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.

WHISTLING PAST THE GRAVEYARD

After two years of strong gains across our strategies, an uncommon sequence of developments took place during the second quarter that led to a meaningful setback/correction in performance. Risks to the global economic expansion escalated simultaneously on three major fronts: global trade policy, U.S. monetary policy, and geopolitics. The threat of a global trade war escalated with the imposition of tariffs by the U.S. and subsequent retaliatory tariffs from the affected countries. U.S. monetary policy adopted a more strident tone with Federal Reserve (Fed) Chair Jerome Powell refusing to budge in the standoff between the central bank’s dot plots and the money market curve. A barrage of geopolitical news reminded investors that populists and nationalists are gaining ground and the global order is under pressure: Italy elected a strange coalition of left- and right-wing populists; the U.K. Brexit negotiations remained stormy; German Chancellor Angela Merkel barely survived a challenge from her coalition partner; and American warships moved to the Strait of Taiwan.

Dollar strength was the principal manifestation from these provocations of risk. It made the quarter—which was already challenged by the combination of both rising rates and energy prices—especially difficult. For developing country financial markets, the rare combination of rising energy prices and a strong dollar was toxic. Bloomberg’s Carry Index of Dollar-Adjusted Total Returns for Short-Term Sovereign Debt in the eight largest emerging countries has fallen almost 10% since the start of the year, most of that since mid-April. This drop is the largest in the index since the profit recession, commodity bust, and near-global economic downturn of 2014-15, yet current economic conditions could not be more different. It is worth noting that dollar strength against other G10 currencies was only marginally less. Emerging market sovereign yields rose to levels higher than other G10 currencies was only marginally less. Emerging market sovereign yields rose to levels higher than the yield on junk-rated domestic U.S. corporate debt; in Mexico, South Africa, Brazil, and Indonesia, real sovereign bond yields literally rose to levels of 500 basis points (bps), which are normally associated with recession. In contrast, the yield on U.S. Treasuries, German bunds, and French OATs dropped approximately 30-50 bps. The fear fostered by dollar strength reflected concerns about global growth, especially the potential destruction of world trade. Market turbulence seemed to reach a crescendo toward the end of the quarter with setbacks in emerging country stock markets, led by the Shanghai Composite, which was off nearly 25% from its peak. By the end of the quarter, the uptrend in raw industrial commodity prices was on ice while “Dr. Copper’s” 15% tumble was tantamount to throwing down the gauntlet on our story of global normalization.
Over the last two years, the macro theme guiding our portfolio construction has been the view that the U.S. and the world were exiting the post-Great Financial Crisis malaise and entering a period of gradually stronger and more sustainable economic growth. The global economy, in many ways, was only mid-cycle as the year began with the emerging world even further behind; inflation was still falling in the developing economies, which comprises over 60% of the global economic pie and an even higher percentage of incremental global growth. It was a view that played to dollar weakness and convergence between developed and emerging country bond yields, and it generated handsome returns until mid-April.

There has been a lot of commentary this year about moderation and disappointment over the pace of global growth. But, the commentary seems more depressing than the actual data. Economic surprise indices have clearly fallen across the board, Europe having the biggest setback, the U.S. having the least due to tax cuts. However, the negative economic surprises seem more a case of overly zealous growth expectations realigning with reality than a material downturn in the global economy. Global growth needed to catch its breath and consolidate—the world economy could not keep accelerating at last year’s pace. Europe, for example, had five quarters of 2.75% growth coming into 2018. We expected growth to slip to 1.75%, which, yes, was a slowdown, but by European standards still a healthy expansion. Before revisions to gross domestic product (GDP) readings, Japan recorded growth in the second quarter of 2017 that exceeded the annual average since 2010. Consolidation was necessary, but the underlying trend, we believe, remains solid and sustainable. A wide range of indicators and economic data continue to support this interpretation and also that our normalization story is still in play:

- The Organization for Economic Cooperation and Development’s global leading economic indicators have stabilized. China’s Leading Economic Indicator (LEI) has turned higher. The U.S. Conference Board LEI flags U.S. real economic growth of 3.5%-4%. With inflation at 2%, the nominal growth rate implications for the U.S. are the highest since 2006. Global monetary policy is still expansionary as reflected in the growth of central bank balance sheets and low interest rates. Fiscal austerity is over in Europe, tax cuts are spreading globally.

