Inflation will likely challenge the Fed again soon

Signs of falling inflation have helped risk assets recently, but the relief is likely temporary. Volatility may continue in fixed income markets, as high interest rates continue to weigh on balance sheets and the market digests the probability of a potential recession.

**Inflation data was lower recently, but we believe it is likely to stabilize above 2%.**

**The probability of recession remains 45%, and the likely timing remains mid-2024.**

**Rates could cause a major risk-off event in the fall of 2023.**

**Inflation will remain sticky**

In the U.S. and other major developed market countries, inflation will be coming down further in the months ahead. This is partly due to monetary tightening and partly due to the normalization of supply chains, labor markets, and the global economy as pandemic effects fade. The underlying inflation in the new steady state will emerge once one-offs fully wane.

Falling global inflation might deceive many, but in a new world where households have a greater willingness to consume while liquidity is relatively high, inflation is likely to stay above pre-Covid levels.

When inflation is high but falling, central banks can pause and wait but cannot cut the policy rate quickly. At the same time, liquidity is still abundant, albeit falling, and, hence, the willingness of investors to buy anything, including Treasuries, remains high.
Core inflation is likely not going back to 2%. The summer months are the peak season for base effects of annual comparisons to a year ago. The annual comparisons won’t make inflation look like it’s improving in the months ahead. Wage inflation is not coming down, and this is likely to keep core inflation sticky at around 3.0%–3.5%.

**More rate hikes are likely**

In the near term, the Federal Reserve’s view on inflation matters quite a bit. Recent releases of Fed meeting minutes showed that members were concerned about the outlook for a couple of measures that have shown few signs of recent slowing — inflation in housing services and core non-housing services. Given this viewpoint, we consider that after the July hike another is likely, probably in November.

The Fed’s efforts against inflation so far have not caused rising unemployment or financial instability but, sooner or later, we believe a trade-off will arrive.

**Figure 1. U.S. Treasury rates sold off during Q3**

![U.S. Treasury rates](source)

Source: U.S. Treasury Department. Past performance is not indicative of future results.

**The potential for a recession**

Markets seem to be pricing out a recession. Risk assets have tolerated the move to higher rates in recent months. Although smaller payroll gains are unavoidable at this stage of the economy, the labor market is strong. Layoffs may increase but not become widespread. There are also signs of bottoming in the U.S. housing market and signs of stabilization in global manufacturing.

In our view, the probability of a recession remains significant as monetary policy works with lags. Over time, companies will have to reissue maturing debt at higher interest rates, and consumer spending will face further headwinds as student loan payments resume later this year. Weaker sales along with declining profitability can start widespread layoffs, resulting in a recession.
However, the more the recession is delayed, the more that central banks come into play. For a U.S. recession to occur, it will require that the Fed continue to hike rates above current levels and/or keep rates high for longer.

**Why a risk-off event could happen**

Liquidity is still abundant but declining. Since the debt ceiling issue is resolved, the Treasury will be increasing its coupon supply. Increasing Treasury supply while liquidity is falling can raise Treasury yields. The financial markets have been pricing out recession risks, as the economy remains resilient, but are not prepared for a spike in rates. The risk rally in 2023 has been mostly thanks to falling rate expectations. Risk assets are due for a correction if rates rise.

**Stagflation might be ahead**

A scenario of sticky inflation is as likely as a recession in the next year, we believe, and in the long run we see an elevated probability for stagflation.

It might soon be time to consider investments for this scenario. In an inflationary environment, assets whose price can rise along with consumer prices maintain their real value. Commodities and real assets like property are well-known examples.

In fixed income, TIPS, despite trading in a less-liquid market, can potentially do better than nominal Treasuries if inflation stays. Future inflation currently priced in by the Treasury market is likely to be less than the actual inflation that will be realized over time.

Toward the end of the 1970s — a painful decade for investors — a broad consensus was reached that inflation was the main problem. Only after then, a hawk like Paul Volcker became the chair of the Federal Reserve. Today, the discussion about persistent inflation is just starting. Many still believe that inflation will fall naturally without necessitating a recession and are willing to invest in assets that do not perform well in inflationary environments. While there are still hopes for genuine disinflation, neither society nor the Fed is ready to take the most painful medicine.

