PGIM FIXED INCOME

Green Light Central Banks, Green Light Bonds

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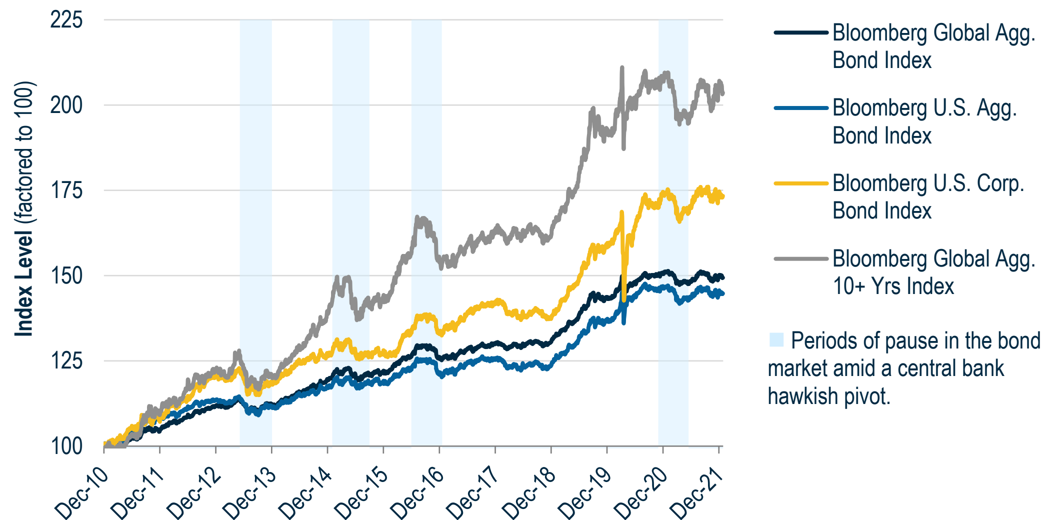
- Global investors have their pick of reasons to avoid the bond market. Inflation is at levels not seen for decades, growth is soaring, and central banks are backing away from bond purchases while some are already raising rates. Hence, the consensus is forecasting higher rates ahead and crying "abandon bonds!"
- Like each crisis of the past 40 years, the current cycle has its idiosyncrasies. But in the end, each economic recovery has one thing in common: a buying opportunity in bonds (Figure 1). The surge in growth pushes yields higher, only to be followed by a seemingly overwhelming downforce from the secular fundamentals of aging demographics and high debt burdens. Granted, returns from the current low level of yields will be more modest than in the past. But in terms of timing, many of the world's bond markets look like they hit their peak in yields at the end of the first quarter of 2021, suggesting the bull market in bonds may already be underway as we start 2022.
- This paper opens with a comparison of the current bout of inflation to that of the 1970s. Despite myriad differences, the net result may be more similar than different: policy makers set their sights on depressing inflation, which ends up turning the tide in the bond market for the better. We subsequently outline a few supporting points for our bullish thesis before looking at the possible risk scenarios and the investment implications.

For Professional Investors Only.
All Investments involve risk,
including the possible loss of capital.

Figure 1

Over the past decade, as each economic recovery has progressed, the bull market has paused at the point when central banks turned more hawkish. This time looks no different with the bull market presumably resuming after the Fed's hawkish turn in Q1 2021.



Source: PGIM Fixed Income and Bloomberg.

IS THIS THE 1970S ALL OVER AGAIN?

The strong economic growth of the 1970's baby-boom era was supported by a wave of borrowing, fueled by the combination of interest deductibility and high tax rates, while inflation was turbocharged by an OPEC price hike and a pinch of wage indexation.[1] The resulting pernicious acceleration in wages and inflation caught investors off guard, resulting in a bond bear market never experienced before in DM countries during peace time. Shocked bond investors drove yields higher throughout the decade.

