GSFM
FUNDS MANAGEMENT

CONVERSATIONS

THE INCOME SERIES

EPISODE 5

Hi, and welcome to Conversations, a monthly podcast from GSFM. The series will focus on investment concepts and outcomes of interest to you and your clients. Our first series focuses on income, and this is the fifth podcast in the income series.

Today's podcast features GSFM's CEO, Damien McIntyre, along with Payden & Rygel's Eric Souders. Eric is a director and strategist on the Global Unconstrained Fixed Income team with a focus on absolute return solutions, and a portfolio manager of our Payden Global Income Opportunities Fund.

Before I hand over, I need to read this important notice. The information contained in this podcast is general, and does not consider your objectives, financial situations or needs. The information and views contained in this update reflect as of the date of recording, the current opinions of the participants, and are subject to change without notice. Before making an investment decision in relation to a fund, investors should consider the appropriateness of this information, having regard to their own objectives, financial situations and needs. This podcast was recorded on the 10th of May 2022.

Damien and Eric, it's over to you…

Damien McIntyre

Thank you, Tracey. And just to welcome you from my perspective and to say once again, that the whole theme of these podcasts is to bring our expert fund managers into a conversation about income. And today's conversation is with one of our longest investment partners, Payden & Rygel, and the portfolio manager of the Global Income Opportunities Fund, Eric Souders. Welcome, Eric.

Eric Souders

Thank you, Damo. Good to be here.

Damien McIntyre

Perhaps we can start by addressing the several elephants that have entered the room in the last six to eight months, those elephants being inflation, rising interest rates, and then with the combination of inflation and rising interest rates, their likely impact on global growth. And then ultimately how that feeds into the bond market, which like equities, has suffered a period of volatility since the beginning of calendar year 2022.

Why don't we start with inflation? And the Fed, they held this narrative that these inflation points were transitory. And what we're finding out that that's not the case. So what's your take on this, and what do you see is the trajectory for inflation, not just in the US, but in other parts of the world?

Eric Souders

Yeah. Obviously a very interesting time, a few different proverbial elephants all coalescing at once. I think that just starting very broadly, we're obviously coming out of a very extraordinary time period. None of us have experienced

in our lifetime, which is a pandemic, and the amount of stimulus associated with really bridging the gap around a global economic shutdown is pretty unprecedented in terms of what's gone on in the developed markets.

I think that the intentions of that stimulus were obviously very good and necessary at that time. We're beginning to experience some of the consequences of some of that stimulus, which now arguably has been excessive stimulus, I'd say specifically in the US where we had a couple of extremely large stimulus packages, and the recovery from an economic standpoint, an employment standpoint, and really a reopening standpoint, I think has happened much faster than many market participants, the Federal Reserve, and just policy makers at large expected.

So you had this really interesting combination of excessive stimulus that was designed to bridge a gap that ended up being a much shorter gap than I think many market participants anticipated. And because of that, we're now seeing an extremely hot economy, at least here in the US. It's a bit more disparate globally, but nevertheless coming out of COVID, the demand for goods has been quite strong, and now we're seeing that really translate into a more broad based demand for services.

And so we're seeing inflation data really permeate across both goods and services over the last three to six months. And I think that, again, that's really a function of that stimulus coming out of COVID combined with really stable durability from an economic standpoint.

And we're seeing the labour market here in the US arguably as tight as it's ever been. You're seeing something like two job openings for every person looking for a job. So an extremely tight labour market. And again, I think that the backdrop was really put in place 12 to 18 months ago, and we're coming out of an extraordinary time and now experiencing pretty extraordinary backdrop from an inflation standpoint.

So I think that Fed has been a little bit behind the curve, and I think that the market is trying to figure out where that likely equilibrium is from an inflation standpoint.

Damien McIntyre

Well, certainly I don't think the Fed is on their own in being behind the curve, it's certainly been our case down here in Australia as you would know. To some extent New Zealand went earlier than us, but Australia only moved for the first time last week. It was a moderate move. It went ahead to the 75 basis points that we've already seen in rate moves in the United States.