- The Fed has been normalizing monetary policy since 2015, which is rational in light of the improvement in the U.S., including economic growth. Real short-term interest rates are still negative and Treasury yields have remained range-bound as the yield curve flattened, indicating that the pace of normalization has been appropriate and that the Fed was keeping up with the inflation curve.

- China has been stickhandling its way through a maze of structural adjustments with an eye on sustaining economic growth near 6.5%-7%. The central bank has reined in shadow bank lending but simultaneously cut reserve requirements and is expanding its balance sheet. Central bank actions, in combination with a number of deregulatory initiatives and tax incentives, are holding up growth while the economic data clearly show a healthy shift unfolding toward household consumption relative to investment.

- In Europe, growth, as stated above, is relatively strong by European standards. Household credit growth is beginning to rally while broad money growth remains well above levels witnessed in the 2014-15 slump, fiscal austerity has ended, and many countries are looking at tax-cutting agendas.

- In Japan, wage growth has clearly broken out to the upside, setting the stage for solid economic growth carrying into the 2020 Summer Olympics.

- World export volume growth rebounded in April after an earlier dip, the nominal value of world exports is on the rise, and the global Purchasing Manager Index (PMI) for new export orders has bottomed out. According to the International Monetary Fund, the value of world exports was expanding at a nearly 18% rate in February, in contrast with -15% in 2015-16.

In our last quarterly commentary at the end of March, we acknowledged and discussed what we felt were the three main risks to our central view of a self-sustaining global recovery. These three factors were all in play during the quarter. Handicapping these factors was difficult then and remains difficult, but we still do not see them co-opting our base case of strong sustainable global growth.

TRADE

A trade war would drive a stake through the heart of industrial America and Wall Street. Since economic suicide is not rational or in the interests of the current U.S. administration getting re-elected, it is therefore not part of our base case. Wall Street is vulnerable because manufacturing profits are a much larger share of S&P 500 earnings—at almost 45%—than manufacturing is as a share of the U.S. economy, which is less than 10%. The globalization of manufacturing has been a major factor behind the rise in corporate profit margins and valuation multiples. Main Street is vulnerable because most trade is supply-chain related and a large share of imports from China represents U.S. multinational re-exports. High tariffs designed to get companies to move back to the U.S. will penalize companies unable to relocate away from the tariffed jurisdictions as well as consumers who ultimately pay higher prices because of the tariffs. In addition, retaliatory tariffs encourage U.S. companies to relocate outside of the U.S., as
was the recent announcement from Harley-Davidson. Tariffs are a blunt tool and the complexity of placing tariffs on a wide range of U.S. imports that are part of an extraordinarily well organized and developed 30 year-old supply chain will have many unintended consequences. Recent surveys already hint at the beginning of American business holding back on expansion pending trade clarification.

From our perspective, the threat of a trade war is really about the Trump administration’s efforts to redefine America’s trading relationships with the world. Either implicitly or explicitly, President Donald Trump is acknowledging what the world has known for some time: America is no longer the global hegemon in an increasingly prosperous multi-polar global economy, and it can no longer afford to act like it. For that reason, the administration is calling upon North Atlantic Treaty Organization (NATO) members to honor their funding commitments if they want to keep the organization together. In addition, Trump sees America as the most open and free trading nation in the world and wants bilateral reciprocity. He views the trend increase in the U.S. current account deficit as a structural by-product of bad trade arrangements that were made to foster an American-led world order that Trump no longer wants to support. How much would Europe’s current account surplus shrink if every country contributed to NATO and there was free trade with America?

The biggest target in this redefinition of America’s trade relationships is China, which the Office of the U.S. Trade Representative argues has exploited every advantage the current world order had to offer. In our view, China does not want a trade war either and aspires to global leadership, looking forward to the opportunity to redefine the global order. China wants the yuan to be a global reserve currency and to appreciate. Still, the country would like to “have its cake and eat it” and won’t easily let go of any trade advantages.

