Brandywine Global Investment Management, LLC
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Macroeconomic Commentary

First Quarter 2019

Macroeconomic research is the foundation on which Brandywine Global's successful, value-driven global fixed income approach is based. We believe a broad perspective and comprehensive knowledge of macro trends are important to understanding the interrelationships between economies, interest rates, and currencies. Offering the same independent and original macro thinking valued by our clients, we share our latest macroeconomic insights here.

THE END OF NORMALIZATION

The world economy wobbled into 2019 on a wave of pessimism with multinational agencies like the International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD), and World Trade Organization (WTO) downgrading the global economic outlook. The contrast from a year ago could not be more striking. At the start of 2018, the same agencies were revising up their forecasts for global growth on optimism inspired by the synchronized global expansion of 2017. If the agencies are as prescient this year as last, the growth outlook will be better than predicted.

Ironically, it was confidence in the global economy a year ago that precipitated what has largely been a self-inflicted economic slump. Policy mandarins in the world's two most important economies were persuaded by the prevailing economic optimism to tighten the screws and normalize what were generally perceived as very accommodative policy settings. In hindsight, the efforts to normalize went too far, too fast:

- In China, the pointy end of the policy tightening stick was shadow banking. The government muzzled this important source of lending to the private sector to -10.5% by the end of last year, down from a +18.4% growth rate in 2017. In addition, the country's fiscal impulse—the change in the budget deficit as a share of gross domestic product (GDP)—dropped below –1% in 2018 from roughly +2% at its peak in 2016.
- In the U.S., the newly appointed Federal Reserve (Fed) Chair moved with misguided confidence bordering on arrogance to raise rates four times, nonchalantly shrink the balance sheet by hundreds of billions of dollars, and speculate in the fourth quarter that "we may go past neutral, but we're a long way from neutral at this point, probably."

Last year ended with markets rioting, the global economy slowing, and America's economy re-synchronizing lower. Tariffs and fears of a U.S.-China trade war did not help nor did the strength in the U.S. dollar. Political uncertainty blanketing Europe was an additional pall on the outlook.

The good news is that current economic sentiment—this time pessimism—has fostered another policy shift. The two protagonists responsible for deflating the global growth story have suspended or reversed their actions to normalize policy:

- It started in China during 2018 with the central bank reversing the Shibor rate increases of 2017 and lowering reserve requirements. The green light was given on renewed infrastructure spending under the public-private partnership program. Policy anxiety has produced more stimulus in 2019 with personal and corporate tax cuts, consumption tax reductions, increased fiscal outlays, and directives from the central government to commercial banks to lend to small- and medium-sized private companies.

Stephen S. Smith
Managing Director & Portfolio Manager

David F. Hoffman, CFA
Managing Director & Portfolio Manager

Jack P. McIntyre, CFA
Portfolio Manager

Anujeet Sareen, CFA
Portfolio Manager

Francis A. Scotland
Director of Global Macro Research

Brandywine Global Investment Management, LLC
1735 Market Street, Suite 1800 / Philadelphia, PA 19103
North America: 215 609 3500 (U.S.)
416 860 0616 (Canada)
Europe: +44 20 7786 6360
Asia: +65 6536 6213
brandywineglobal.com

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- U.S. monetary policy normalization was humiliated into a hard stop during the first quarter. The Federal Open Market Committee's (FOMC) "dot plots" have collapsed to no rate increases this year after flagging two to four rate increases only three months earlier. The Fed announced an early end to quantitative tightening and indicated it is reexamining how best to execute its mandate in light of its failure to achieve an average inflation rate of 2% over the last 20 years.

On top of these constructive policy shifts, the U.S. and China appear to be hammering out a trade deal. We believe the trade deal will have teeth and bring China closer to the rules imposed by the WTO. If our suspicions are correct, it will be good for China and good for global growth.

The factors that depressed growth last year are lifting. Broader market reaction has been mixed. The dollar trend has flattened compared to last year but has not reversed. Risk assets rallied during the quarter, including global bourses, corporate bonds, and emerging market (EM) sovereign bonds. However, yields plunged on developed country bonds. Bunds made headlines in March as they traded through zero, boosting global sovereign debt with a negative nominal yield to over $10 trillion. In the U.S., the slope of the yield curve flirted with an inversion, depending on how you measure it, which is an early but reliable leading indicator of a possible U.S. economic recession.