Eric Souders

Absolutely, yeah. And I think that again, coming out of very extraordinary time period has obviously been, been exacerbated by the conflict in Russia and Ukraine. And so that, I think has just created an additional element that was completely unexpected by policy makers and has really just, I think been the icing on the cake, so to speak from an inflation standpoint. So yes, I think that policy makers in the developed markets, now it's probably very clear that they've been behind the curve and that they need to move fairly expeditiously. And the Fed has actually used that exact word, "We're expeditiously trying to make things right, raise rates," but the trick for them now is doing it in such a way where they can try and tame inflation by virtue of slowing growth, but not slowing growth too much.

I think that's really the crossroads that the market's at now, which is, perhaps we've peaked from an inflation standpoint, and we could talk a little bit about that. How's that going to impact growth? And then comparing that to where valuations over the last three to six months have been reasonably stretched.

And so you have these three things coming together at once; which is inflation that's a problem, growth which is going to be slowed because of that, and then also valuations, which have been fairly lofty across both equity and credit markets.

Damien McIntyre

I haven't had a look at the US 10 year this morning, but the time I looked, it was 3.16% or 316 basis points. In the last two years, that's four times up. It wasn't that long ago that we was 10 year was in the mid-70s?

Eric Souders

Right, yeah. It's been a very extraordinary move. I think we've been a little bit surprised that the market isn't pricing a more dramatic outcome in the long end of the curve. And what we've been looking at is 10 real rates. And what we've seen just the last 30 to 60 days is 10 year real rates here in the US rise from roughly -1%, all the way to +25

basis points, which is a pretty breathtaking move, and actually puts us back from a real rate standpoint where we were at the end of the hiking cycle in the last half of 2018.

So it's been a pretty spectacular move with respect to both nominal, but I'd say more specifically real rates. So we think there's a little bit more value now actually in the intermediate to long end of the curve. But what's really fascinating, Damo, is if you look at inflation expectations five years five year forward, which is your normal barometer for medium to longer term inflation expectations, that number's only around 3%. So despite inflation number today which is around 8% here in the US and has obviously elevated in other markets like Australia, like Europe, for example, the market is really, I think discounting how long that inflation is likely to remain in place.

We're looking at that five year, five year number at 3% and taking a little bit more comfort that this might be transitory and that the market is thinking along those same lines. And one quick data point that I'd mention just to support the, this might be transitory outcome, is we have seen a pretty meaningful shift in some of the inflation data over the last month or so, where durable goods in terms of real PCE growth is actually 10% lower on a year over year basis in that last report, while services inflation is about 6% higher.

So we're seeing a very natural evolution from goods to services inflation and a pretty dramatic decline there in durable goods. So we do think that there's reason to think this may be a peak inflation that we're experiencing now, it's likely to be a little bit sticky, but we do think that there's reason to believe that we have peaked, and that inflation is likely to move lower over the next three to twelve months.

Damien McIntyre

Yeah, you're right. If you step back and look at this unemotionally, the supply chain issues coming out of COVID and then exacerbated through the recent conflicts in Ukraine, they're one thing. And eventually, they will wash. Out when all this settles down, there'll be a period of adjustment, maybe six months, a year, but eventually that corrects itself. There's one question though, that I'm curious about your thoughts on, and that is the labour market.

Certainly in Australia until very recently, our borders have been closed. So migration has been zero. And that's causing this tightness in the labour market here. We've almost, if we haven't had our lowest unemployment print recently, certainly in the next read or the next print should say. How do you see migration impacting employment numbers in the United States? Do you think that has been a contributor to the tightness there?

Eric Souders

I do think that that's certainly contributing toward it. I think we just have an extremely strong labour market where, again, coming out of COVID, there's been just tremendous resurgence in terms of demand for services. And I think that employers probably, and rightfully so, they probably overreacted a bit throughout COVID in terms of maybe layoffs and downsizing. And we've seen come back with a vengeance here over the last three to six months. So the labour market is extremely tight, and I actually think that it's likely to remain tight for quite some time.

