

## Audio Transcript: Inflation Pictures Come into Focus May 23, 2024

**Katie Klingensmith** [00:00:01] Welcome, everybody, to today's edition of Around the Curve, Brandywine Global's podcast. I'm Katie Klingensmith with Brandywine Global, and I'm delighted to be joined by my colleague Paul Mielczarski, who's the head of macro strategy. Paul, it's a pleasure to have you. There's so much going on right now, always. And I think right now just to dive into what's happening in the world. It's interesting to understand why the Fed has been on hold for so long. And if they may actually stay on hold for a long time yet. Just help us understand what's going on with the inflation picture, and what are the big preoccupations that are driving the Fed right now?

**Paul Mielczarski** [00:00:48] Great. Thank you, Katie. Look, so the first thing I'd say is that we have already made significant progress on inflation. If you look at core PCE inflation, it has dropped from 5.5% to just under 3% over the past two years. So, that is a very significant decline. Now, while inflation has surprised on the upside in Q1, the latest April print did show some moderation, which we do expect to continue in the coming months. And the reason why we expect it is because the recent upside surprises that we saw in first quarter have really been concentrated in service sector prices in areas like rent and auto insurance where lags are particularly long. So, high inflation in these sectors really reflects economic shocks from two, three years ago, not necessarily current economic conditions. So, I do think it's very reasonable to expect that inflation in these sectors will moderate meaningfully over the next one to two years. At the same time, if I look at goods price inflation, it is already low, and there's scope for further declines going forward. We're making good progress on labor market rebalancing. And this is already starting to be reflected in moderating wage growth. And finally, you know, while the economic growth has been strong, this has really been supported by strong population and productivity growth. So, even though over the last six quarters we've had almost 3% GDP growth, on average, the unemployment rate has actually moved up slightly over that period. So to me, that suggests that you can have strong growth without putting upward pressure on capacity and leading to corresponding inflationary pressures.

**Katie Klingensmith** [00:02:49] It does feel like the consumer has been very reliable in the U.S. Can we still rely on this level of consumption, this level of demand?

**Paul Mielczarski** [00:02:57] That is an important question. So, just switching to growth, we did actually see a little bit of weakness in Q1 GDP numbers. But this was largely a function of a significant drag from inventories, which will provide a sort of a corresponding boost in Q2 numbers. But abstracting from some of the data noise, you know, the U.S. economy has grown at almost 3% rate over the past six quarters, which is really quite remarkable given that we've just had the most aggressive Fed policy tightening cycle since the early 80s. Now, going forward, we do expect some moderation in U.S. growth, along with some rebalancing of some of the drivers, like consumption that you mentioned. You know, so over the past two years, we've actually seen some weakness in manufacturing activity. Housing activity has been very weak. Going forward, these sectors are going to be at least less of a drag on growth. But at the same time, private service consumption and government spending have really made outsized contribution to growth. And we do expect these sectors to slow in the future. Now, we do believe that monetary policy is restrictive and is currently a headwind to economic growth. And you could really see that reflected in, you know, for example, very weak private sector credit growth. You are seeing pockets of stress in commercial real estate markets. You are seeing some increases in credit card delinquencies and some pretty soft readings for small business confidence surveys. You

know, and just finally just thinking about recession risk, because obviously that's something a lot of people were sort of obsessing about this time last year. And, you know, I think the consensus has really switched towards a soft landing view. I think that's probably the soft landing scenario is probably the more likely, particularly if the Fed is able to cut rates later this year. But at the same time, I think we do have to recognize that this has been an incredibly unusual economic cycle with sort of no obvious historical comparisons. So, some of the sort of playbooks that we're used to applying may not necessarily be relevant. So, we are really being open-minded about, you know, possibility of a recession risk. And ultimately, we are watching economic data very closely. It is possible that, if we do see a larger slowdown in consumption, in service spending, maybe together with a bit more of a fiscal drag, you know, we could potentially see a sort of a deeper retrenchment in labor demand, and a more significant increase in the unemployment rate, which potentially would take you on a more recessionary path.

**Katie Klingensmith** [00:05:58] So, I want to just go back to a couple of the points you made earlier, Paul. So, do you feel like the slowdown in inflation that we just saw in the U.S. Is the beginning of a turn, or are we still going to see inflation bouncing around?

**Paul Mielczarski** [00:06:12] I think we still have more to go in terms of a decline in inflation. I do think that ultimately core inflation or core PCE inflation, which is what the Fed focuses on, you know, will potentially settle somewhere in a 2 to 2.5% range over the next 1 to 2 years. Now, to me that's roughly consistent with the Fed's target, maybe a little bit above. You know, so we feel from my perspective, you know, for the Fed it's good enough. But one thing important to mention is that you're not necessarily going back to where you were before the pandemic. So, in the decade before the pandemic, average core PCE inflation was around 1.6%. So, the Fed was actually persistently missing its inflation target with inflation running too low. I think going forward, I think it's more realistic to expect that inflation is going to be more in line with that 2% target, if not, you know, at times a little bit above.