What remains to be seen is how much pressure develops before new agreements are reached without causing economic damage. The potential for a bad outcome is universally recognized. Based on recent developments, something has to give fairly soon. The break in copper, the recent weakness in commodity prices, and the slide in the Chinese equity market are yellow flags that the trade threat cannot escalate much longer before there is real pain on Wall Street and Main Street.

**U.S. MONETARY POLICY**

The risk with the Fed’s renormalization is that it moves too far too fast. Historically, the Fed keeps turning the screws until there is a crisis or a recession. The range of uncertainty this time seems unusually high given the retreat from the extraordinary policy settings of the past 10 years. Yet during the second quarter, Fed Chair Powell showed no hint of bending to the plight of emerging markets. Powell was particularly blunt about requiring a material and unexpected weakening in the U.S. economy before he would consider scaling back the current program to shrink the balance sheet.

The market thinks the Fed’s plans are too austere based on the profile of the money market curve and this year’s rally in the long end of the Treasury curve. In our view, the real monetary risk is the dollar. The dot plots make sense if the dollar is flat or weaker, but do not if the dollar were to appreciate for the remainder of this year. It is possible that monetary stringency could create a dollar shortage, a warning already flagged by the Governor of the Reserve Bank of India, Urjit Patel. From Patel’s perspective, the world is on the brink of another emerging market crisis and Argentina and Turkey are the canaries in the coal mine. However, this is not our view on the dollar or on emerging countries, as we discuss later.

**GEOPOLITICS**

Political developments are probably the hardest to handicap but the easiest to worry about. Italy’s election is another reminder that populists and nationalists are on the rise. Chancellor Merkel’s challenges are an added reminder that the old order is under attack. These changes speak to the failure of establishment politicians to recognize the stress on European society from influences like mass immigration after a prolonged period of austerity and high unemployment.

We do not want to be accused of whistling past the graveyard but it is important to acknowledge a few positives as the geopolitical bombs go off. Part of Italy’s coalition—the Northern League—campaigned not only on an anti-immigrant platform but also on a platform of low flat taxes. There is no real groundswell of support for exiting the euro in any European nation at this time. The Brexit circus playing in the U.K. is a reminder to all European Union (EU) member countries of the difficulty in going it alone and the vulnerability of not being part of a larger bloc. The biggest uncertainty fostered in the near term from the Italian election is the prospect for a blowout in the budget deficit. What is interesting today is the central bank has played its hand with the wind down of quantitative easing. Italian bond spreads are responding to the potential fiscal consequences of the coalition government and the market is taking it in stride.
UNDERSTANDING OUR GLOBAL FIXED INCOME POSITIONING

The bet across our fixed income strategies has been on a gradual self-sustaining global economic expansion where the Fed could normalize at a pace that would tolerate lower long-term yields in the emerging areas of the world while developed country yields slowly picked up. The dollar in this story would stay weak. Correspondingly, we have been underweight duration on a global basis but geographically barbelled with little duration in the developed world and long duration exposure in select markets of the emerging world. We have been particularly constructive on emerging market currencies for the same reason, and we have large overweighted in peripheral European countries relative to the euro and yen.

Consequently, it was dollar strength in the second quarter that was the primary challenge to our performance. Global market conditions during the quarter fostered risk aversion and the related countertrend strength in the U.S. dollar with almost every currency weakening against it. As the outlook on global trade weakened, the currencies of export-centric countries and regions fell in tandem, as was the case with the eurozone. The 2018 rebound in oil and industrial metal prices was not enough to rescue commodity-related currencies against the U.S. dollar, like the Australian dollar, Canadian dollar, Norwegian krone, and Colombian peso, all of which should have instead traded on strong domestic fundamentals. The U.K. continued to negotiate its departure from the EU, and the British pound fell against the dollar as the process became more complicated. Political uncertainty sparked a risk-off rally in higher-quality European sovereign bonds, such as German bunds and French OATs, and selloff in Italian BTPs.