### Sector views

**Figure 2. Risk assets performed well in Q2**

Excess returns* relative to Treasuries, Q2 2023

<table>
<thead>
<tr>
<th></th>
<th>Excess returns (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-yield bonds</td>
<td>3.00%</td>
</tr>
<tr>
<td>EM debt</td>
<td>2.50%</td>
</tr>
<tr>
<td>U.S. IG corps</td>
<td>2.00%</td>
</tr>
<tr>
<td>CMBS</td>
<td>1.50%</td>
</tr>
<tr>
<td>Agency MBS</td>
<td>1.00%</td>
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</tbody>
</table>

* Excess returns are calculated relative to comparable-maturity U.S. Treasuries for each index. Excess return does not always mean “outperformance.”
Source: Bloomberg, as of 6/30/23. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results. High-yield bonds are represented by the Bloomberg U.S. Corporate High-Yield Index, which covers the U.S. dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody’s, Fitch, and S&P of Ba1/BB+/BB+ or below. EM (emerging market) debt is represented by the Bloomberg EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. U.S. IG (investment-grade) corporate debt is represented by the Bloomberg U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market. CMBS (commercial mortgage-backed securities) are represented by the Bloomberg U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of $500 million. Agency MBS (mortgage-backed securities) are represented by the Bloomberg U.S. MBS Index, which covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid adjustable-rate mortgages) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).
Corporate credit
We have a cautious view on the corporate credit market, although we continue to find pockets of idiosyncratic opportunities. We believe investment-grade and high-yield fundamentals and technicals are strong, while valuations are largely reflective of a non-recessionary economy. In the second quarter, the Bloomberg U.S. Corporate Investment Grade Index returned –0.29%, and the JPMorgan Developed High Yield Index returned 1.86%.

Corporate fundamentals were strong entering 2023 and have been resilient up until now, with margins, leverage, and balance sheet health slightly off their peaks but near decade highs. We do not believe a recession is imminent absent further distress in the financial sector, but we are positioned for slower growth or a mild recession in 2024. We expect market technicals to remain tethered to broader risk appetite in the near term. Valuations are still somewhat attractive, particularly high yields and lower dollar prices. Macro forces of high inflation, central bank tightening, slowing growth, and tighter credit conditions remain considerable headwinds to both fundamentals and market technicals, although we are likely nearing a point where the hiking cycle will start to wind down.

Floating-rate bank loans
We expect the leveraged loan market to generate returns in 2023 that are above their long-term annual average. The leveraged loan market has continued its positive momentum into July, with the Morningstar LSTA US Leveraged Loan Index hitting 94.5 on July 10, which is 160 bps higher than the end-of-May reading when price dispersion had seemingly peaked. We believe the U.S. leveraged loan market may be at, or very close to, a price dispersion inflection point, when loan prices will begin a sustained recovery. Loan price dispersion is likely to remain high, in our view, thereby creating more opportunities for outperformance for an active, credit-driven strategy. Prudent credit selection will be an important driver of alpha. New issuance activity is also a potential source of attractive investment opportunities, particularly with issuers that must address loan maturities.

Commercial mortgage credit
Commercial real estate is facing meaningful headwinds and increased risks, in our view. We believe the risk of recession remains relevant through 2024, as the Fed continues to combat inflation by raising the cost of capital. Recent bank turmoil will likely result in a tighter lending channel and higher capital costs. We believe property types that can adjust rents (e.g., hotels and apartments) will hold their value better, while property types with longer leases and greater exposure to rising capital costs and/or needs for capital investment will face pressure. We believe many of these risks are priced into the CMBS market, which has experienced significant credit spread widening. The most attractive relative value opportunities require detailed analysis and security selection.

Residential mortgage credit
Residential mortgage credit spreads widened significantly in 2022 and continue to offer attractive risk-adjusted return opportunities despite some tightening in 2023. U.S. homeowner balance sheets are solid, in our view. They are supported by a combination of locked-in, ultra-low mortgage rates and the substantial price appreciation that houses have experienced in recent years. We expect home prices will be flat in 2023, followed by tepid growth in subsequent years, as affordability pressures limit demand while supply gradually increases.

Prepayment
Despite fears that the market would be overwhelmed with supply of agency MBS, the FDIC’s liquidations have been met with robust demand. It now appears the systemic risk posed by regional bank failures is behind us. Supply should taper in the near term as new production slows and as the FDIC winds down its portfolio. Demand has been robust in recent weeks; however, the future of bank demand remains uncertain and may hinge upon regulatory changes. Overall, we find value in agency mortgages. Many prepayment-sensitive assets now offer an attractive risk-adjusted return at current price levels, in our view, and significant upside potential if interest rates stabilize and rate volatility declines. Certain subsectors offer the potential for more upside if prepayment speeds slow further.
**Tax-exempt bonds**
Municipal credit fundamentals continue to be stable, in our view. Higher employment and increasing wages have bolstered tax receipts in the past few years. We continue to monitor the housing market, including home values, an important factor in property tax revenues.