**Katie Klingensmith** [00:07:16] So, what do you think the Fed's current reaction function is? I mean are they going to be willing to cut rates if they're not seeing inflation fall below two?

**Paul Mielczarski** [00:07:25] I think what the Fed, I don't think the Fed's going to wait for inflation to fall below two. I think they just need to be confident that you are on the path towards that target. So, if we are generally right with our view of inflation, I think you should see at least two 25 basis points cuts this year, even if the economy remains resilient. And that's because rates are restrictive. And, you know, are still at pretty elevated levels. And if inflation is progressing towards target, you really don't need that degree of restriction. Now another thing to consider is that Chair Powell did mention that he's closely watching for any signs of potential unexpected slowdown in the labor markets. Now, the Fed is forecasting that the unemployment rate will be at 4% by the end of this year. But we are already at 3.9%. So, it actually wouldn't take too much to finish the year above that target. And if we did see a little bit more of a meaningful increase in unemployment rate, whether it's four and a quarter, four and a half. I think that could potentially lead to more aggressive policy easing.

**Katie Klingensmith** [00:08:38] So, I remember that we talked quite a bit, broadly in the marketplace and here at Brandywine Global, a year or two ago about the Fed keeping rates too high for too long and some crack emerging. And you did mention that there are signs of slowdown in lending and in certain indicators in the market. Do you still feel like

there is the potential for what do seem to be pretty restrictive rates to suddenly cause a much bigger problem, either in broad economic activity or in financial stability?

**Paul Mielczarski** [00:09:09] So look, certainly there's potential. And we did have a crack in financial resilience around this time last year. You know, if you remember, sort of March, April 2023, we had a number of large regional banks fail. You know, the Fed had to provide some liquidity facilities for other institutions. You know, so that was a sort of a meaningful shock, which to the surprise of many did not lead to a deeper economic downturn, which we were able to shrug off. So, again, you know, if policy rates remain at relatively elevated levels, both in nominal and real terms, there is always potential that we see some cracks, whether it's in commercial real estate. And, you know, with this ongoing adjustment whether we see more pressure on levered loans and private credit, you know, areas which basically where you have floating rate debt currently being, you know, sort of serviced at very high interest rates. So, there's certainly some potential for shocks. I mean, for now, again, because we haven't had it just yet, and we're potentially shifting towards an easing cycle. So, you kind of think, well if it hasn't happened yet, why would it happen once the Fed is starting to cut rates? But again, I think you have to be open-minded about that possibility.

**Katie Klingensmith** [00:10:40] Yeah, absolutely. So, just to bring that all together, you think that the balance of risks are still a soft landing and likely that the Fed at least considers cutting once or twice this year?

**Paul Mielczarski** [00:10:52] Our view is essentially that we see a slowdown in nominal GDP going forward. And this will be a mixture of softer inflation and somewhat softer growth. Again, you know, you could basically see a situation where nominal GDP is tracking towards 4%. And at that point, you really don't need policy rates to be above 5%. In that kind of environment, the Fed could easily take rates closer to 4% as well.

**Katie Klingensmith** [00:11:24] You're an investor. What does this all mean for what's still a pretty wonky Treasury curve?

**Paul Mielczarski** [00:11:30] Ultimately, we are overweight U.S. bonds, and we do believe that 10-year yields around 4.5% are quite attractive. Markets are pricing in about 150 basis points of rate cuts over the next three years. I think as I mentioned earlier, we do believe that policy rates are restrictive. Inflation is on a path towards the Fed's 2% target. In that sort of scenario, it's very unlikely that the Fed will need to hike rates again. But we do see a number of plausible scenarios under which rates are cut a lot more than what's priced in today. So, I do believe that bonds offer investors an attractive asymmetry. From a longer-term perspective, we do believe that 10-year real yields of 2 to 2.25% are actually quite attractive. They're generally consistent with the underlying trend growth rate of the economy. At the same time, U.S. equities are pretty expensive on a wide range of valuation measures. The U.S. equity risk premium is now at the lowest level in 20 years, which again, from a, sort of, a medium-term perspective would favor a higher allocation towards fixed income. Now, the equity risk premium has almost no predictive power on a 6 to 12-month time horizon. So again, for shorter-term focused investors, that's not something you should pay a lot of attention to. But on a 5 to 2 year time periods, there really is a very strong correlation between today's equity risk premium and the subsequently realized relative performance of stocks versus bonds. So, for an investor with more of a medium-term horizon, now is a really good time to be shifting some of the risk away from equities towards fixed income.

**Katie Klingensmith** [00:13:26] And Paul, just to push on that, you mentioned that the real yields are attractive at the 10-year point. Is that where you're focused?

**Paul Mielczarski** [00:13:34] Look, I think, you know, for us it's probably somewhere between 5 to 10-year point of the curve. You know, going into a policy cycle, you generally want to be a little bit closer to the short end of the curve, so there'd be more of a five-year. Again, you know, from over a medium-term perspective when you're thinking about what's the likely real equity return over the next 10 years for U.S. equities? And again, I kind of struggled to come up with a number that would be much higher than 4%. And when I compare that to a 2% real 10-year yield or even a little bit higher, you know, to me that spread is effectively favoring fixed income.