And that's a reason to be, I think, pretty optimistic on the outcome for financial markets and the fact that we do have decent opportunities now to actually incorporate income into portfolios in such a way where the labour market's tight, the consumer remains really strong here in the US certainly. And the employment backdrop, we don't think is likely to change for quite some time, just given the pure mismatch in terms of job openings versus people that are actually looking for jobs.

So again, I think that the Fed is probably going to be looking to slow growth a bit because that's really the only way that they can tame inflation in the near term. But even then I think that the employment backdrop is so strong, that that provides pretty good fundamental support for the broad economic backdrop.

Damien McIntyre

So you really don't see even with rising interest rates, given the strength of the consumer and that the consumer's largely employed, it really will underpin growth numbers for a while?

Eric Souders

I think that's right. Consumption is roughly two thirds of the economy here and certainly the primary factor on a global basis. And so employment is paramount in that regard. You could have a situation, and part of the calculus that we're thinking about going forward, you could have a situation where there might be a recession from an asset

price standpoint, and just a valuation standpoint in financial markets, but not necessarily a Main Street recession where you have a material spike in unemployment.

So we're obviously in a very unique time period coming out of again, an extraordinary backdrop. So it shouldn't surprise us if strange things happen in that way, meaning there could just be a Wall Street slowdown that doesn't necessarily impact Main Street to the same degree that it might have in prior recessions.

Damien McIntyre

Asset prices really are all priced off interest rates. Markets will settle when the bond market settles in my humble opinion. So let's just talk about the trajectory of rate past and future. So we've the Fed move 50 basis points at the last strike, where do you see the trajectory for the remainder calendar year '22?

Eric Souders

Right. I definitely agree that the market is taking cues from what's going on with respect to interest rates from a valuation standpoint. So we think that the way the market is pricing the Fed today is pretty fair. We think in other parts of the world, like your neck of the woods in Australia, the market is probably overpriced, the RBA a little bit. So we don't necessarily think that 2% will be the terminal rate in Australia. But we do think that the market is appropriately pricing in what's going on with respect to the Fed.

I think that 50 basis points is probably fair for the next couple of meetings. I've got to say, I think that the Fed is obviously behind the curve. If you use an analogy of driving a car and approaching an intersection where the light's red, the Fed probably knew that the light was red pretty far away from the intersection and they could have begun tapping the brakes. They didn't necessarily take that route. So they're probably forced to pump the brakes a bit faster at the intersection.

So that's I think a long way of saying that if the conflict in Ukraine and Russia continues, and we don't see dissipation with respect to some of the wage price inflation that we've seen, it is possible that the Fed does pivot a bit and look to go 75 basis points one of the next meetings, it could be the next meeting or the one after. This is despite Powell taking that off the table at the last meeting. I think that's been walked back by some other governors.

So we do think that the Fed's going to continue to go. We think that seven or eight rate hikes cumulatively is pretty fair, the next seven to eight months or so, but we don't really think a terminal rate in the US beyond three and a quarter to three and a half percent is likely. And I think that again, the market is already testing and is already telling the Fed that, that higher rates, especially if it occurs in a very short period of time, it's tough for the market to price that.

Normally monetary policy takes 12 to 18 months just to show its effect. So you have a situation where that's really being pulled forward in a very, very short window. There's not going to be enough time to really tell how much impact it's having on markets. And so I think that's where the crossroad resides today, which is the market trying to really price things and understand how the Fed's path and pace is going to affect valuations.

So we think that interest rates are pretty fair here. We think that the yield curve in the US is likely to flatten before it's likely to steepen. We've seen some steepening here in more recent couple of weeks, but we do think the path of least resistance is probably a flattening of the yield curve, and that's largely a function of growth, likely being a bit more priced out going forward, relative to what's been going on the last few months.

Damien McIntyre

I'm curious on your thoughts about short term rates approaching 200 basis points through calendar year '22. I think that's not an unrealistic expectation for investors. And then you think the 10 year should be somewhere around 300 to 350 as a consequence of that?