State and local tax collections fell 4.2% in Q1 2023 compared with Q1 2022. At the same time, total tax revenues are nearly 30% above 2019 levels. Also, state and local governments’ rainy-day funds and financial reserves remain elevated at close to 30-year highs. Municipal defaults through June are down nearly 50% versus the average of the past four years and continue to represent a very small percentage of the market. As such, we believe the credit outlook remains favorable, though we continue to actively monitor credit conditions. Security and sector selection remain a cornerstone of our investment process.

Our positioning generally features overweight exposure to both the lower tiers of the investment-grade universe and the highest-rated portions of the high-yield universe. We remain cautious on lower-rated municipal bonds in general, given our view that the Fed’s aggressive tightening cycle could result in slower U.S. economic growth later this year. The portfolios are diversified in a wide range of sectors, including charter school, retirement community, private higher education, housing bonds, essential service utilities, and state-backed bonds. We have targeted a modestly long duration position in the portfolios relative to their Lipper peer groups. (Duration is a measure of the funds’ interest-rate sensitivity.)

**Emerging market credit**
We remain cautious on our intermediate outlook in EM, although we are beginning to see recession risks and inflation risks declining for now. China’s expected recovery has been disappointing, challenging the idea of a sustained recovery. However, the global growth outlook doesn’t appear as fraught as we expected earlier in the year. We do expect some adjustment in monetary policy in the event that a severe slowdown materializes, but central banks will be somewhat constrained as long as inflationary pressures remain. Regardless of the policy path, we continue to believe higher-grade EM names are overvalued given the current environment. At the same time, we see recession risks and inflation risks declining, which should be supportive of EM over the near term. As such, we expect a bit more downside within the next 3–9 months, but timing remains challenged. We prefer for now to stay beta neutral and seek relative value opportunities, remaining very selective on our high-yield risk exposure.

**Currency views**

**Dollar may waver**
The dollar’s course is likely to be shaped by U.S. Federal Reserve decisions, as well as risk appetite and how that impacts U.S. investors’ allocating capital abroad. The Fed’s rhetoric suggests it is likely not done with rate increases. The market has pushed out rate cuts to 2024, acquiescing to the fact that inflation continues to come down slower than hoped and the labor market remains tight. This makes a decisively hawkish pivot from the Fed hard to imagine. Risky assets globally have rallied considerably from the lows of 2022, but over the coming months, global optimism is likely to be challenged and more-cyclical currencies should underperform the dollar. From a longer-term perspective, we believe we have seen the highs in the U.S. dollar, and meaningful rallies will be opportunities to sell the greenback.

**Euro may be attractive**
The European Central Bank (ECB) has continued to raise rates and remains adamant that it has more to do about inflation, which has peaked but is not falling as quickly as desired while the labor market remains tight. The global growth backdrop should be less favorable as market optimism has shifted to pessimism about China, the eurozone’s largest export destination. At the same time, it is important to note that China’s monetary and fiscal authorities remain ready to provide support. This less favorable backdrop should create tradable ranges for the euro in the near term, but we believe meaningful dips will be opportunities to buy.
Pound sterling under inflation cloud

Faced with inflation that has been consistently higher than expected, the Bank of England (BoE) hiked rates by 50 bps in June. Its rhetoric remains far less hawkish than market expectations. The market is looking for another 125 bps in hikes by the end of the year, but the BoE’s reaction function remains a bit difficult to ascertain, and the pound sterling may be subject to disappointment. The BoE’s August meeting has considerable risks, as it will provide updated economic forecasts and has the potential to clarify policymakers’ reaction function relative to those new forecasts. While sterling continues to remain cheap to its longer-term valuation, we believe a more neutral stance seems prudent, given risks.

Yen may benefit from gradual policy shift

The Bank of Japan (BoJ) had been the policy outlier for some time. While it has begun policy normalization, its track record suggests the process is likely to be quite elongated. It’s probable that its yield curve control program will eventually be dropped, but it’s more likely that the BoJ will widen the band for rates in the coming months, providing some modest support to the yen. While local rates are important for the yen, the level of rates in the U.S. and the rest of the world plays a larger role, as they impact the cost of hedging and the flow of capital. The cost of hedging (and the expected cost) has widened out, and USD/JPY has traded higher in tandem. This weakening in the yen has been met with official comments about excessive moves in the currency, like those that predated intervention in September 2022. With stickier inflation and stronger data in the U.S. being better priced in, rallies in the dollar-yen exchange rate are opportunities to sell the dollar, we believe, due to eventual Fed/BoJ policy reconvergence.
The Fixed Income Outlook represents the insights of our investment research teams.

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As of July 31, 2023.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

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