THE DAILY CHECK-IN WITH GOLDMAN SACHS

GUEST: MIKE SWELL, HEAD OF GLOBAL PORTFOLIO MANAGEMENT WITHIN THE GLOBAL FIXED INCOME TEAM IN GOLDMAN SACHS ASSET MANAGEMENT
HOST: LIZ BOWYER, GLOBAL HEAD OF BRAND AND CONTENT STRATEGY
RECORDED: MARCH 5, 2021

Liz Bowyer: Hi Mike.

Mike Swell: Hey Liz, how are you?

Liz Bowyer: Good, thanks. As head of our Fixed Income Global Portfolio Management Team, you oversee over $700 billion in assets. Let's talk about treasury yields. We've seen a sharp rise recently, which has some investors worried. Can you give us a sense of what's happening and what investors are concerned about?

Mike Swell: Sure, Liz. I would say number one, people are most concerned with inflation. I mean, we've been in an environment where rates have been so low. Inflation, in general, has been very, very low. And they're concerned with the very significant recovery we're seeing in the economy, that along with a lot of debt issued by the government, that we're going to see a significant increase in inflation.

So, I think you have some investors that are scared. But I think you have a lot of, kind of, hedge fund-oriented investors, more opportunistic investors that are trying to short the treasury markets. So, I think in general it's going to be somewhat short lived.

Liz Bowyer: Well, so, some people are drawing parallels between what's happening today and the taper tantrum of 2013 where the Fed announced that it would eventually taper its purchases of treasury bonds, which surprised many investors and led to a massive selloff in the bond market. Do you think that's a fair comparison?

Mike Swell: I think it's a very, very fair comparison. I think the big difference is that in this case, you have a Fed that is not reacting to rising rates. In the case of 2013, you had the Fed starting to send signals that they were going to likely tighten monetary policy or tighten as a result of reducing their purchases and eventually selling assets. So, I think in the end it's a pretty similar dynamic.

I think what happened in 2013 is that you saw a very abrupt selloff in risk assets along with an increase in rates. And then, eventually, the Fed said, "Yep, we don't want this. We're not really concerned about overheating of the economy." And so, you saw over the course of '13 and '14 a reversal. And I think you're having a pretty similar event going on right now.

But right now, really, it's really only impacted the rate market. And it's starting to have a little bit of cracks in the equity market. I think the big concern for investors is that this increase in rates means that the party's over. That the Fed or that the market is very concerned about inflation.

And people should keep in mind that we didn't have inflation pre COVID shock. And we're likely only going to have inflation over a short period of time as we deal with, kind of, the base effects of prices having been very deflated when the COVID shock it. And we're going to see higher prices in the very near term.

As we look into 2022, you're likely to see growth normalize, inflation normalize. And the Fed is going to keep money easy. And as a result, it's going to be a good environment for risk assets. And it's going to be a decent environment for fixed income assets as well. I think people who are calling for the end of the bull market in bonds are prematurely calling the end. And I think they did that six months ago. They did it a year ago. They did it two years ago. We're going to be in an extended period of time of low rates. And I think, eventually, get back to low vol. But right now, what you have is an environment where people are extrapolating really high growth that is a recovery from the COVID shock that's going to occur in 2021. And they're extrapolating a little bit higher inflation that's going to occur in 2021 due to the fact that we had very depressed prices in 2020.

When you look in on the forward, we're going to normalize to trend-like growth. We're going to normalize to, probably, below trend-like inflation. And so, as a result, we think the Fed still has some issues. Now the Fed wants to get the jobless rate down pretty meaningfully. They want to improve the quality of jobs in America. And as a result, we think you're going to see rates stay low for the foreseeable future. And there's a lot of money out there that will be attacking the fixed income markets.

Liz Bowyer: So, let's talk a little bit more about jobs and this idea of quality of employment. What are some of the nuances of that conversation?

Mike Swell: Well, I think there are two factors that have been changes in Fed policy that people have forgotten about very quickly. Suddenly, they're very concerned that we're seeing strong growth. We're seeing, you know, improvement in the job picture. And as a result, we're definitely going to see a significant level of inflation. People are forgetting that the Fed wants to see the economy run hot for a foreseeable future. And as a result, what they want to do is they want to see inflation for an extended period of time at or above their target. We're not there. We might be there for a month or two. But we're still going to be very significantly below that. So, as a result of that, Fed on hold.

And on the job side, they not only want to get back to full employment, which is somewhere around 3 or 3.5 percent. We're now at 6 - 6.5 percent, so we have a long way to go to see full employment. But they want to see better employment. And this was a change in Fed policy that was announced last year where it's not going to be good enough to get back to 3 or 3.5 percent. The Fed does not want a situation where people are-- we have a lot of lower paying jobs, people are not fully employed, we're not bringing people back into the workforce, people that were outside of the workforce. So, they want to see job inflation. They want to see wage inflation. And as a result, they're going to leave rates low for an extended period of time.

And so, we don't think you're going to see rates rise in 2021 from a policy standpoint. We don't think policy is going to change in 2022. Likely not until 2023 do we see a change. So, as a result, that's not a bad environment for fixed income assets, number one. And also, likely to be a constructive environment for risk assets as well.