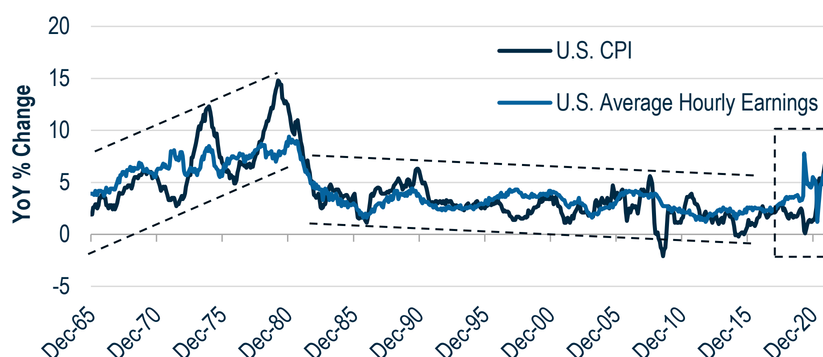
In contrast, today's surging wages and inflation struck like a bolt from the blue. *Much of the current bout of inflation and wage hikes stem from the idiosyncrasies of the COVID recovery—demand driven by reopening and stimulus with supply constrained by the effects of past and present lockdowns. Once these have passed—which may take years—we expect the secular forces of the last three decades to reassert themselves, returning wages and inflation to the contained, pre-COVID conditions* (Figure 2).

[1] How did high tax rates and interest deductibility reduce the after-tax cost of debt, effectively encouraging borrowing to consume? Say income/profits were taxed 65% (roughly the U.S. top marginal rate) and interest rates were 10%, the value of the tax shield from borrowing would be 65% of the 10% as of each dollar of interest paid in taxes would be reduced by 65 cents in taxes saved—assuming the borrower had income. As a result, the after-tax interest rate would be only 3.5%. With nominal growth in DM countries pushing or breaking into the double digits, this made borrowing very attractive.

Figure 2

(Click to return to Risks Section)

While the 70's episode was driven by debt and population growth, the current surge in wage growth and inflation—occurring in the midst of a multi-decade demographic wind down—appears to be an anomaly likely to subside in the quarters or years ahead.



Source: PGIM Fixed Income and Bloomberg.

In short, aside from the high level of inflation, the current environment shares very little in common with the 1970s (Figure 3).

Figure 3

A simplified "then" vs. "now" comparison of the drivers that contributed to the two periods of inflation.

Metric	Then	Now
Demographics	Young	Mature
Debt levels	Low	High
Tax rates	High	Low
Upward price shock	Yes—OPEC driven	Yes—supply chain driven
Wage indexation	Yes, significantly	Very little
Currency weakness	Yes, certain economies	In EM, not DM

Source: PGIM Fixed Income

COMPELLINGLY DIFFERENT DEMOGRAPHICS WORTH A HARDER LOOK?

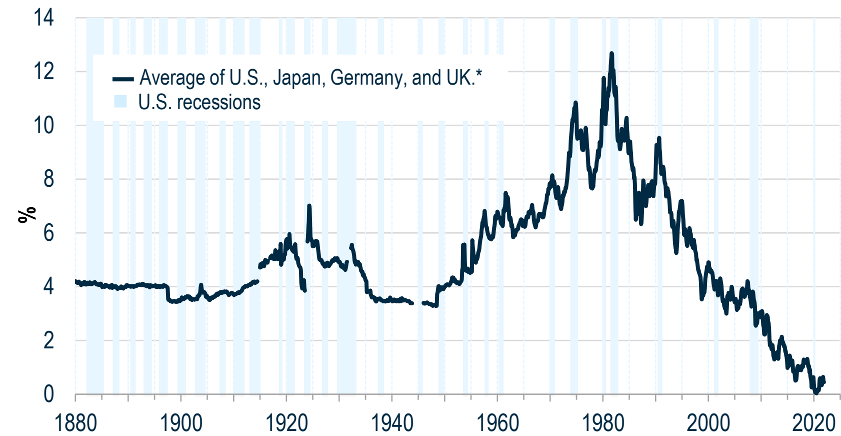
Looking just at the demographic evolution, it is striking how closely the increase in rates through 1980 and the subsequent decline corresponded to the population growth rate in DM countries (Figure 4).

Maybe there is no need to overcomplicate things: growing populations drive up market interest rates, while aging demographics depress equilibrium interest rates in real and nominal terms. If so, the implications for the bond market seem fairly clear based on the current demographic configuration: 1. the aging trend will accelerate, not reverse; 2. therefore, interest rates should stay low or even fall over time, not reverse; and 3. in such a "low and lower" rate environment, bonds are likely to outperform cash over time.

