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**MANUS CRANNY, BLOOMBERG:**

Mike Cudzil joins me now, alongside my other guest, Erik Knutzen from Neuberger Berman. Gentlemen, good morning. Good to see you. Mike, if we go to this point first of all that you've made, it's a high bar to a rate hike. Three cuts are still technically in play. It sounds like this Fed will tolerate a slightly warmer version of porridge in terms of the PCE. Was it all as dovish? Does it qualify as a solidly dovish outcome, Mike?

**MIKE CUDZIL, BLOOMBERG:**

Yeah, thanks for having us, and good morning. I think looking at what the Fed did yesterday, they raised nominal growth pretty significantly and yet kept the dots unchanged. I think markets took solace in that. The committee was pretty split between two or three cuts, but we think that's more minutia. And I think more than anything, the markets really focused on Chair Powell's comment; if unemployment starts to falter, the Fed will react. And I think that was a really key moment and a key statement by Jerome Powell and probably means that fixed income and portfolios can act as that ballast once again, that negatively correlated asset that will perform well when other assets are not performing well. The Fed has told you they will act. They will start cutting even with inflation above target, and they will act more forcefully if the economy starts to wobble. So I think those two points are what the market focused on and why markets are behaving the way they are.

**CRANNY:**

What is not to love about that message for risk, Erik Knutzen? Good morning. We'll come back to the negative correlation in just a moment, whether that reasserts itself. Eric, good morning to you. Here we are. We are flying higher. The market walked away with a solidly dovish message rather than prevaricating about a 10 to 9 split on whether we went to two. Are you as engaged in the bullish upside as the market is?

**ERIK KNUTZEN, NEUBERGER BERMAN:**

Well, I would observe what's not to like about the Fed dots and the Fed outcome yesterday. As Mike said, increased expected growth, moderately increased inflation, decreased unemployment, and said we're going to keep rates the same. And in fact, delivered a pretty clear message that if we get a growth shock, we're prepared to cut. The Fedput is back. That certainly creates an environment that is favorable for growth assets. And we'll dig in. I think it is critical to dig in a little bit more on the stock bond correlation issue. So we think it is an appropriate time to own equities. We want to be exposed to equity markets, not terribly overweight, given valuations and some concerns about inflation and earnings growth down the road. But this is definitely an environment where given short-term economic improvement and this overall environment, we want to have exposure to growth assets. But we do think the Fed is still data dependent. And we think that it's not so much about whether they cut two or three times or three or four, it's the fact that the Fed is on a path from five and a quarter to five and a half to three percent Fed funds rates over the coming years. And that endpoint is much more important than the bumps and changes along the journey.

**CRANNY:**

And indeed, they did indicate a higher potential terminal rate. Mike, let me just bring it back to you and dig a little bit deeper into this negative correlation, the reassertion of the negative correlation between bonds and equities. Just extrapolate that for me and how quickly that might well reassert itself.

**CUDZIL:**

Yeah, I think when you look at what inflation's done, it's come down dramatically from nine to three percent. I agree with Erik that the Fed's data dependent aside from the last two months, where the data has remained quite strong. Inflation has been well above expectations. It wasn't too long ago we were talking about three month annualized inflation being below target. We don't hear that anymore. And so I think this is a Fed that wants to get started. And then we'll let the data determine just how quickly they can get that rate back down to target. And then if we do see the economic activity slow very meaningfully, which Jerome Powell said more than once, there's a chance that unemployment will come down, that it’ll start to wobble. And if unemployment starts to wobble, they will respond. And so you're now at a place where you have starting yields of four and a quarter to four and a half percent in the belly of the curve. You add some spread product on top of that. You get book yields north of five percent. If you just sit here, you earn your yield. And if risky assets wobble, you'll have some capital appreciation. So in terms of risk and risk-free assets, we think both have a place in a portfolio and offset one another. So from that standpoint, it seems like, yeah, you're supposed to own some risk and you're supposed to own some risk-free assets.

**CRANNY:**

So that plays for you, Erik, which is to pick up bonds in the belly of the curve, but also pick up the investment grade credit. And I've had one or two guests that have said to me, Manus, stop focusing on defaults and start focusing on the growth trajectory of the United States of America. That is the underpinning of why I want to be longer of investment grade and that I'm not to get overly obsessed by how much the spreads have compressed so far.

**KNUTZEN:**

Yeah, I think it's two key drivers right now. What we're seeing is the markets after two years of really focusing on and pricing policy rate increases and inflation. This year, markets have gone back to focusing on economic growth. And that is the environment that we were in for 15 years post-GFC where you saw stocks and bonds have negative correlation, be good diversifiers to each other, and the Fed reinforced that message yesterday basically saying we're okay with a little bit of inflation, but if unemployment rises, we'll cut. That's an environment where bonds can help hedge stocks. And so one of our key themes is that we want to move out of cash, lock in some yields. We do like that two to seven year portion of the yield curve. I wish I could be more controversial and disagree more with the bond portfolio manager, but being high quality in that two to seven year portion of the curve and benefit from having some duration. We think duration is once again helpful and that you're going to see a reduction in correlation between stocks and bonds in a more growth focused environment.