Liz Bowyer: And is your outlook affected at all by the new fiscal stimulus which will require additional deficit spending to fund?

Mike Swell: So, that's definitely a significant issue for treasury demand in the near term. We're going to see an enormous amount of supply that has to get absorbed. That's one of the reasons why we've seen this selloff in the market, and particularly a steep [UNINTEL] of the yield curve, is that we have to reprice the long end of the treasury market to attract a marginal buyer. It's starting to happen. I think that over the course of the next few months you'll see kind of longer end rates clear and you'll see investors come in.

I would say that this increase in rates has been a godsend for pension funds. So, pension funds need to buy long dated assets. Now their funded status has improved dramatically. We work with a lot of pension funds that are looking for this steeper curve and looking for rates to rise. So, we think that's a demand source that is going to be there to buy longer dated supply.

I think the big concern is less the supply and more the impact on inflation. So, I think that there are a lot of economic textbooks out there that say higher deficit spending, more printing of money leads to inflation automatically. And we don't think that's necessarily going to be the case. And so, we'd expect to see inflation in 2022 resume back to a below Fed target somewhere in the 1.5 to 2 percent area. And as a result, we think we'll be back in one of those low vol environments where you see Central Bank unhold and rates more moderate in terms of volatility.

Liz Bowyer: So, you mentioned pension funds, but what does all of this mean for individual investors when it comes to bonds and asset allocation?

Mike Swell: I think it's important for individual investors, advisors, to think about asset allocation. And as a result, when you think about asset allocation, you have to think about balance across your portfolio. Fixed income plays a critical role in a portfolio. And I think that while there's a near term breakdown in the correlation between bonds and risk assets, and that's what the biggest concern is and it's what we saw in 2013 where you saw rates rise unexpectedly and you saw risk assets in equities perform very poorly. That's where the big concern is. And if people think that there's going to be a long-term breakdown between fixed income and risk assets like [UNINTEL], they're going to reduce both. And that's kind of what you've seen over the course of the last few weeks.

Longer term, the correlation makes sense. It's a negative correlation. Bonds create ballast for your portfolio. And so, we think it makes sense to stick with your asset allocation. And in general, with rising rates, on the margin you want to take advantage of it. Maybe on the margin increase your allocation to fixed income assets, particularly in credit where we think you're getting compensated for default risk, default risk is very low. We're all talking about significant recovery in the economy this year and next year. And as a result, you should see default expectations go down. So, we think credit assets make sense.

And then in terms of municipals, longer dated municipals, high yield municipals offer an enormous amount of value on a tax adjusted basis. And so, stay the course. We're not going into a bear market over the course of the next few years in bonds. And recognize that bonds play a critical role for your portfolio.

Liz Bowyer: So, Mike, you seem fairly sanguine about the rising rate environment. But what are some of the risks to your views?

Mike Swell: Well, as bond investors, we typically spend most of our time on the risks, given that with bonds your downside is you get zero and your upside is you just get paid back. And so, we spend an enormous amount of time, we're pretty kind of negative, cynical people in the bond market. And so, we're-- while I've given you kind of our view, it's because we've spent an enormous amount of time thinking about the inflationary environment.

And number one, the amount of supply that's coming over the course of the next six months is real. And so, you have to have some change in the price dynamic to bring in that marginal buyer. And we think between pension funds, non-US investors that look at the US market as a very attractive place to invest, we think that you'll see equilibrium occur there.

And really, the question really comes down to inflation. And that's where we've spent a lot of our time and said, you know, "Where can we be wrong?" And we still come back to the point that the level of full employment that needs to occur to see wages really start to increase, I mean, we need to see 4 percent improvement in the unemployment rate. And so, you have to have a lot to happen just to get back to where we were pre COVID. And if you look at where inflation was running pre COVID, it was in the 1.5 to 1.75 percent area. After that you saw the Fed change their policy to say that we want to see average to be at 2 percent or even higher. That means over sort of an extended period of time.

And so, when we look-- you know, there's nothing to make us think that we're going to be in an inflation regime as we look at 2022 and 2023 that's going to be worse than where we were pre COVID. So, we spend a lot of time thinking about it. There are meaningful productivity gains that are happening in the global economy. Technology has played a very significant role.

Obviously, productivity gains lead to lower price pressures. And then you also have globalization, which is still a very significant factor. And we don't think the globalization factor, as companies have the ability when prices increase in one market to move to another market. And so, we think we're going to be in a much more stable inflation regime than what's getting priced into the bond market right now. Take advantage of it. As you see the dislocations occur, as you start to see the [UNINTEL] over the course of the next couple that's that are going to go up to 2, 2.25 percent, it's going to scare some in the marketplace. The discussion of the deficit is going to scare some as well. You'll see a steeping of the curve. In general, as you push up to 2 percent on the ten year, if that does occur later in the year, really, we think it's going to be a very significant buying opportunity.

Liz Bowyer: Thanks Mike. It was great talking with you.

Mike Swell: Oh, you're very welcome. Nice talking to you.