Audio Commentary Transcript: Synchronization versus Desynchronization
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October 31, 2018

Brian: I'm Brian Giuliano, part of the Global Fixed Income team here at Brandywine Global.

Anujeet: And I'm Anujeet Sareen, a portfolio manager here in Global Fixed Income.

Brian: And what a year it's been. Volatility is back. Dispersion across asset classes, dispersion within asset classes—you've really seen overseas equity markets have had a lot of difficulty. In particular, emerging markets this year, and yet the U.S. capital markets were relatively resilient, right? Equities did fairly well up until a few weeks ago and volatility seems to have come on shore to the U.S. economy. So Anujeet, where do we stand in the global economic cycle right now?

Anujeet: I think that the thing to notice about the global economic cycle is that it's become very desynchronized this year. 2016 and 2017 we had a synchronized acceleration in global growth. You had all parts of the global economy improving in the U.S., Europe, and Asia. That's really changed this year in particular. The U.S. economic story has been a very good one, certainly supported by the tax cuts that we saw back in the spring. Asia in particular, but also Europe, have slowed this year. And I think this has been a really important theme to understand about this entire expansion, not just the last couple of years. That there's been times in which the global economy has been more synchronized and other times less synchronized—and it has to do with a divergence in policy between the U.S., Europe, and then on the other side, China.

Brian: So Anujeet, you mentioned divergences this year. So what's the likelihood of the global economy resynchronizing over the next three, six, nine months?

Anujeet: I think that probability is going up if we look at a year or so. So where's the divergence coming from? I mentioned it's the U.S. running a monetary policy regime quite different from that of the Chinese. In the U.S. and Europe—where we're used to seeing when we have a recession, the Federal Reserve (Fed) and European Central Bank (ECB) lower interest rates for several years as unemployment rises. Then once the economy improves and unemployment falls you see the Fed raising interest rates over a few years, right? It's a long cycle from start to finish often lasting 10+ years. In the case of China, in particular, while they're very long term in certain respects, when it comes to monetary policy they've actually been much shorter term than one might expect. This is most evident in the Chinese housing cycle. You've had 2-3 year booms in housing and then busts. And that's repeated now a number of times over the last decade. That's having quite a big impact on commodity prices, on global trade, and emerging market performance as well. So the Chinese, after supporting stronger housing back in 2015 and early ’16, have been pulling back. Since then you've seen a marked deceleration in property sales in China and we're now at a point where they've started to go back the other way. As I mentioned these are these 2-3 year cycles. The Chinese, as we look into 2019 are now shifting to introducing policies to support growth. So we've seen tax cuts come out of China. We've seen them lower the reserve requirement ratio for banks. They have lowered interest rates and the currency has also weakened. So all of these are conspiring for a stronger Chinese economy, particularly into the second half of next year. And I think that's the point at which you might see a re synchronization of growth globally.

Brian: For almost 50 odd years now, you've had capital win out at the expense of labor, the rise of the 1%, the middle class has seen their incomes stagnate. People are upset. They're angry. And they're voting with that anger. And you've seen a real rise in populism the past few years and it's not just here in the U.S. It's in Europe. It's in emerging markets. It's spreading. It seems to be gaining traction. So what are the implications for this rise in populism in markets today?

Anujeet: I think this is a very important theme. There is, on the one hand, as I talked about a desynchronization of growth from an economic perspective this year. But on the political side, I think what you're capturing is a synchronization of the political cycle. The fact that the returns to economic growth have been so uneven is affecting the politics of many countries. We've certainly seen this in the United States. We're seeing it play out in the developed world in places like Italy, Sweden, and the U.K. It's manifesting in a variety of ways. Certainly the trade and protectionist rhetoric reflects this tension—this political cycle that's underway. And the point from all of this is ultimately we're going to see an increasingly fiscal response. Monetary policy cannot address these sorts of issues. They have to do with equity and distribution, and fiscal policies are the tool that that's needed. We've seen it used quite aggressively here in the U.S. already. Whether it's from the tariff perspective or tax cuts and I think as you look out though the next couple of years you'll see a lot of other countries follow suit. They'll be using fiscal policy to support economic activity and increasingly so over the use of monetary policy.

