Macroeconomic Update

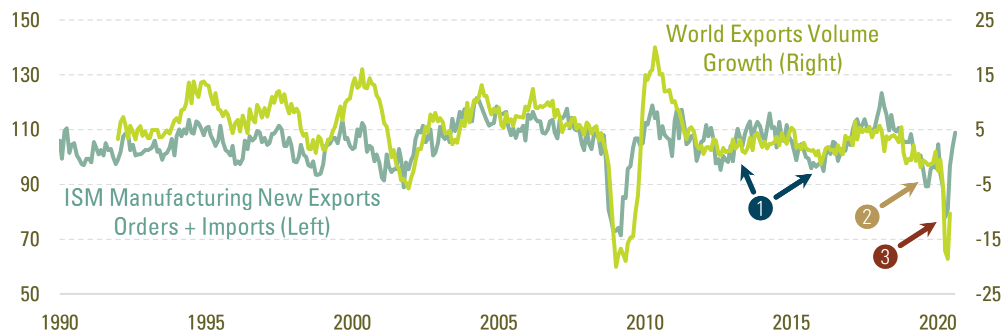
September 21, 2020

YEAR-TO-DATE MACROECONOMIC CYCLE: UNCONVENTIONAL BUT CLASSIC

We entered 2020 optimistic on global growth and were positioned accordingly. The world economy had been slowing for two years. China smothered shadow-bank financing in 2017, the Federal Reserve (Fed) raised rates and shrank the balance sheet in 2018, and there was a trade war. By the end of 2019, China's authorities were encouraging credit growth, the Fed was cutting rates and expanding the balance sheet, and a trade deal was waiting to be inked. Things were picking up.

Whatever positive trajectory the global growth story might have been on for 2020, it was hijacked by the COVID-19 pandemic (see **Figure 1**). Fear and government lockdowns swept across the world. The global economy collapsed on a scale never seen in modern history. There are no comparable crisis events, including the Spanish flu of 1918. Reactions to the coronavirus outbreak have been far more extreme than 100 years ago in almost every respect, considering the current epidemic has proven less lethal or infectious.

Figure 1 ISM Manufacturing & World Trade
As of 8/31/2020



1 Big reflationary policy pivots lifted growth from these slumps.

2 We were looking for another lift to growth beginning late 2019 on the back Fed easing, China stimulus, and expected end to trade war.

3 Instead, we got the virus and a global economic lockdown. For first time since WWII, global production is expected to contract.

Source: Brandywine Global, Haver, Macrobond

Despite the unique source of this year's global bust, the macro cycle in 2020 so far has been a classic one. This assertion might sound odd considering the relentless warnings of risk-asset overvaluation, perceptions of a disconnect between asset prices and the economy, and the worries about a new viral wave. The shocking violence that has erupted in major U.S. cities and the steady escalation in China-U.S. confrontations are other factors that enter the calculus of uncertainty. **However, business cycle and liquidity conditions, the crux of the macro cycle, are what have mattered.** Risk assets across many markets have normalized following their collapse in March. These recoveries are justified based on the evolution of liquidity conditions—from shrinking in March to accelerating ever since. They are further validated by the outlook for the economy—from a plunging contraction to a faster-than-expected rebound. It may be a macro cycle that has broken new ground, but it is still a macro cycle.

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For Institutional Investors Only

Historically, periods of economic distress follow a policy mistake, financial crisis, or both. For investors, this is a phase associated with economic recession, falling equity markets, rising corporate bond spreads and Treasury bond prices, increased CDS rates, and weak FX across emerging market sovereign borrowers. There is usually a surge in the value of the U.S. dollar, a byproduct of the global economic and financial system's reliance on the greenback as medium of exchange.

All the market elements mentioned above played out earlier this year, not in weeks or months, but in days. Risk assets collapsed:

- The S&P 500 dropped by 35.5% in only 23 days from its February 20 highs.
- Bloomberg Barclays Indexes recorded a 400-basis point blowout in investment grade corporate bond spreads over the same time period. In reality, the spreads were even more extreme near the peak, based on our involvement in the market at that time.
- 10-year Treasury yields fell 163 basis points to 31 basis points from the end of January to March 9, the bulk of that move occurring in 13 days.
- The dollar rallied from March 9 almost 9% in only 9 days.