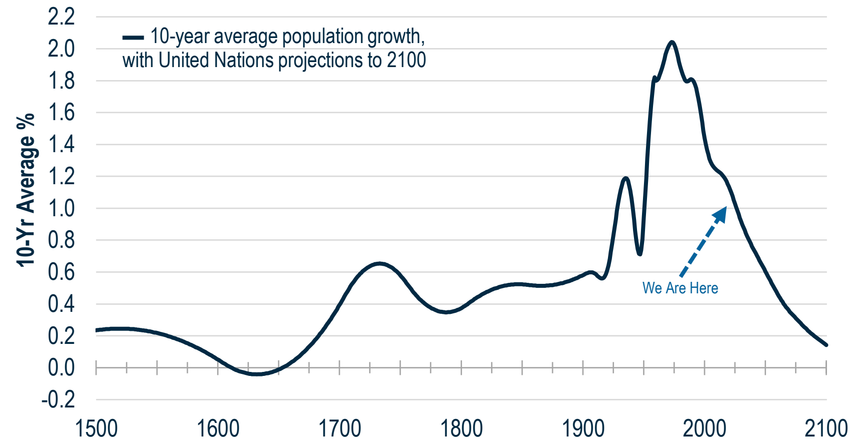
Figure 4

Young, growing populations and the related factors drive up market interest rates, and aging demographics depress equilibrium nominal and real interest rates. And if that's most of it, where to from here? Yields either stay low or go even lower…

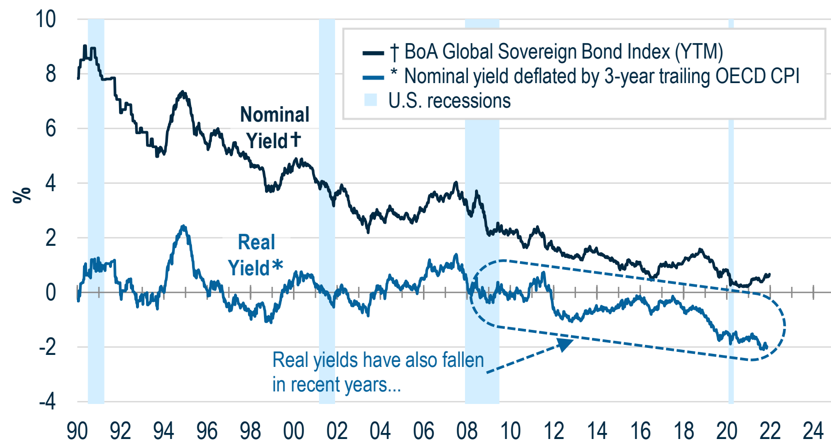
Average Long-End Sovereign Bond Yield and Global Population Growth



*Gaps due to missing data.



Developed Economy Nominal and Real Interest Rates



Source: Minack Advisors

ONE SIMILARITY WITH THE 1970S: INFLATION TOPS POLITICAL PRIORITIES, AND THE CENTRAL BANKS TURN HAWKISH

This brings us to one key parallel between the current environment and the 1970s: in both cases, political priorities changed from fueling growth to controlling inflation (Figure 5). With the change in public opinion and the political winds, the current path of least resistance for central banks has shifted to fighting inflation at the expense of boosting growth.

Figure 5

With a green light from President Carter to stamp out inflation, Paul Volcker's Fed aggressively tightened financial conditions, with one of the powerful opening salvos launched the weekend of October 6/7, 1979, which was later dubbed "the Saturday Night Massacre." Granted, the current episode is on a much smaller scale. Nonetheless, the wave of inflation has driven a rare swing in political priorities, including those in the Biden Administration, that has given the world's central bankers, such as Fed Chair Jerome Powell, a green light to place inflation fighting ahead of boosting growth.

Carter prioritizes controlling inflation…
April 12, 1978

…and Volcker launches anti-inflation program into high gear.
October 6, 1979

Biden prioritizes controlling inflation…
November 10, 2021

…and Powell accelerates policy tightening.
December 15, 2021

Image Source: Adobe Stock.

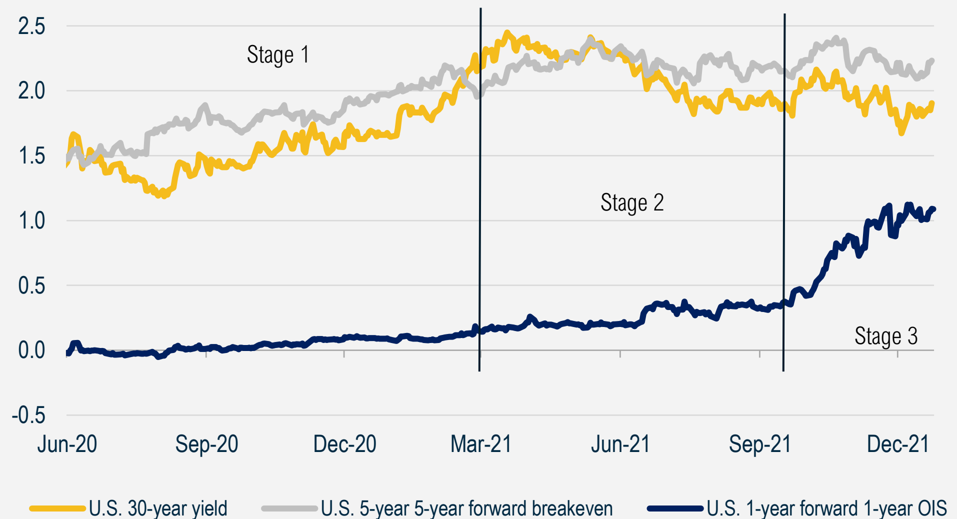
LIKE THEN, THE HAWKISH TURN BY THE CENTRAL BANKS MAY BE A NET POSITIVE FOR BONDS