THE GLOBAL LANDSCAPE: LESSONS FROM 2018

The events of 2018 help clarify that, absent any kind of policy initiative, the underlying trend in the world economy is slow and inflation almost nonexistent. The elements driving this structural profile continue to be debt, demographics, and deflation. What seem like modest attempts to withdraw stimulus or impose restraint—as was the case last year—risk a slow expansion becoming a contraction:

- High debt levels mean even modest increases in rates have disproportionate effects. U.S. housing activity buckled in the fourth quarter with the 10-year Treasury marginally above 3%. In other areas of the world, the effects of higher long-term rates were even more visible. Real estate inflation is rolling over in countries like Canada, Australia, and Sweden, where small rate increases translate into big debt-service adjustments for households overloaded with debt. Macroprudential measures to control lending have proved to be potent. In addition, it took only a modest rally in the U.S. dollar in 2018 to expose some severe EM stress points.
- After a brief respite higher, China's producer price series flirted with deflation last year. Chinese producer prices had been falling from 2011 until early 2016 before rising temporarily in 2016-2017. U.S. long-term breakeven inflation measures were unable to rise above 2% in 2018 and cratered as the year came to an end. They have bounced higher this year but have stalled well below 2%. In Japan, 10-year breakeven inflation rates remain stuck at about 25 basis points. German breakevens fell to below 1% last year, barely stabilizing during the first quarter this year.
- The dearth of private global spending relative to savings continues to be a big part of the slow growth/deflationary baseline for the world economy. It helps explain why interest rates remain near historic lows despite massive government budget deficits in both the U.S. and China, not to mention Japan. In the U.S., the personal savings rate after the global financial crisis (GFC) has remained elevated at an average rate of just under 7%. Household credit growth remains subdued. Correspondingly, the post-GFC improvement in the U.S. balance of payments has held steady for over 10 years. China's gross national savings rate has retreated about 11% to 41% since the GFC, owing to government efforts to redress the loss of global demand through domestic spending and dissaving. Aging and shrinking populations in the developed countries are part of this story. Europe is becoming more Japan-like. In China, the labor force contraction that is expected to start in a few years implies there is a good chance that China grows old before it gets rich.

Looking back over the last few years, periods of reflationary economic strength relative to this modest background have come from expansionary fiscal policy. China stimulated fiscal policy in 2015 and 2016, which led to the global rebound in 2016-2017. America cut corporate taxes, which drove U.S. economic strength through much of 2018. Once the effects of these measures dissipate, growth returns to a slower benchmark.

THE CASE FOR A SOFT LANDING

The macro issue for the balance of the year and into 2020 is whether policymakers have done enough to reverse the negative influences from 2018 and achieve a global soft landing. Our base case is that China will lead the developing world out of the current business-cycle trough, although its upturn will be subdued in comparison with 2016. There is no will among China's leaders to follow the old script and stimulate with more leverage. The U.S. economy is mean-reverting back to trend as the effects of the tax cut recede. Collectively, these trends should lead toward convergence into a global soft landing. Early leading indicators support this view, although the economic data to validate these signals may not be visible until the second half of 2019.

- Recent, more constructive data out of China have helped sentiment and suggest China's economic deceleration may be over. Similarly, the

strength in emerging country equity markets and leading indicators, along with timelier business cycle metrics like the purchasing managers' index, point to economic stabilization. While it is too soon to be conclusive, what is unequivocal is the willingness of the Chinese authorities to keep at it until stabilization has been achieved.

- In the U.S., the yield curve flattening is a yellow flag on the economic outlook. The growth rate in the Conference Board Leading Economic Index, in which the yield curve is one of 10 components, is receding but remains well above zero, the level at which recession risks would become more imminent. In our view, the Fed has already overshot neutral and the next move will more likely be a rate cut. We do not think President Trump should try to undermine the independence of the central bank, but we agree with his criticism that policy has moved too far.
- Europe's economic cycle in most respects feeds off the global growth impulse from China and the U.S., but especially the former. Depressed Chinese car sales have been an important factor in the slump in German car production. Stabilization in the former should help stabilize Europe's powerhouse economy. The European Central Bank (ECB) for its part has geared up for an extension to the asset purchase program. Meanwhile, Italy's budget forecast could be the vanguard of more fiscal stimulus out of Europe.
- The long-planned sales tax increase later this year in Japan presents a threat to domestic consumption growth. It remains to be seen if the government will follow through.
- In the emerging world, the gradual rise in short-term policy rates in 2018, intended to buffer currency depreciation, is clearly over. In fact, an easing cycle is now unfolding. This shift may be one of the elements acting to provide relative strength in the EM purchasing managers' indexes, both manufacturing and services, relative to the developed world.