Eric Souders

I think that's fair, yeah. I think that when we think about long term inflation expectations around let's say two and a half to two and three quarter percent, that seems pretty fair, probably a bit higher than inflation has been running the last 10 years, which is closer to 2%. So let's just say that inflation is 50 to 75 basis points higher, and then you're left with a real rate of around 75 basis points, that puts fair value on the 10 year around three and a 5%.

As you mentioned, Damo, we think here with 10 year yields around 3.1%, they're a bit lower today, we think that we're pretty close to fair value on the 10 year. And when we look at the front end of the curve, especially in the US, we think that 3% is likely to be a peak in terms of where the front end might go over the next three to six months.

Damien McIntyre

So let's just take a quick walk around the park in terms of, obviously we've discussed your thoughts about the cash rate and your thoughts about the 10 year. Let's talk about some of the other assets. Payden are known as a low duration manager, and you do prefer the invested short end of the curve. What are you seeing in those markets?

Eric Souders

Yeah, absolutely. So the good news about this strategy being unconstrained and not having a benchmark is we've got a real nice universe to choose from. So I think that our view there, broadly speaking, it ties into what I was describing with respect to the consumer and just the durability of the labour market, not only here in the US, but I think across developed markets and that is we're starting at a very, very strong point from a profitability standpoint, from a profit margin standpoint. Leverage has been coming down in the high yield market now for four or five quarters. And we're seeing just in terms of fundamentals, arguably the strongest starting point going back multiple years.

So that's the good news. And I think that from a default standpoint, the likelihood of broad defaults is just quite low. And I think that's one of the main reasons why high yield so far this year hasn't overreacted in the same way that it may have in the past when the equity market goes down 15% or 20%.

So all that's to say with yields in the front end, and investment grade credit now, you can buy BBB rated, very stable, very solid businesses with yields of four and a half to 5%. That's fantastic. And if you look at those yields now in the fixed income market, they're actually higher than they are in the equity market. That has not been the case going back the last two or three years when all yields were very low. So you have the chance to own very solid investment grade corporate names where fundamentals are just very, very sound at yields that are not only attractive from an outright standpoint, but also relative to some of your alternative of yield options, which would be buying the common stocks. So we think fixed income looks interesting, especially in the investment grade corporate market.

We also like certain parts of the securitize market. I think that for us, the housing market here in the US has been incredibly strong, arguably too strong over the last six months. You've got a combination of things going on, which is a tremendous supply demand imbalance. We're at roughly a 40 year low in net inventory here in the US in residential housing. You've got credit underwriting that remains very strong. It's actually become even stronger post COVID. So underwriting is sound. And valuations look pretty good in that market as well. And of course, you have some inflation protection there.

So we like the housing market, both residential and commercial, because we think that it offers a real nice way to incorporate stable income, but also have some resistance to the inflation backdrop as real assets like housing prices tend to go up during inflationary periods.

So I'd say that there are very good prospects, Damo right now across the corporate credit market investment grade, and really high yield. I didn't even talk about high yield, but also in certain parts of the securitized market, like commercial and residential mortgage credit, where you can get a real nice profile from an income standpoint, but also provide some insulation with respect to inflation.

Damien McIntyre

And what are your thoughts about emerging markets?

Eric Souders

Emerging markets has been a really interesting category over the last 12 months. It's one of the rare times really in history where we've seen emerging markets central banks raise rates before the developed world. Typically, you see developed markets like the US or Australia or Europe raising rates before the emerging market complex. The emerging market world had experienced much, much more elevated inflation, really the last year or two coming out of COVID relative to what we'd experienced in the developed markets. And so the central banks there have been raising rates much faster than the developed world.

And so it's nice because now they're in a position to actually be able to cut rates. And so if there is a global slowdown from an economic standpoint, the emerging market world is in a position to be able to ease relative to the developed market, which is clearly not anywhere near easing mode for now.

The other good news for the emerging market complex is the commodity backdrop has been extremely stable. The emerging market world is usually heavily reliant on commodities, but also can tend to be exporters of commodities. So certain parts of Asia or Latin America, for example, have been an area of focus for us where you're seeing real yields that are elevated because of the inflation that I described in central banks raising rates, and then also them benefiting from an economic standpoint from the rise in commodities, as many of these countries are commodity exporters.