What was different about the recession was the speed and degree of collapse—a consequence of the pandemic, a petrified global population, and a government-ordered end to economic activity. The sudden plunge in economic activity has been more like a natural disaster but of epic proportions.

Historically, the policy response to a period of economic stress is always the same: reflate. Central banks cut rates and expand balance sheets, automatic fiscal stabilizers switch on, and budget deficits swell as the unemployment rate goes up.

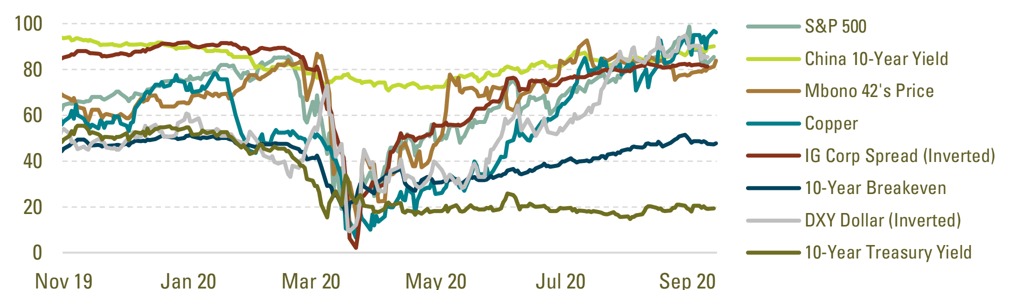
All these policy elements were in play again this year but spread out over days and weeks, not months and quarters, and on an unprecedented scale. It took the Fed almost 4 years after the Global Financial Crisis to expand its balance sheet by the same amount it did this year over a period of 10 weeks. The Fed also broke new ground by purchasing corporate bonds. Governments around the world turbo-charged traditional fiscal stabilizers with massive supplementary spending programs. In the past, 2% equated to a big fiscal boost; the current crisis has realized programs ranging from 5-15% across different countries and up to 50% of gross domestic product (GDP) if loan guarantees are included. The line between fiscal and monetary policy has become blurred with governments implementing some form of Modern Monetary Theory.

IMPACT OF POLICY RESPONSES ON RISK ASSETS

The effects on markets have been classic (see **Figure 2**). A wide range of risk assets have normalized as we draft these comments, including the S&P 500 Index, emerging market bond prices, copper prices, and investment grade corporate bond spreads. The dollar is meaningfully lower than at the start of the year. Within each risk bucket there are significant divergences, the U.S. equity market the extreme example. The U.S. equity rally has been led by a handful of big tech growth stocks while the value sector has lagged badly.

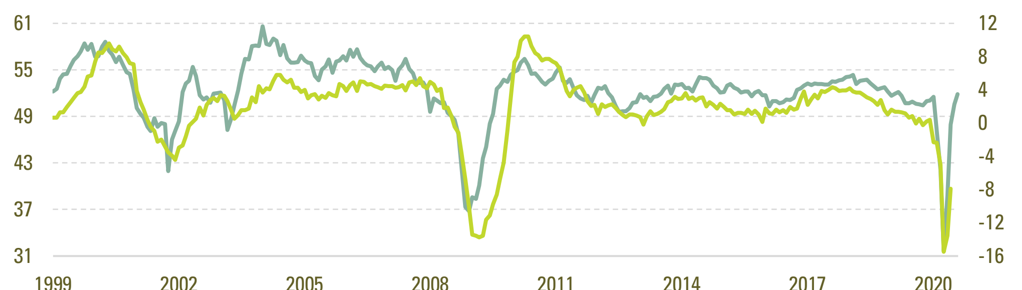
The rally in risk assets has correctly anticipated a rebound in the economy and suggests more normalization is already in the economic pipeline. For all intents and purposes, the global economy bottomed in April and May (see **Figure 3**) with the subsequent rebound materializing first in China, followed by Europe, and then the U.S.

Figure 2 Many Risk Assets Have Normalized
As of 9/15/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP), Macrobond

Figure 3 Global Manufacturing PMI and Industrial Production
Annual % Change, As of 8/31/2020



Source: Haver

Like the renormalization playing out across the various buckets of risk in asset markets, the scale of economic recovery is widely dispersed across different segments of the global economy as well as sectors within each economy:

- In China, government support focused on corporate incomes, particularly the state-owned enterprises, which helped business keep labor employed. The Li Keqiang Index of output is back to pre-crisis levels. Domestic retail sales growth remains depressed.
- In contrast, U.S. government measures focused on support for household incomes. Even though the unemployment rate has skyrocketed, the level of retail sales has almost completely recovered.