Just as Jimmy Carter's installation of Paul Volcker set the stage for the bull market of the 1980s, this time the Fed triggered the resumption of the bull market in March 2021 simply by lifting its dots, indicating its priorities were shifting from pushing up growth to controlling inflation. And this phenomenon is global: the steps central banks around the world have taken towards tightening also appear to be triggering peaks in other bond markets' long rates, as demonstrated in the following section.

The world's DM bond markets are signaling that hawkish central banks are good for bonds, especially long bonds. The following provides some varying observations across the U.S., Euro, and Australian markets.

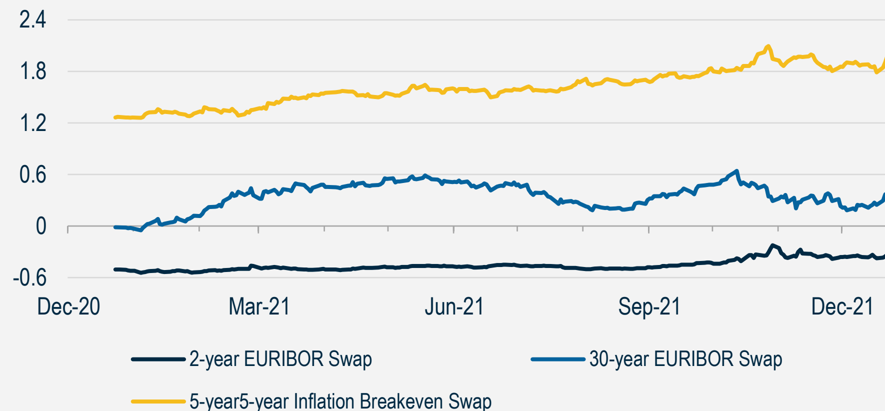
Figure 6A: The U.S. Rate Experience

Stage	Period	Fed's Approach	Result
1	**Start of recovery until March 17, 2021**	Infinite patience, growth main focus	The 2-year yield and the likelihood of near-term rate hikes is quite low. However, concerns about the Fed potentially falling behind the curve push up intermediate and long rates as well as inflation expectations.
2	**March 17, 2021 until September 22, 2021**	Balanced view on both inflation and growth	After the Fed's dots begin to rise, signaling flexibility or a more balanced policy view, short rates slowly begin to increase, while long rates and intermediate forwards stabilize as the increase in inflation expectations slows.
3	**September 22, 2021 to Current**	Inflation main focus	As the Fed turns its focus to inflation, short-term rates rise rapidly, reflecting growing expectations for rate hikes in the quarters ahead. The market subsequently pushes down long-term rates and breakevens, suggesting the net result of a steeper hiking trajectory will be a lower path for growth, inflation, and interest rates over the long term.



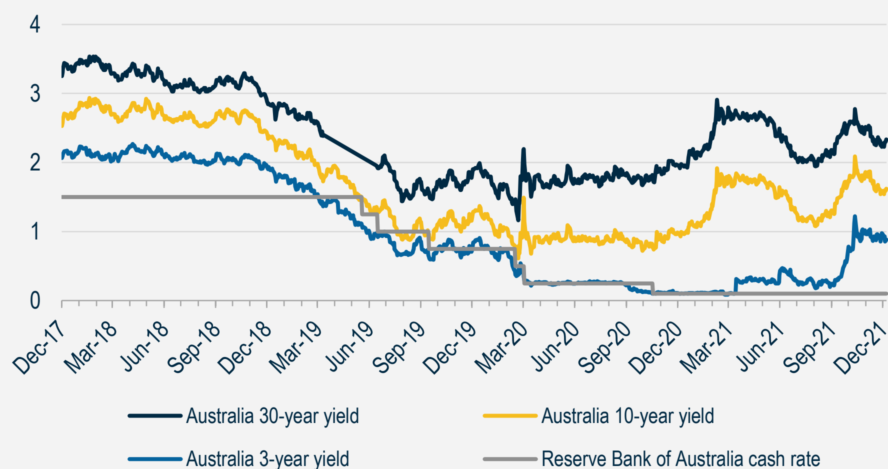
The ECB's course has been more nuanced, denying an intent to tighten, but nonetheless cutting bond purchases in September 2021. At its October meeting, President Lagarde failed to talk down the market's pricing-in of rate hikes, and at its December meeting, the ECB set a taper schedule for 2022. Overall, the shift away from accommodation appeared to stabilize long rates in a range similar to their pre-COVID levels and halted the rise in inflation expectations.

