Audio Commentary Transcript: What Will It Take to Trade Places in 2019?
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January 14, 2019

Brian: Hi everyone thanks for listening. Today we'll spend some time talking about our global macro outlook for 2019. I'm Brian Giuliano, part of the fixed income team here at Brandywine Global.

Steve: And I'm Steve Smith, portfolio manager for Global Fixed Income.

Brian: So Steve, we've recently talked a lot about the theme of trading places for 2019, which is simply the notion that in 2018, you saw an acceleration in U.S. growth while the rest of the world decelerated, and our thinking is in 2019, you're going to see the exact opposite. In essence, U.S. economic activity is set to slow while overseas growth stabilizes, and you could even see some countries overseas have their growth profiles accelerate. So Steve, walk us through this theme of trading places.

Steve: Well, the theme of trading places would be the opposite of what in some ways happened last year. And so the way this thing sort of unfolded—or did unfold—was all scuffed up and beat up after just being flat out wrong on the whole idea that we were going to have a globalized synchronized advance last year. The lynchpin that changed in retrospect was the tariffs on ZTE in the middle of April of last year turned the commodity currencies down. And I'm not going to go through that but the rest of that is history. And so as I said, being scuffed up or black and blue, thinking about where we go from here. In the beginning of November we finally start to see the lights and that we're going to have this idea of trading places that came up. Now, you think about it, we've been following this economic data like a hawk and the synchronized global growth was how it was holding in place relatively well looking at PMI order books. And in September when the data came in I was really set back on my heels. I mean the order books rolled over big time. And so the questions that I had when I saw my accounts was, "Well Steve things really look ugly now, but in looking ugly they've gotten here, the stock market and EM peaked first. Currencies peaked on April 17th, the commodity market at the end of the second quarter, and then finally the U.S. stock market succumbed to this global slowdown. So the market's going to discount this trading places in advance. What are we thinking about and what do we mean?"

Well let's just take one big idea and this is what it really is about. Since December 16th of 2015, you're off to a slow start. We thought it was a mistake. The Fed has been raising interest rates now for three years. China this year has cut rates. We've raised rates 250 basis points. They have lowered rates 250 basis points. The "trading" idea is that these markets lead with a lag. Interest rates in the U.S. with a period of about 18-24 months, and in China it's probably 9-12 months. And we think that we are at the precipice of the U.S. economy slowing from this—you know—3.5%-4.0% kind of rate down to a two handle and we think that the Chinese economy has now gone through a recession just like they did in 2015 and is on its way of coming out.

Brian: So the Chinese—as opposed to a couple of years ago 2015, 2016 where Chinese policymakers really took a bazooka to the market right in terms of fiscal monetary action that they took—this time it seems like they've done a lot of smaller things. They've cut taxes, they've increased infrastructure spending, they've decreased reserve requirement ratios for the banks. They've done a lot of little things at the margin. So you're thinking that if you add all these little things up it should be enough to bring their economy out of this funk?

Steve: Yes. One of the things we had this big discussion about in the morning meetings is that well what's the lead time? And so every single time that the Chinese aggressively cut rates the lead time's about 9 months to a year. And then you get into the whole argument, "Are they doing enough or does it actually work? Are they going to cut taxes? How much infrastructure spending are they going to do?" And people go through this thing naively trying to add all of these things up and a lot of people disagree, or they agree to disagree. I just look at it and say the one thing that's been consistent is the central bank's cutting rates big time, reducing reserve requirements—that somehow within that time lag—the economy picks up. Now we've done some of the work on this and by our lights we think they've added about 150 basis point to GDP, and the list is about two pages long of all these small things that they announce almost every single week. So we actually think that sometime here in the first half of this year you're going to start seeing economic activity pick up in China and it's going to be discounted by the equity market first and the currency markets are going to anticipate it. And that's what we think is going to happen and we do need to have China play itself out for this to work.

Brian: You brought up trade a few minutes ago. So you don't think trade policy over the past year, it hasn't just been exacerbating volatility, there are fundamental shifts going on right now because of these changes to trade policy.

Steve: This has been a really, really big deal, Brian. And I know we could probably fill this room with all the editorials that have been written about it. But the basic theme is that the Chinese have been given a pass: they get into the WTO, they had all these rules and regulations they were supposed to require, and the U.S.—the Clinton administration you know all the way back the Reagan administration—they all believed that as the Chinese were doing their new form of capitalism, that they were going to abide by the rules of the WTO. And we have just given them a pass. You know the espionage is stealing intellectual property, the fact that you know they've subsidized the paper and forest product industry by $27 billion, steel by $27 billion. I can get down this list and in some ways I really believe that it takes a bully to confront a bully. You know Donald Trump finally decided to confront them and I thought it might have been more benign in the beginning but he basically has opened the light and opened a window on what the Chinese are doing and we are now seeing that not just a U.S. realizes this, the Europeans, we see that the Australians and New Zealanders are going to buy some of their cell phone technology as they build out G5. And so opening that has really changed the game. I've read where 31% of the corporations have money invested or plant equipment in China, and are thinking about—rather than making more investments in China—the investments are going to be smaller or they may move their plant out of China. And so I really think that Donald Trump has hit the Chinese over the head with a 2x4, he definitely has their attention, and you are seeing it in the numbers. The Chinese economy is really being impacted by what the U.S. is doing. And so I really think that trade has been a big, big deal. Trade has been a big, big deal in slowing the economy down. You look at capex. Capex is going on ice because corporations love to be able to know, "OK what are going to be the tax rates? Are there going to be tariffs? Aren't there going to be tariffs?" It's not that the corporations are going to come to a halt in the way they do business but they just put things on hold. And as all of you know, markets are driven by things that happen at the margin and trade is a big deal. My bet is that the Chinese are going to move.

