Macroeconomic Update

Brandywine GLOBAL
A Franklin Templeton Company

Easing into a Compelling Outlook for Bonds

Paul Mielczarski
Head of Global Macro Strategy

After a strong finish to 2023, the U.S. bond market resumed its sell-off in the first quarter on the back of hot January and February inflation prints and continued U.S. growth resilience. Is the first quarter sell-off a temporary setback for fixed income investors or an ominous sign pointing to another year of bond market underperformance?

We believe that after the recent sell-off, the risk-reward trade-off for bonds is now quite compelling. Ultimately, we believe the last two inflation prints were only temporary setbacks, and the broader disinflation process remains on track. Meanwhile, consensus growth expectations have been revised sharply higher and going forward, it will be more difficult for the U.S. economy to outperform expectations. Finally, valuations and positioning in both equity and credit markets are quite stretched, and bonds could benefit from a potential correction in risky assets.

Back to Watching Inflation Data

U.S. core Personal Consumption Expenditures (PCE) Price Index inflation plunged to just under 2% last December from almost 6% in Q1 2022.[1] It bounced back to 2.8% in February, delaying the Federal Reserve's (Fed's) policy easing plans. After the recent setback, the Fed likely will want to see at least two benign inflation prints before cutting rates. Therefore, March and April inflation data will be crucial in determining whether the Fed can start the easing cycle in June. While it is certainly possible that the timing of the first cut slips into the second half of the year, we believe economic data in the coming months will ultimately validate the Fed's belief that the high inflation regime is behind us.

Inflation does not need to return to its pre-pandemic pace for the Fed to be able to declare mission accomplished. During the 2010s, U.S. core PCE inflation averaged 1.6%, and the Fed was concerned about persistent undershooting of its 2% target. Core inflation in the 2.0% to 2.5% range during a period of economic expansion would be acceptable within the Fed's average inflation targeting framework.

Growth Resilient but Not Inflationary

The consensus forecast for U.S. gross domestic product (GDP) growth in 2024 has increased from 1.0% to 2.2% over the past four months, according to a Bloomberg survey of U.S. economists. Importantly, a large part of recent economic strength can be attributed to strong labor force and productivity growth. The Congressional Budget Office (CBO) expects working age population growth in 2023 and 2024 to be around 0.4% per annum, higher than the pre-pandemic average. Productivity growth over the past six quarters has averaged more than 2% per annum, which is about 1% above the pre-pandemic baseline.

Strong supply growth has allowed for faster GDP growth without additional inflationary pressure. U.S. economic growth has averaged almost 3% over the past six quarters. During this period, however, the unemployment rate has increased by around 0.4% while the industry capacity utilization rate has fallen by almost 2%.

Fed Chair Jay Powell indicated during his March press conference that the central bank is paying close attention to the labor market. Headline employment growth remains strong, driven by a couple of large sectors, including education and healthcare. However, broader labor market indicators are more mixed. For example, the unemployment rate has moved up while the quit rate has steadily declined. It is noteworthy that the Fed expects the unemployment rate to be at 4% by the end of the year, close to its current level. Therefore, even a marginal softening of labor demand could push the unemployment rate above the Fed's forecast, potentially triggering a policy rate response.

Waiting for Curve Normalization

While the Fed keeps monetary policy on hold, the prospect of buying 10-year Treasury bonds at 100 basis points (bps) below the overnight rate seems unappealing. But if we are only a few months away from the first rate cut, the risk-reward trade-off for duration starts to become more favorable. The start of the easing cycle should kick off the long-awaited process of yield curve normalization, creating an incentive for investors to switch out of short-duration investments.

What also makes bonds compelling today is the fact that growth expectations have shifted sharply higher in recent months. With consensus expectations now firmly in favor of continued U.S. economic resilience, bonds provide investors with positive optionality in case the economy hits a pothole.

U.S. economic resilience in the past few years has been achieved with much larger fiscal deficits and a much lower personal savings rate, compared with the pre-pandemic baseline. We believe fiscal policy will provide less of a tailwind to economic growth going forward. The low personal savings rate leaves consumers vulnerable to any potential shocks that could trigger retrenchment in business spending and hiring.