Figure 6B: The European Rate Experience



After signaling a multi-year intention to cap rates out to three years, in Q4 2021, the Reserve Bank of Australia sought the flexibility to remove stimulus and limit its forward guidance. The markets consequently pushed short rates aggressively higher. However, long rates have remained range bound, showing faith in the central bank's ability to control inflation and achieve a soft landing.

Figure 6C: The Australian Rate Experience



Source on Figures 6: PGIM Fixed Income and Bloomberg.

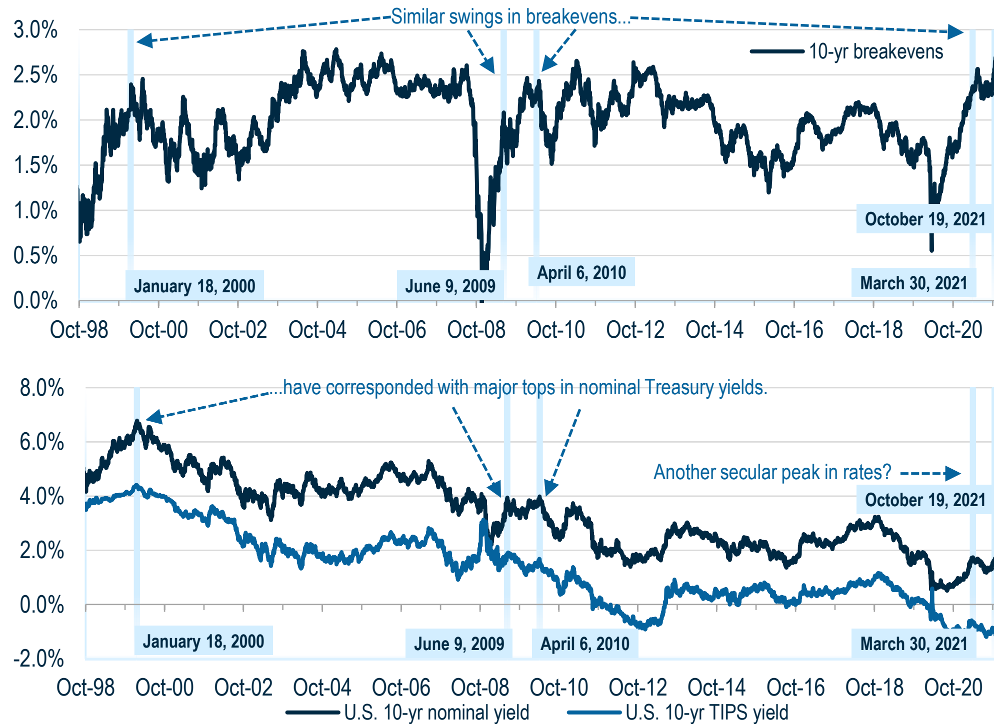
ISN'T IT TOO SOON FOR LONG-TERM RATES TO CREST?

One sign of markets' forward-looking nature is the timing of trends in breakevens—or the bond market's expected inflation rates—and their relationship to the cycle in nominal bond yields. While it may be intuitive to assume that rising inflation expectations signal a rough

patch ahead for bonds, in fact, nominal rates tend to peak soon after breakevens increase, as observed in Figure 7 on the following page. Furthermore, breakevens and inflation often remain elevated as nominal yields subsequently decline. So, while it may seem early, current conditions are typical of a topping process in nominal yields.

Figure 7

Rather than the onset of bear markets, rising breakevens have historically signaled oversold rates and overblown inflation concerns.



Source: PGIM Fixed Income and Bloomberg.

WHAT MIGHT DERAIL OUR BULLISH THESIS?