The negative sentiment associated with normalization in risk assets and recovery in the economy remains rooted in the fear of a resurgence of the pandemic, resulting in another retreat in private-sector activity. When will people stop being afraid? How resilient will the global economy prove to be when remedial fiscal measures are turned off? What is the lack of normalization in Treasury yields telling us?

As for Brandywine Global's investment decisions year to date, the scale and speed of the market reaction to the epidemic during the first quarter caught us by surprise. Observing events in Wuhan during early February, it was difficult for us to conceive that London and New York could be locked down as well. We experienced a global collapse when the U.S. and Europe did, and our portfolios were affected accordingly.

In late March, the speed and the scale of the policy reaction provoked by the pandemic became very apparent to us, and we pivoted. We reallocated portfolios aggressively to where we thought the biggest fixed income anomalies would benefit most from the ballistic reflationary macro policies being lined up around the world. That took us to U.S. corporate bonds, and we built significant positions where mandates permitted. The compression in spreads on the back of policy reflation has been dramatic. The recoveries in emerging market fixed income and the drop in the dollar have been similarly remarkable. Together, these elements have helped our portfolios surge dramatically as well since March.

As we head into the final month of the quarter, normalization across wide swaths of capital markets has led us to begin repositioning portfolios. These adjustments include selling or hedging our corporate bond portfolios, owing to the near full realization of the price opportunity that erupted in March.

Looking out at the next one to three years, the big macro issues remain the same: the evolution of the business and liquidity cycles. Factors that will affect these cycles include: changes in policy implementation by the Fed; the evolution of the virus and responses to it; the outlook for fiscal remediation and its impact on the U.S. and global economy; and the outlook for inflation. In addition, there are a host of exogenous developments, including the U.S. election and China-U.S. international relations, which will have bearing on the business and liquidity cycles as well.

MACRO CYCLE DRIVERS: ONE TO THREE YEARS AHEAD

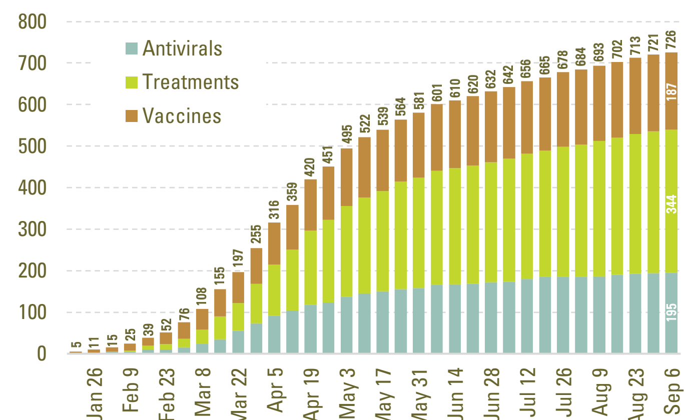
1. BUSINESS CYCLE OUTLOOK

On the macro front, the biggest issue is the evolution of the business cycle. Will it stall or retreat if the virus resurfaces? How will governments and policymakers respond?

Our base case assumption is that people both learn to live with the virus and that therapies, treatments, and vaccines will emerge to overcome it. There has never been a greater assault of money, science, and business against a single disease (see **Figure 4**). The whole world is on the same side of this fight. It is only a question of time before this disease is overcome or burns itself out as have other viruses. Charting the likely course for the unwinding of fear and anxiety and the restoration of some sense of personal safety is not in our remit. However, it seems rational to assume that the impact of these fears as a depressant on world economic activity will erode with time.

In the meantime, we doubt that governments around the world are likely to reimpose any kind of broad-based or sweeping lockdown measures again. Instead, a more measured approach seems probable with the

Figure 4 Unprecedented Industry Response against COVID-19
Number of Therapies (Cumulative), As of 9/6/2020



Source: Biotechnology Innovation Organization (BIO.org)

focus being on containing clusters that threaten to expand. There is widespread recognition that lockdowns were a blunt tool that may have done as much or more harm than the virus itself. The strategy may have worked best in China where the government was able to impose lockdowns and then demand reopening. It has worked less well in developed economies. While the aim was to avoid overwhelming the healthcare system, numerous scientists and medical doctors are concerned about the long-run health consequences of the stay-at-home orders.