While it may not seem apparent from the headline GDP numbers, tight monetary policy is restricting the economy. The growth of private sector credit has slowed sharply since the start of the Fed tightening cycle to levels typically seen only during recessions. Credit card and auto loan delinquencies are rising. The commercial real estate sector is under pressure, with spillover impact on regional banks.

Keeping policy rates above 5% is not necessary if core inflation is converging toward the Fed's target. The Fed risks acting too late and being forced into an aggressive easing cycle if it waits for clear signs of economic weakness, e.g., a rising unemployment rate.

UK Bonds Are Attractive

In the past six to nine months, the eurozone, UK, and Canadian economies have made significant progress toward reaching their central banks' inflation targets. However, unlike the U.S., real GDP growth in these economies remains relatively weak. This combination of inflation normalization and subdued economic growth provides a macroeconomic tailwind for bond markets outside of the U.S. In most cases, however, this positive dynamic is already reflected in relative valuations, with 10-year yield spreads versus the U.S. at historically low levels.

One market offering a compelling mix of attractive valuations and bond-positive macroeconomic tailwinds is the UK. Inflation is on a clear trajectory toward 2%, while the UK policy rate is high. Private sector wage growth has plunged to just 3% from around 8% this time last year. With inflation expectations back to pre-pandemic levels, the Bank of England has made a dovish pivot, signaling its willingness to cut rates in the near future.

Strategy Implications

We like bonds at current yield levels and are looking to add to portfolio duration as U.S. 10-year Treasury yields approach 4.5%. We think the odds of the Fed not cutting rates at all this year are relatively low. If the Fed delays the start of the easing cycle, it could potentially end up cutting at a faster pace. Furthermore, with the U.S. equity risk premium at its lowest level in 22 years, bonds are attractive from an asset allocation perspective for investors with a longer-term investment horizon.

We have a medium-term bearish view on the U.S. dollar (USD). We believe that the dollar is expensive on a range of valuation measures. We also believe that at least part of the recent U.S. growth outperformance has come from exceptionally stimulative fiscal policy compared with other G10 economies. At some point, deceleration in U.S. fiscal support will lead to reduced U.S. growth outperformance. In addition, the medium-term U.S. debt dynamics are a negative headwind for the dollar.

We have been primarily expressing our USD bearish views via high-yielding emerging market currencies, particularly in Latin America (Latam). For USD to weaken against G10 currencies on a sustainable basis, we need to see erosion of the carry advantage from holding USD. For now, interest rate spreads are still moving in favor of USD, with central banks in Europe and Canada now expected to cut rates ahead of the Fed. But that could change quickly if we get a few soft inflation prints or the U.S. unemployment rate moves above 4% on a sustained basis.

We also continue to like Latam local currency bonds, which still offer historically attractive nominal and real yields. The Fed monetary easing cycle should allow Latam central banks to gradually normalize still elevated policy rates.

Corporate bonds have benefited from strong inflows into credit products, the result of investors focusing on attractive all-in yields. However, investment grade and high yield credit risk premiums are now low, and corporate bonds could be vulnerable to any potential economic or market shocks. From an asset allocation perspective, we prefer U.S. agency mortgage-backed securities (MBS), which offer attractive spreads but with more defensive portfolio characteristics.

---

[1] Haver Analytics, Bureau of Economic Analysis, 6-month average of monthly inflation, annualized.

All macroeconomic and statistical data sourced from Haver Analytics unless otherwise noted.

Index Definitions: The Personal Consumption Expenditures Price Index is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Brandywine GLOBAL

A Franklin Templeton Company

Brandywine Global Investment Management (Europe) Limited

5th Floor, Cannon Place
78 Cannon Street
London, England EC4N 6HL

Around the Curve

BRANDYWINEGLOBAL.COM

AROUNDTHECURVE.COM

Issued and approved by Brandywine Global Investment Management (Europe) Ltd.
Registered office 5th Floor, Cannon Place, 78 Cannon Street, London EC4N 6HL.
Registered in England and Wales, No. 632417.