Sustained above-trend growth could bring a higher range for rates, but that looks unlikely. At the top of the list, an extended upside growth surprise has the best chance of pushing up the term structure of rates back to—or maybe even a step or two above—their 2021 highs. This could arise from underestimating: 1. the strength and duration of the COVID-reopening process, or 2. the impact of shifts in consumer preferences that have occurred during the crisis—particularly the increased demand for housing. We will keep an open mind. But at least as of now, the factors pointing in the other direction lead us to believe a scenario of eventual moderation is more likely.

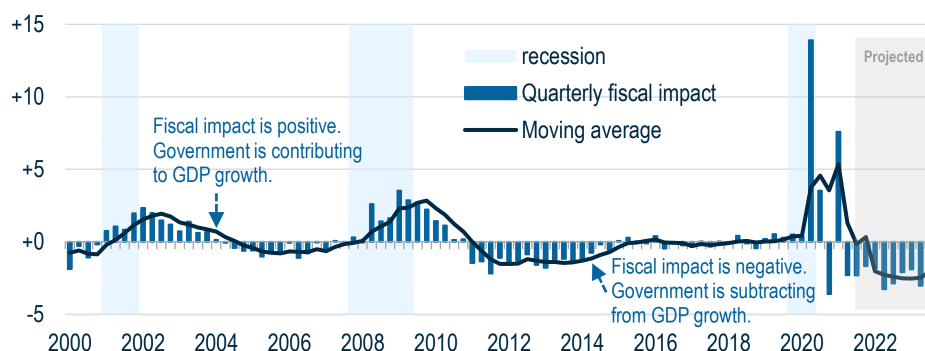
Is reopening a threat? Given the substantial recovery to date, it seems unlikely. Given the substantial recovery to date, it seems unlikely. Given that most of the jobs lost during COVID have already been restored, the recovery has likely passed the most rapid pace of growth. As reopening progresses and COVID fades, price pressures should abate as demand—now focused on goods—becomes more diffuse, spreading more evenly across goods and services, while more supply comes back online as workers return to their production jobs. So, again, it seems more plausible to expect moderation, rather than acceleration, in growth and inflation as we estimate the peak impact from reopening is already behind us.

Are the fiscal afterburners an upside threat to growth and rates? While additional stimulus may emerge in any number of countries, the magnitude of these fiscal thrusts is likely to pale in comparison to the amounts spent to date during the crisis. *As a result, the sequential economic impact from any incremental stimulus over the next year or two is almost certain to be negative; it's just a question of how negative it will be* (Figure 8). To the extent that some countries begin belt tightening sooner than later—which is arguably in order given the stage of the recovery and the extended deficits in most countries—the fiscal headwinds will only intensify.

China, however, is a wild card on the fiscal side. Given the strong, ongoing challenges from COVID lockdowns on top of the real estate deleveraging push, China more likely represents a downside, rather than an upside, threat to global growth. Nonetheless, there are signs of fiscal and monetary easing, and therefore, an upside surprise cannot be ruled out. In short, China's symmetrical risks to the growth outlook certainly warrant monitoring in 2022.

Figure 8

Would additional U.S. fiscal impulse pose an upside threat to the markets? Given the unprecedented stimulus during the crisis, even if further packages are enacted, the net impact of fiscal policy is still likely to be an economic headwind.

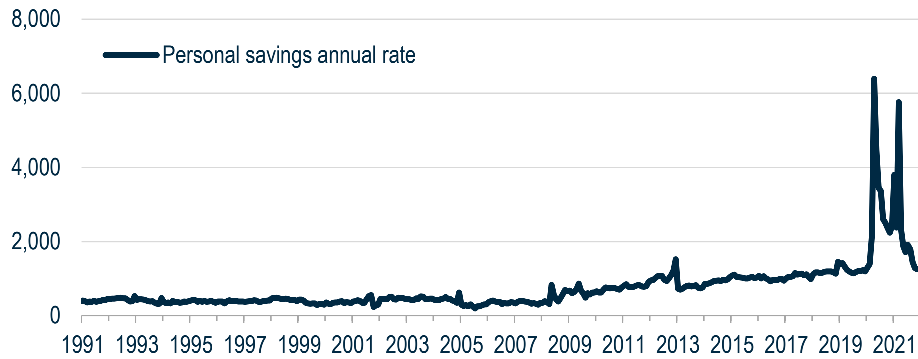


Source: Hutchins Center Fiscal Impact Measure

Are elevated savings an upside threat to growth and rates? While the *stock* of savings undoubtedly remains elevated, the *rate* of savings in many economies appears normalized, with its decline contributing to the strong expenditures in recent quarters (e.g., the U.S. savings rate shown in Figure 9). Thus, stabilization in the savings rate seems likely at these levels and, rather than boosting consumption, could actually detract from growth. In fact, given the uncertainty with the course of the virus and waning fiscal impulse, it would not be surprising to see the savings rate potentially rise once again, which could add to those headwinds. At any rate, while spending from savings could boost the expansion, it seems more plausible that, at a minimum, the peak positive impact is behind us and is unlikely to fuel a re-acceleration in growth at this stage of the recovery.