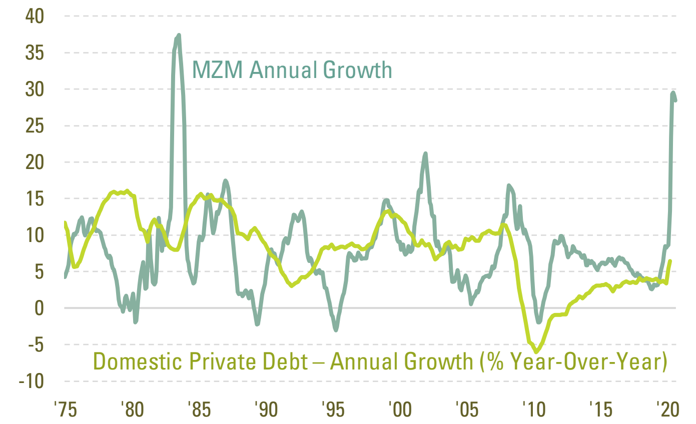
In addition, governments cannot afford to sustain deficits running at 20% of GDP indefinitely. At the moment, fear of the pandemic has locked up private savings on a scale ample enough to keep yields depressed. As fears subside and if rates rise, the solvency of governments will start to become an issue. At some point, the policy dialogue will shift to fiscal sobriety.

In fact, investors may need to worry more about a "fiscal rocket" than the so-called "fiscal cliff" over the next few years. Consider the characteristics of the current environment: explosive money growth; massive fiscal stimulus; hundreds of billions in pent-up savings; negative real interest rates; a falling U.S. dollar; low energy prices; and liquidity available basically for free (see **Figures 5, 6, and 7**). Then consider the starting point: a deep trough in economic activity. These factors add up to the possibility of this year's U.S. bust becoming next year's boom. With governments seemingly unwilling to remove fiscal support in the face of elevated unemployment rates and central banks committed to raising inflation, the macro downsides seem low in relation to the possible upsides.

The regional drivers in the global growth outlook over the next few years will still be the U.S. and China. While U.S. macro factors look quite constructive, the caveats are the pandemic and the prospect for a Biden presidency. The latter's platform calls for major tax increases.

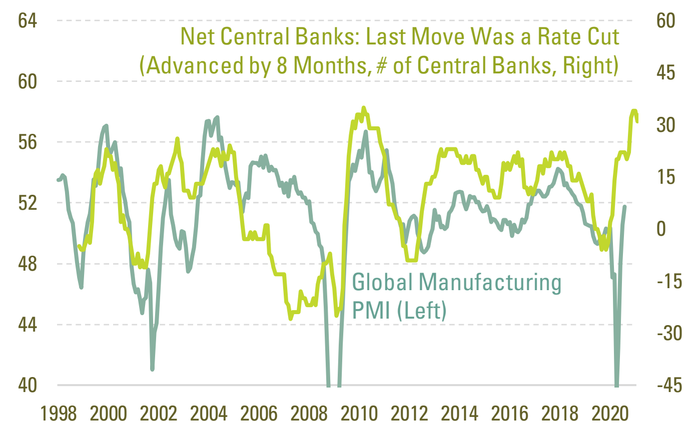
In China, we expect growth to be underwhelming over the course of the next several years. China's consolidated budget deficit is close to 14%, which is one reason it did not engage in massive fiscal support during the pandemic. Despite its high savings rate, the economy is already heavily indebted, and much capital has been allocated to the low-return state sector. Those factors plus a declining labor force and less reliance on exports argue for much lower growth rates than in the past. China is already pulling back on some of its fiscal levers. In our view, China will not be the high-beta growth story of the world economy over the next few years.