Brian: And if manufacturing starts to make its way out of China, some of it probably comes back here to the U.S., but other emerging markets, particularly some of those Asian emerging markets probably stand to benefit as well.

Steve: For the work that we've done on it and other people have done—this is really ironic because the worst performing bond market and currency for about two months during the fourth quarter—was Mexico. They're the number one beneficiary, as well as Vietnam and Malaysia. And so the way I look at what's going on—and I've given speeches over this for two decades: Apple, for instance, has all this intellectual capacity in Silicon Valley and they can espouse all these wonderful things they want for the proletarian to do. You could do a litany of stuff from global warming all the way down. But who's going to pay for it? They can obviously afford to pay for it, but where are their some odd 700,000 people working for Foxconn in China? So what's happened as we've opened this window? Well it's just like when you put a plant in Alabama or all these plants down in North and South Carolina. Look at the economic environment now versus two decades ago. So if Apple now puts a plant in Wisconsin and they put another one in Texas, you're going to build this 25 or 30 mile umbrella. It's really going to help “Joe Six-pack” in the United States. And so I think what's going on right now is really going to be positive for global growth because it's not going to be just for productivity because productivity was all “Made in China” it's now going to be redistributed around the world and I think we are at the beginnings of that. If you see it happening in America you can imagine how it's going to flow through to the rest of the emerging markets and other countries that have just been making investments in China.

Brian: All right Steve let's shift gears and talk a little bit more about the U.S. Let's talk about Fed policy specifically here. The 10-year U.S. Treasury yield is down almost 70 basis points from its recent high a couple of months ago. Is this the U.S. bond market simply pricing in slower growth, lower inflation? Is there something more sinister going on?

Steve: Sinister. There's an interesting word. Maybe it is something more sinister. This is the trading places story. I mean I could have an opinion or listeners could have an opinion. What's the neutral rate for the Fed? And for those who don't know—because not everybody knows—a neutral rate would be at what interest rate is the economy going to grow? At say 2% and have full employment, keep unemployment at say 3% with a three handle and it's not inflationary. Now the reason the Fed gets in trouble…it's not the first couple rate increases, it's a last one that causes a recession. Powell, Bernanke, nobody knows what the neutral rate is any more than maybe I do or you do. And so, Powell actually set this whole thing off when at the beginning of this year. Just being honest, David and Francis thought the neutral rate in our shop was maybe between 2%-2.5%, I thought it was 2.5%-3%. And now I changed my mind. I think 3% might be a little high. And so for Powell to say all of a sudden the neutral rate might be 3.5%—that is really a dramatic statement to make. And in fact I would say it's arrogant because nobody really knows.

The only thing I would say if the Fed was doing its work is where we are now, you surely have slowed housing for the last nine months. And that probably should go into some of their economic models. So why is this really important? My webcast the first quarter of this year, I don't know why I mentioned the equity market, but I thought P/E multiples would down by 10%. So we'll just say from 19 to 17. Why? Because if they were going to raise rates four times and with higher interest rates, the P/E multiple should be lower. But has that transpired over nine or 10 months, the equity market was OK. But when Powell came out and said 3.5% might be low, the stock market decided to discount that in a one-quarter period of time and it took P/E multiples down another 10% or more, and we ended up with P/E multiples at around 15 and created all this chaos that we had in the market.

And so what we've been doing now is Powell and the Fed had been backing off of that and they've just been doing it gradually. And that last statement, not only did they talk about the terminal rate, but they do actually even mention global trade. They mentioned all the things that we've been pointing out and I think the Fed—such as the reserve currency—is responsible not just for the Phillips curve here in the U.S. but they do have responsibility for global growth. So that question you just asked me, Brian, is really important and for all I know, the reason we added duration in our domestic-only product that went from 1 to 10 years. It was really because we just thought well maybe market neutral for all I know could be 2% percent, not the Fed's think of 2.5%-3%, and we're going to see that if they go on hold. And why don't they go on hold and see what the economy does in the next 6 months? How does it respond to a 250 basis point rise that they have already put into place?

Brian: To your last point I thought Robert Kaplan made a good point last week where he basically said exactly that: you don't have to do anything. You don't have to increase interest rates right now. And more broadly, look at the past 12 months. Look at the U.S. economy. We've added 200,000 jobs a month on average to the U.S. economy. We have inflation that's falling now below the Fed's target rate. And middle class America is finally starting to see real wage gains. So to Kaplan's point, you don't have to do anything right now if you're the Fed.

Steve: Well that's what I always say. Why do you want to keep the bottom two or three quintiles of the working population in America out there just all the time depressed because their wages aren't going up? I think this is great. If we have capex in the U.S., Apple does its thing, other companies do its thing, Micron's building out another big plant and you get productivity of 2-2.5%, you get wages up running at 3.5% or slightly more. Why isn't this good for America and good for the average person? And I think that's what the last election is about. And from an economic standpoint these are the things that I see. As you said I'm an economist not a preacher and I actually like what's been going on economically. And I don't think that the Fed's job should be to cut its kneecaps off. I think they would like to see if it can actually run. In fact the Fed has only spent one quarter since the great financial repression with inflation above their target rate. So what Kaplan said, I think you're right, I'm glad that you summarize it that way, Brian.

Brian: Yeah. Well thanks everybody for listening. That's all the time we have for today. Please don't hesitate to contact us if you have any questions.