Figure 9

While still elevated, the U.S. savings rate may be stabilizing, removing one powerful economic tailwind of recent quarters.



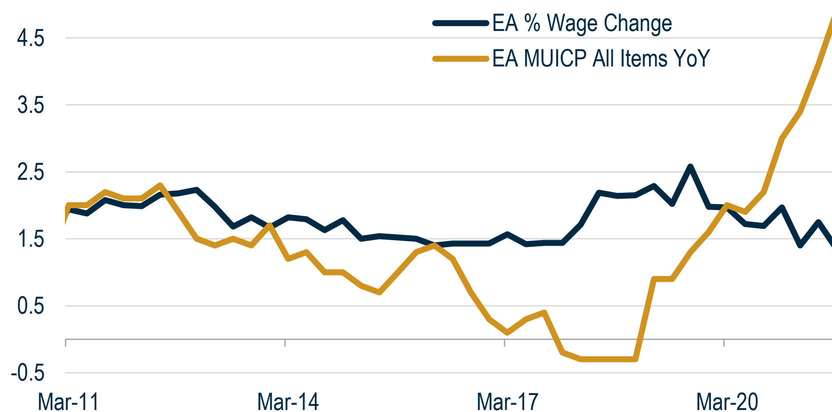
Source: PGIM Fixed Income and Bloomberg

How about a wage-price spiral? Despite mounting concerns, as mentioned previously, the elements of an upward spiral in wages haven't appeared. In comparison to the 1970s experience—a steady trend of upward wage growth that kept pace with the accelerating rate of inflation—the current surge has emerged quite suddenly (see Figure 2 again). Rather than a secular shift, the current pop seems to predominantly stem from the idiosyncrasies of the COVID recovery: i.e., demand boosted from reopening and the lagged impact of fiscal stimulus as well as faster inflation caused by the supply constraints of current and past lockdowns. Once these have passed, the secular forces driving moderate growth and price stability over the past three decades should reassert themselves, returning wages and inflation to the contained ranges, along with low equilibrium interest rates, that existed pre-COVID.

Notably, the recent acceleration of wage growth is hardly universal. For example, euro area wage settlements have remained incredibly subdued, visibly lagging the rise in consumer price inflation (Figure 10). Barring a significant change in this relationship, the erosion of real income will eventually return Europe to its pre-COVID conditions of low growth and below-target inflation. Contrary to the market's expectations, that could push the ECB to the sidelines for the foreseeable future.

Figure 10

European wages appear to be trailing inflation by a wide margin. As long as this relationship continues, a deceleration, rather than an acceleration, in growth appears more likely.

