue QT because it's normalizing the balance sheet and they would be normalizing interest rates back to a neutral level. So they're normalizing both things. The second thing on QT that I would just highlight is that it's interesting to me that people are talking and so focused on tapering when you look at reserve levels, bank reserve levels, they actually haven't tightened at all, really, despite the fact that the Fed's reducing its balance sheet because it's all come out of the RRP. So I think there's more that the Fed can do here. Maybe they do it a little bit more slowly, but my expectation would be that QT is going to continue at least throughout this year.

**BASAK:**

More risks ahead to keep an eye out for. Debbie Cunningham of Federated Hermes and Tiffany Wilding of PIMCO, we thank you so very much for your time.