RISKS

The main risk in the outlook is that things take longer to stabilize than expected. The implication of a lengthier bottoming-out process would be additional volatility on the way to stabilization. Global money growth, one of the earlier leading indicators of the current world slump, has yet to stabilize. In addition, there are risk factors specific to policy.

1. China's authorities want to deleverage the economy. For the moment, the authorities' attention has shifted from this long-term goal to economic stabilization. The concern is that they return to this first objective prematurely on the first sign of more positive economic momentum. Historically, the approach to deleveraging has been to muzzle credit growth in the private sector, which is extremely deflationary. We doubt this risk will be significant factor this year.
2. In the U.S., the risk is that the Fed has already overshot neutral but is loath to react in the opposite direction if needed. The balance sheet will be reduced another $200 billion by September before the program ends. The flattening in the yield curve is a warning that many, including the Fed, are downplaying because of possible distortions caused by central bank purchases. Our view is that the yield curve remains an early but fairly reliable indicator of the policy stance. At the moment it is flat, not inverted.
3. Most investors have been anxious about a breakdown in U.S.-China trade talks and ensuing tariff implications. Another risk may be what a successful conclusion of those talks implies for world trade. There is speculation that part of any deal would require China to step up its imports from the U.S. in order to close its bilateral deficit with America, which is currently $345 billion. However, China imports mainly commodities. Any commitment to boost imports on a scale this large over a short timeframe would involve a redirection of China's imports from commodity producers in the rest of the world, like Canada, Australia, and Latin America, to the U.S., raising the possibility of upward pressure on the dollar against these currencies. At the moment, there is no concrete information on the trade outcome.

OUTLOOK

In broad terms, we are positioned for an orderly if subdued reflation in the global economy that gets drawn out over most of this year. We have observed signs that the anomaly building in rising U.S. bond yields was beginning to affect U.S. housing. By the end of the first quarter, 10-year yields had retreated about 80 basis points from the peak in November. In our view, the yield on U.S. 10-year notes is no longer anomalous and there are early signs of renewed activity in housing, although the market is not yet expensive based on our internal metrics. Our expectation for a global soft landing is not particularly bond bearish, especially with competing duration in Europe and Japan offering negative carry. Markets like bunds and Japanese government bonds participated in the global bond rally late last year but from levels that were already low in our view. With yields below zero, it is hard to understand the case for ownership on the part of a discretionary investor such as ourselves. Owning these bonds on a hedged basis provides carry, but the return outlook is derived from the currency outlook, not the local bond viewpoint.

The Mexican bono market is possibly one of the most inexpensive bond markets in the world today. Yields are high relative to trend, the yield curve is flat owing to a particularly hawkish central bank, and recent stability in the peso benefits the inflation outlook. Non-oil trade improvement underscores the increased competitiveness of the currency. A global soft landing is especially important for Mexico. A firmer China should help keep oil prices stable, and stabilization in the U.S. should feed back into Mexico exports as well, especially autos. President Obrador is not the pro-market reformer that his predecessor Enrique Nieto tried to be. However, it is clear he views market forces as something he must respect as part of his agenda.

The U.S. dollar is well advanced in its third bull market since the U.S. went off the gold standard in the early 1970s. By the standards of the previous bull moves in the early 1980s and the mid-1990s, the current bull market is long in the tooth. The main element common to all dollar bull moves is extraordinary U.S. growth relative to the rest of the world. This was the case last year, driven in large measure by the tax cuts. As these tailwinds dissipate and U.S. growth reverts to trend, the growth case for the dollar eases, especially if China continues to move to bolster domestic activity. Mean reversion lower could take longer than in the past and follow a more volatile trend, but the outlook seems more negative the further out you look. One caveat to this view could be the outcome of current trade negotiations as noted earlier.

Simply put, we are bearish the dollar and, observing the trend of the JP Morgan Emerging Markets Currency Index, it appears to be forming a saucer-shaped bottom. The economic data may continue to weaken owing to time lags, but policy shifts from the two major protagonists should lead to a reversal of the deteriorating trend. We believe this development will be good for our weak dollar view.

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