The precipitous fall in the Brazilian real and sovereign bond prices signaled the market’s unwillingness to overlook political risk in favor of incipient positive economic data. The Mexican peso fell substantially during the quarter, its descent hastened by AMLO’s consistent rise in election polling. Although President Erdogan’s reelection was priced into markets, the Turkish lira fell against almost every currency. Turkey’s central bank did not act quickly enough to defend the lira, and markets remained skeptical as to whether monetary policy will be impervious to political influence. Although Bank Indonesia acted swiftly by raising rates at two successive meetings in order to defend the rupiah, local-currency bonds came under pressure. The Malaysian ringgit also weakened despite the government’s pursuit of corruption and reform.

The outlook for the greenback is the single most critical feature of our positioning and key to our outlook. We are persuaded by the arguments in favor of a weaker dollar and view this year’s rally as a countertrend advance that has rebalanced a market that became overly dollar negative at the start of the year. Consequently, we remain significantly underweight the dollar generally and still tilted to emerging market currency exposure.

First, there is a valuation tailwind generally pushing the dollar lower, but especially in areas of the world like Mexico and several other emerging markets where we are invested. Embedded in the Mexican peso is an extremely bearish outlook for trade negotiations with the U.S. and on domestic politics. The biggest loser in a trade war with the U.S. is the American auto industry. Both countries want a deal, and the new Mexican president was elected on a platform of fighting corruption and drugs. His goal of raising real wages for Mexican workers rhymes with many of Trump’s themes in relation to Mexico.

Second, the current environment has been compared to the Reagan tax cuts of the early 1980s, which drove the dollar up substantially. This comparison is not appropriate. Capital was attracted to America in the early 1980s by the depressed prices of U.S. domestic financial assets, which followed one of the worst recessions in the post-war era. In addition, capital was attracted by the inspirational free-market leadership of President Ronald Reagan and his willingness to stimulate the supply-side potential of the economy with deregulation and tax cuts. It was a sea change in economic leadership, mirrored in the U.K. by Prime Minister Margaret Thatcher, and it fostered a generational change in economic leadership that lasted for 25 years, with many countries embracing the U.S. laissez-faire approach. A staunchly restrictive Fed led by Chairman Paul Volcker also kept short-term real interest rates extremely high at over 10%, stocks were selling at 8x earnings, and the dollar was cheap when Reagan took office.

The current environment could not be more different. Asset values in the U.S. are already high and the economy has been growing for almost 10 years. Many of America’s traditional allies are disaffected by the leadership of the current administration as it sets out to dismantle the U.S.-created global order. Notwithstanding its diminished stature and doubts about U.S. hegemony, the government still wants to borrow trillions of dollars from the rest of the world in coming years. U.S. Treasury new issuance is expected to represent 75% of net new issuance over the course of the next five years. In addition, real short-term rates are still marginally negative in the U.S. and Fed Chair Powell has already been upbraided by two senior U.S. administration officials for his plans to normalize. A strong dollar hardly seems in the interests of a smaller trade deficit, and White House tweets on monetary policy seem a matter of when, not if.

Similarly, the emerging market environment could not be more different than what existed in the run-up to the crisis of the late 1990s. Instead of the high inflation rates and overvalued and fixed exchange rates of the late 1990s, many emerging markets currently have low and falling inflation rates and undervalued and floating currencies. The Mexican peso is off 38% from its 2013 peak and is 15% below our measure of purchasing power parity (PPP). The South African rand is still over 50% lower than its peak in 2011 and is roughly 5% below its PPP.
We continue to sing from the song sheet of a more normal global business cycle. The dollar could still move higher if the trade war gets worse, or the Fed proves to be overly stringent, or some geopolitical development drives investors to safety. In the end, we believe pragmatism rather than ideology will prevail. In our view it is the opinions on how these events will play out that has driven the selloff in emerging market currencies and bonds—not the data. If anything, the global economic data has improved in the last few weeks.

The drum beat of globalization has had a profoundly positive impact on the standards of living across the globe. While most observers are preoccupied with the downside risks of the current trade friction, ultimately America’s drive for fair trade could prove to be a potent catalyst for global growth if the result is a more open global economy.