Brian: So let's shift for a minute to a recent development in Europe: Angela Merkel and her recent resignation as head of the Christian Democratic Union (CDU). She'll be staying in place as chancellor of Germany for the next couple of years. But this is a very marked shift for leadership in Europe, right? She's been at the helm of the CDU since the early 2000s, she's been chancellor since 2005, and she's been a poster child throughout Germany as well as Europe of fiscal prudence. So with her starting to shift to the background, what does this mean for fiscal policy in Europe?

Anujeet: I think a lot of her challenges stem from a very similar theme we just discussed. I mean the scale of immigration into Germany over the past 5-10 years has been enormous. Part of that's been due to the exceptional weakness in economic growth in Southern Europe that has led to labor mobility in Europe—folks moving to Germany to find employment. But it's also come from the refugee crisis. And the consequences of that significant movement of people within Germany is something that the German political framework needs to consider. To the extent that Merkel represented this inclusivity. And inviting people to come into the country, I think that was a real positive. The fiscal prudence is also a positive from a pure fiscal perspective, but some attention to how do we address this significant increase in foreign population in the country? I think that needs to be addressed. That's where fiscal policy can play a role. I think this is why, in my own opinion, I think Europe's going to really acquiesce to some of the demands from the Italian government, for example, to ease fiscal policy to support economic growth. I think there's going to be a push in that direction. It won't be a straight line. There'll be some push back and it won't go in a straight line. But ultimately I think you'll see fiscal easing throughout the euro area over the next couple of years.

Brian: Let's shift towards another manifestation of populism and that's what's going on with global trade for the past 12 months now. And the good news is that on one hand United States-Mexico-Canada Agreement (USMCA) we've got an agreement in principle with NAFTA 2.0. But it seems now we've focused our attention here in the U.S. squarely on China. So Anujeet, what does that mean for the markets? What kind of volatility might we see?

Anujeet: While continuing on this theme of synchronization versus desynchronization, I think a year ago, we would have said that the trade rhetoric for the United States is pretty synchronized. The Trump Administration was very critical of the trade agreements we have with Europe, with NAFTA, with Mexico and Canada, China, and other countries as well. That has now changed as you know. So this year we've seen the Trump Administration develop a new agreement with Canada and Mexico. The USMCA agreement, the trade stress, the European Union has also been put on ice for now as they work through some negotiations there. And so the focus has turned to China. I think understanding what this means for markets from here, there's two perspectives that are worth keeping in mind. The first is a more near-term cyclical perspective. That how might this play out over the next year or two? We would argue that there's a lot more concern around trade now priced into asset markets and to the extent that you get even a modicum of improvement in the relations between the United States and China. You might see quite a positive outsized reaction in asset markets. I think the probability of that is rising, with the mid-term elections just around the corner here. Once we get through those we think that the Chinese will have a clearer sense of who they're negotiating with. The president of course won't change, but they need to know what Congress will look like to understand what can get passed through the legislative body. So I think we're closer to a point of both the Chinese and the U.S. having a clear set of rules to work within. And I think the other important piece here is that the equity weakness we're seeing in the United States likely reflects how this trade rhetoric or these trade pressures are beginning to affect U.S. companies and the U.S. economy as well. To the extent that up until the beginning of this month, or the end of the third quarter, U.S. equities were sailing through as if this didn't affect them at all. I think the Trump Administration felt emboldened to remain quite firm on their demands of the Chinese. I suspect that's going to change now as we look forward and there'll be more of a real negotiation. I think that will take place. So I think the probability of some near-term resolution is going up whether that happens at the G20 summit a little bit later this year or turns into the early part of next year, I'm not sure. But I think that probability is rising. I think the second perspective, though, is the long-term perspective. And that is that China's broader rise in the global sphere, not just as a global economic power, but as a military power. I think the tension between the United States and China on that front—that's a little bit more structural not least because of the very different styles of governance. One of the areas that combines both the military issues as well as the trade issues is the fact that there's still a significant share of the Chinese economy that is state owned. And to the extent that those companies are involved in economic transactions around the world, I think there is concern about the United States and other countries that there is this blurred line between what's private and what's the public entity in China, and how they're participating in the global economy. So I think that's a longer-term issue. I don't think that gets resolved anytime soon. But on the on the trade side, which is more relevant for this economic cycle and for asset markets, the probability of a resolution is rising.

Brian: And that's all the time we have for today. Thanks for listening. And please don't hesitate to contact us if you have any questions.