**CRANNY:**

Erik, you've actually downgraded your position in cash. And Mike, this is where I want to get a sense from both of you. So you're actively downgrading from cash and deploying, Erik, in the first instance. That's a big call because we're talking about the six trillion stock in money market funds. So just give us a sense of how actively you're deploying, and then Mike, I want you to pitch in in terms of that narrative and how that plays, Erik.

**KNUTZEN:**

Yeah, it's our highest conviction move right now. We were overweight cash for the last couple of years. It worked very well, obviously, in 2022. Last year, it was good relative to bonds, less so relative to stocks. And we're actively gone from overweight to underweight and we're actively deploying into high grade intermediate quality. And that could be short to raise, short to intermediate duration, even higher quality, high yield emerging market debt. In investment grade, we especially like structured products, asset backs, et cetera, but also into quality equities. And there are biases towards the US and Japan. It's a have and have nots market. And we want to be able to take advantage of a broadening out of the equity market with a focus on quality. And then finally, some alternative assets where we do want exposure to tails such as exposure to some inflation surprise areas of commodities, materials, et cetera.

**CRANNY:**

And Mike, if you can just play into this, you talk about that relationship between equities and bonds shifting back more aggressively with this deployment from asset managers like that, from cash into the market. It is going to be more to investment grade, relative to sovereign?

**CUDZIL:**

Yeah, I think you want to add risk to portfolios. I think you want to add a little bit of duration, certainly move out of cash. That reinvestment risk that wasn't so present last year, you had cash return five and a quarter percent, you had duration return five and a half percent. And this year, you're going to have a more meaningful reinvestment risk than you've had in quite some time, where reinvestment risk was a bonus just a few years ago. It's certainly going to be a detractor on your cash. So moving out into the intermediate part of the treasury curve. But then, yeah, we find spread assets more attractive. There are some safe parts of the investment grade corporate credit markets, financials in particular. Utilities are another area we find attractive. But we find, generically speaking, securitized products more attractive than investment grade corporate credit. So agency mortgage-backed securities, triple A, CLOs, triple A, CNBS. These are all in the belly of the curve. These are senior in the capital structure. These are securitized assets. It's rare you get to add seniority, add liquidity and add yield to a portfolio. So de-risking a portfolio and adding yield, that's a nice marriage that we like. So we like securitized products over generic investment grade corporate credit. But still see opportunities within the investment grade corporate credit market as well.

**CRANNY:**

Sounds like nirvana, never mind Goldilocks. Gentlemen, stay with me. We've got more to do. Mike Cudzil and Erik Knutzen, my guests this morning on the market.

Mike Cudzil and Erik Knutzen are my guests this morning. Gentlemen, from a slightly more global perspective — I think Tim (Graf) is based in London, so he has a slightly different perspective. But when I looked at fixed income markets, and this is, Mike, maybe to you, first of all, are you tempted in this cycle starting post the SNB and that perhaps global bond markets should be touched into as well?

**CUDZIL:**

Yeah, it's a great question. It's an area of focus for us, for sure. We think whether it was the Swiss last night or the BoE, the ECB and the Fed, most likely, they all get started around the same time. They all start cutting rates in the middle of this year. But that's where the similarities most likely stop. Speed and destination, probably different across the globe. And that should create opportunities in global bond markets. So yeah, we find global bond markets quite attractive, maybe even more so than here in the United States. And that would include Australia, UK, German bunds, and even Canada. And so all those markets are pretty attractive. What you saw here in the US was more of a fiscal impulse than you saw across the globe, as well as fixed rate mortgages here in the US where monetary policy doesn't have the same bite. And as a result, you're starting to see a meaningful economic slowdown elsewhere and that gives the central banks across the globe scope to cut more than the Federal Reserve. So yeah, I think global bond markets are offering interesting areas of opportunity and we're certainly engaged in those areas.

**CRANNY:**

A lovely perspective. Speed and destination differs for everybody as of June. Erik, for you, what does it do to risk?

**KNUTZEN:**

Well, I think there are some reasons why it may not be Nirvana or some kind of Gordon Notes on the positive symphony. And those would be around term premium and real yields as you go out the curve and also kind of thinking about expectations around structural inflation longer term. And the Fed raised that last resting point dot to 2.6% from 2.5 and nine out of the 16 dots were above 2.5. And so that's a first indication that longer term inflation may be a little higher, and the Fed is going to tolerate a little higher inflation over the longer term. And that's a different environment than what we've had. And perhaps a different environment that's being priced. And related to that is the expectation on our side and the need for higher term premium and real yields as you go out the yield curve. So I would like the two to seven year point of the yield curve. And from 10 years out, we'd say 10 years are fairly valued. And you're going to need to have to have more premium in there.

**CRANNY:**

Mike and Erik, we've got to draw a line in it there. Let's see how this evolves, my guests this morning, Mike Cudzil and Erik Knutzen. This is Bloomberg.