I think the wildcard there, Damo, is going to be China. What we've seen with respect to the COVID lockdowns the last several weeks has been a bit of a concern because obviously, China is a big driver for not only global markets, but obviously the emerging market world more specifically. And so we are expecting China to stand up to the four and a half to 5% growth target that they've talked about, the last couple of quarters. And we do think that China will likely provide more stimulus for their economy. But I think that's the one thing that we're really keeping a close eye on is, what will China do next?

Damien McIntyre

The position in China really is quite extraordinary, given COVID is almost a thing of the past in the West. In the UK, for example, it's almost like it didn't exist. So to see an economy the size of China in lockdown really is extraordinary given we're two years on and the world is so much more vaccinated than it was even a year ago.

Eric Souders

Agreed.

Damien McIntyre

Every day and year you work in the markets and live in the world, really nothing should surprise us, should it?

Eric Souders

No

Damien McIntyre

Coming back just to tie this all together, what we've seen is some reasonable or significant volatility, depending on your standpoint, in financial markets since the beginning of January. Bond markets have adjusted significant, but we're in the business of buying bonds to generate income. So right now the backdrop for us in that context is actually pretty good. And eventually, whether it's this quarter or next quarter, it will stabilise as the war and the Ukraine sorts itself out, and as the supply chain issues around the globe sort. So the backdrop's looking pretty good.

And as you discussed earlier, Eric, got lots of different asset classes that were previously expensive for want of a better description, that now look very interesting. You must be feeling good, well, as good as you can under these circumstances about deploying capital into some of these asset classes.

Eric Souders

Yeah. I think that when we invest, we're always thinking of three main categories, fundamentals, valuations, and then technicals and liquidity. And when we evaluate each of those major categories today, the fundamental backdrop, it still remains quite strong. As I mentioned, the starting point is about as good as we've seen going back five to 10 years from just a profitability and just a debt service standpoint, really across corporate credit and the broad securitised arena.

So that's positive. It's likely to slow, but again, I think the starting point is extremely important. The valuations, while they look a lot better than they did six months ago, and that's not only on the risk free rate side, as we've got higher yields across, the developed government markets globally, but we've also got credit spreads that are now looking pretty interesting. Investment grade credit spreads at around 150 basis points, that looks pretty good when you stack that up historically.

High yield credit spreads at 400 or so basis points is beginning to look up pretty interesting. So valuations are looking much, much better, particularly, as you mentioned, Damo, when you examine the prospects on a go forward basis versus what we've experienced historically. It's really difficult when you're investing in front end, fixed income, in that three to four year maturity range, it's really difficult to lose money on a four looking basis when yields are around four to 5%. So we like the precedent that's been established from a historic standpoint, particularly when we look at the fundamentals which are quite strong.

The final category is technicals and liquidity. And I think that you know the Federal Reserve is taking their foot off the gas. They're not going to be purchasing as many assets. The market is trying to process that. And so we actually think that could turn into a positive. Once some of this, I think, temporary negative sentiment and just calculus that the market's trying to figure, out once that's processed over the next one to three months, we really think you're probably going to have a very supportive backdrop in all three of those categories.

So I think that from our lens, we feel about as good as we have in multiple quarters with respect to the prospects for short duration fixed income a go forward basis.

Damien McIntyre

Well, that's great, Eric. Thank you very much for your thoughts. Eric, you'll be in Australia in the last week of May, and you'll be visiting clients across Australia. By that time, this podcast will have been published. But that said, I'm sure in different forums, all of our clients can explore these topics with you in greater detail. And the nice part also is that for the first time in two and a half years, we can do it face to face.

Eric Souders

Absolutely. Yes, very much looking forward to that

Damien McIntyre

Okay. Well, thank you very much for your time, Eric. And we look forward to seeing you out in Australia soon.

Eric Souders

Fantastic. Thank you, Damo. Cheers.