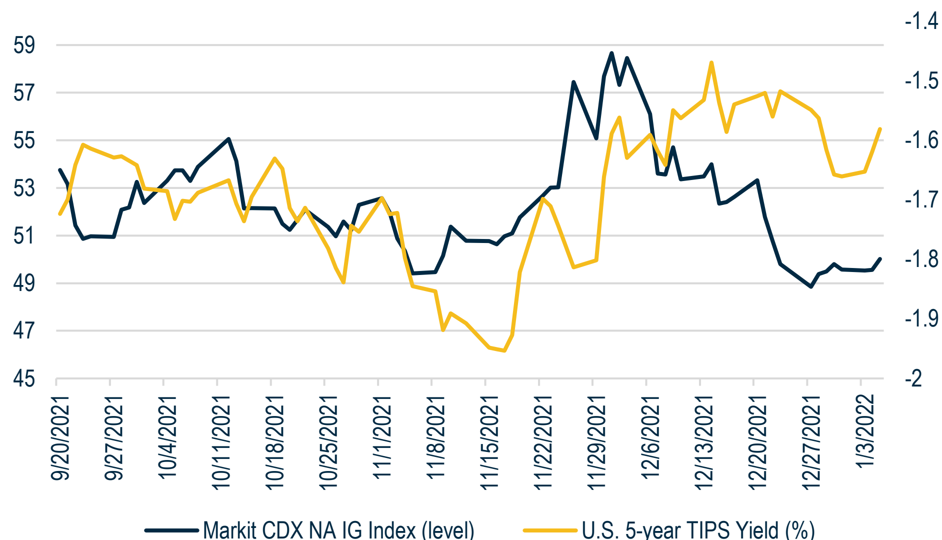


Source: PGIM Fixed Income and Bloomberg

Are the central banks behind the curve? Actually, it looks like they are ahead of the curve… and maybe dangerously so. Long-term interest rates and breakevens appear to be peaking, or past their peaks, suggesting that central banks are ahead of the curve and on course to dampen growth and inflation in the years ahead (see Figures 6a-6c). Additionally, the recent increase in correlation between real Treasury yields and credit spreads suggests the risk of a hard landing is rising (Figure 11).

Figure 11

Are the central banks getting too hawkish? Recently, one barometer of tighter Fed policy—rising TIPS yields—has correlated with widening credit spreads, suggesting the Fed's more hawkish stance may already be increasing the risks of a hard landing.



Source: PGIM Fixed Income and Bloomberg

Isn't a surge in inflation a primary threat to the bond market? While this is most often put forth as the leading threat, we believe that growth is the key. If history is any guide, a rise in inflation that occurs while growth is weakening tends to be perceived as temporary, rather than demand driven and endogenous, and, as a result, has typically been accompanied by either stable or falling rates. From a fundamental perspective, if growth slows, borrowing to consume and invest would be biased to slow, contributing to a low-rate backdrop, despite an increase in inflation. And as mentioned in the section on breakevens, rates often begin to fall while inflation is high. So, contrary to popular opinion, we would argue that inflation is actually not the most proximate problem for the bond market; rather, we put growth at the top of that list.

Could tapering kill the market cheer? Given the forward-looking nature of markets, history suggests the opposite: by the time a central bank begins tapering, rates are peaking. Additionally, government bond supply is currently stepping down as fiscal stimulus fades and budget deficits fall from their crisis peaks, which from a technical perspective, will roughly offset the drop in Fed purchases. This could improve the supply/demand picture in the bond market by providing additional technical support. It may sound crazy, but the historical record suggests that central bank tapering is typically bullish for bonds (Figure 12).

Figure 12

Is tapering a threat to the bond market? Given the forward-looking nature of markets, recent history suggests the opposite: by the time the taper has been announced, rates have peaked.

Source: PGIM Fixed Income and Bloomberg.

SMOOTH SAILING AHEAD SEEMS UNLIKELY

Are we suggesting it's all smooth sailing for bonds from here? Hardly. After all, given the unusual economic backdrop and the uncertain course of the virus, economic data are likely to remain volatile and even more difficult to forecast than usual. As a result, market volatility may be prone to spikes as sentiment fluctuates along with the gyrations of the economic growth and policy outlook. And in a world of low yields—which lengthens durations—and variable liquidity, changes in market sentiment may be more impactful than in the past. In short, we see the backdrop as generally positive, but expect elevated fluctuations around the central path. While that may seem like an insuperable negative for bonds, the fact is that other asset classes, such as equities, will be subject to the same vagaries and fluctuations. Hence, it will likely pay to remain in the fixed-income markets over the long term, but as has been the case in recent years, investors will need to carry a good dose of fortitude to reap the benefits.

CONCLUSIONS

No one can deny that growth and inflation are abnormally high. But this appears to be more the result of a COVID-induced fluke that could last a few more years, rather than a repeat of the 1970s. Why? Because as the afterburners of the COVID recovery fade, the underlying secular fundamentals of aging demographics and high debt burdens are likely to once again re-emerge and re-anchor long-term rates at low levels. In fact, long-term yields and inflation expectations appear to be peaking or already past their peaks. This timing, while hardly intuitive, is typical of recent cycles where rates have peaked early in the expansion just as inflation expectations have risen, and the bull market has resumed.

Granted, yields—and hence prospective bond returns—are lower each cycle. But if yields maintain their lower range or fall further as we expect, government bonds should continue to outperform cash, and spread product should continue to outperform government bonds given the incremental yield and the potential to roll down yield and spread curves. As a result, investors who maintain strategic fixed income allocations should not only continue to benefit from the incremental returns and diversification of bonds, but also from the alpha gained via actively managed sector allocation, issuer selection, and term structure across the global bond markets.

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