**Katie Klingensmith** [00:14:20] One final question. How much of the U.S. Treasury curve is influenced by the Fed's balance sheet policies right now, or is it really all about the policy rate?

**Paul Mielczarski** [00:14:32] I think the policy rate expectations are the biggest driver of bond yields at this point in time. And the balance sheet policy has really kind of happened in the background and does not seem to have a meaningful impact on pricing of fixed income. The question is more around, sort of, fiscal policy and the fiscal trajectory to what extent that influences term premium. Now, you know, in the second half of last year, there was sort of a growing concern about the fiscal outlook, and we had one of the rating agencies downgrading U.S. credit rating. You know, that obviously coincided with a pretty significant selloff in fixed income. Some of those, sort of, that increase in term premium has been reversed. But in the future, obviously, you know, potentially some of those fiscal risks will come back to focus and impact the pricing in the long end of the curve.

**Katie Klingensmith** [00:15:38] Seems like the U.S. economy has been less sensitive to restrictive interest rates. Just some context. How is the cycle playing out in some of the other major economies?

**Paul Mielczarski** [00:15:49] As you mentioned, other developed economies have generally experienced weaker economic growth as compared to U.S. over the past two years. Now, in some cases, like Canada, Australia, and New Zealand, this just reflects a larger drag from housing-related activity in response to higher policy rates. So, these countries generally have mortgages which are much more closely tied to the policy rate. So, the pass-through from monetary tightening to higher mortgage costs is much quicker as compared to U.S. where we, of course, have 30-year mortgages. Now, in case of Europe, I think some of this growth underperformance was really due to a massive terms of trade shock after Russia invaded Ukraine. And that in terms of trade shock, you know, I think that had an impact over a number of quarters, if not years. I think another important factor to consider is the relative fiscal policy stance between U.S. and the rest of the world, where the U.S. response, the fiscal response to the pandemic in U.S. has been much more aggressive and longer lasting compared to other DM economies. But potentially, there's a much greater payback to come in U.S. and less of a payback from that fiscal stimulus in other DM economies. Now, finally, we are starting to see some signs of improving growth outside of the U.S. I think the important factor there is just you're seeing falling inflation, which is boosting real incomes, which is supporting stronger consumption. We are seeing some gradual improvement in business confidence surveys. And central banks outside of U.S., if you look at the Swiss National Bank, if you look at the Swedish Central Bank, now ECB, Bank of England, Bank of Canada as well, they're either cutting

rates or policy rates already or about to start cutting in the next month or so. And we do think this should be supportive for economic growth in these countries going forward.

**Katie Klingensmith** [00:18:09] So as global investors, where does that point you in terms of the currency opportunities and different curves?

**Paul Mielczarski** [00:18:18] From a medium-term perspective, we do believe that the dollar is expensive both versus developed and emerging market currencies. Now at the same time, the U.S. risk-free rate is still very high, particularly as compared to other G10 economies. So, it is possible that the dollar will remain expensive for a while longer. For now, we've really been focused on being long Latam currencies, but funded with a basket of a mix of dollars, euros, and sterling. You know, we do believe that Latam currencies offer some pretty compelling mix of attractive valuations, high real rates, and decent economic fundamentals. And we also do think that fixed income assets in these markets are very attractive, with countries like Mexico and Brazil offering investors 5 to 6% real yields on local government bonds. Now, we are waiting to see signs of a potentially deeper slowdown in U.S. growth that could really warrant a more aggressive Fed easing cycle. And if we believe we are starting to see that, I think that would be really the time to be short the dollar on a more broad-based basis. And then, finally markets and us, we still really focus on U.S. inflation trajectory and the timing of the first Fed rate cut. But by August or September, the focus will really shift towards the U.S. elections. That's because the outcome of the November elections could lead to some very significant changes in U.S. trade policies, U.S. fiscal policies, and other policies then and could really trigger some very significant currency market swings.

**Katie Klingensmith** [00:20:26] So, Paul, just to bring this to a close. Can you summarize quickly your overall expectation for the U.S. economy, how the Fed is going to react, and where you see the best opportunities for fixed income investors?

**Paul Mielczarski** [00:20:41] In the end, we do think that the U.S. economy is on a soft landing trajectory, that inflation will ultimately converge towards the Fed's target on the 1 to 2-year time horizon. We do expect growth, which has been running above trend, is likely to slow towards trend, if not somewhat below. In that sort of environment, we do think that there's generally a supportive backdrop for US fixed income, and we do like U.S. Treasuries. We do like agency backed mortgage securities. We also find some interesting and attractive opportunities in emerging market local fixed income, particularly in Latin America where real yields are attractive, where economic fundamentals are supportive. And we think that the Fed policy easing cycle would provide a supportive backdrop to these assets as well.

**Katie Klingensmith** [00:21:55] Thank you so much, Paul Mielczarski, for sharing your views and the views of Brandywine Global as today's conversation, Around the Curve.