Figure 5 Liquid Money Supply Growth
As of 8/31/2020



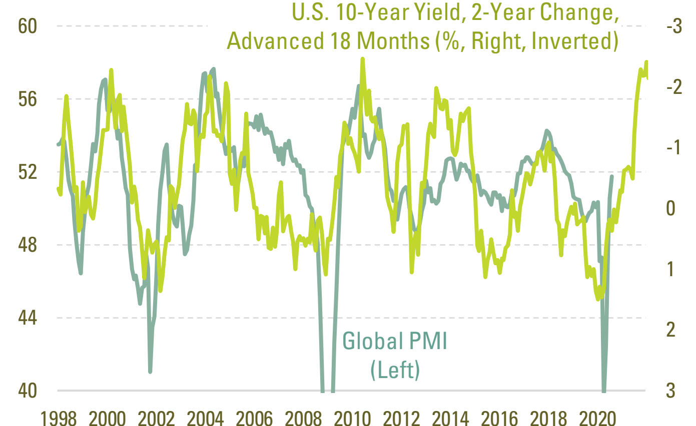
Source: Haver

Figure 6 Global Manufacturing PMI and Monetary Policy Stimulus
As of 8/31/2020



Source: Macrobond, Haver

Figure 7 Foundation for an Economic Expansion
As of 9/14/2020



Source: Macrobond, Haver

2. INTEREST RATE/LIQUIDITY OUTLOOK

Currently, there is high-probability conviction in the belief that the Fed will not raise interest rates over the time horizon of this exercise. Instead, the biggest policy actions will come through balance sheet management. The announcement from the Federal Open Market Committee at the annual Jackson Hole symposium confirms a shift in the way the central bank perceives the execution of its mandate. While the technical details are still lacking, Fed Chair Powell has stated that the U.S. central bank will not consider raising interest rates before reaching an "average" inflation rate of 2%. Powell has justified this shift in perspective based on its conviction that the "natural" rate is very close to the zero bound and that there is too much uncertainty over what is an equilibrium level of the natural unemployment rate.

This is a colossal announcement on many different levels:

- It was only two years ago as he stepped into the leadership role at the central bank and raised rates above 2% that Fed Chair Powell stated he thought the natural inflation rate was significantly higher. Powell has finally aligned his views with the opinions of the market as expressed in money market and yield curves. There is no imminent inflation threat.
- With the Jackson Hole announcement, the Fed has officially conceded that its ability to predict inflation has been worse than useless. The framework it had been following to realize its goal has resulted in the persistent underachievement of its target. There was nothing in this announcement about how it intends to achieve an average inflation rate of 2%. However, there will not be an increase in rates before it does.
- The bias in monetary policy is to pursue and sustain a negative real rate of interest. In many ways, this is a shift more in the direction of the monetary policy of the Bank of Japan *without* yield curve control or a commitment to a specific level of the 10-year government bond yield. Instead, the central bank has made only a commitment to expand the balance sheet by a certain amount this year. It is unclear if that will be enough.

The open decision *not* to engage in yield curve control suggests that the Fed would be happy to see the yield curve steepen. It would be a sign of rising growth and inflation expectations and would be positive for commercial bank profits and the credit creation process.

Summary: Fed policy is still all about maximizing employment, keeping inflation at an average rate of 2%, and avoiding conditions that foster financial instability. With the aggregate economy still in the hole and well below the high-water mark, let alone potential GDP, the case for inflation returning seems later in the one- to three-year outlook than sooner. When it comes, the Fed is now promising that it will let the economy run hot before reacting.

3. FISCAL DRIVERS: SOBRIETY OR A UNIVERSAL BASIC INCOME?

Before the pandemic, the secular story was stagnation. Declining populations in Japan and Europe, a declining labor force in China, reduced population growth and less immigration in the U.S., and less private sector credit demand everywhere were conspiring to depress long-run potential demand or spending. On the other hand, non-linear gains in technology were boosting productivity and the supply side of the global economy. Globalization contributed to the productivity story. The growing wedge between global supply conditions and slower spending trends has been, arguably, the main reason for low inflation and lower-for-longer interest rates. It has not been the result of the extraordinary policy measures of global central banks, the view taken by the proponents of financial repression.

The pandemic has made this calculus much worse in the near term. Private-sector savings rates have risen around the world with stay-at-home behavior. Governments have been forced to expand budget deficits as an offset. In spite of the latter, rates are at rock bottom. Liquidity is basically free. What will it be like for the next few years?

Some portion of the increased private-sector savings rate is likely to decline in the years ahead, but it might not be completely reversed. U.S. households were so shocked after the Global Financial Crisis that savings rates lifted and never receded. How able governments will be at redressing budget deficits will depend on how rapidly unemployment is reduced. If Japan is any example, we could have big deficits and big government spending for years. Japan has run a budget deficit on average of 6% for the last 20 years. Attempts to rein that in through higher taxes have led to periods of economic weakness.

Summary: While there may be attempts at fiscal remediation over the next few years, it will be hard to execute if unemployment remains elevated.

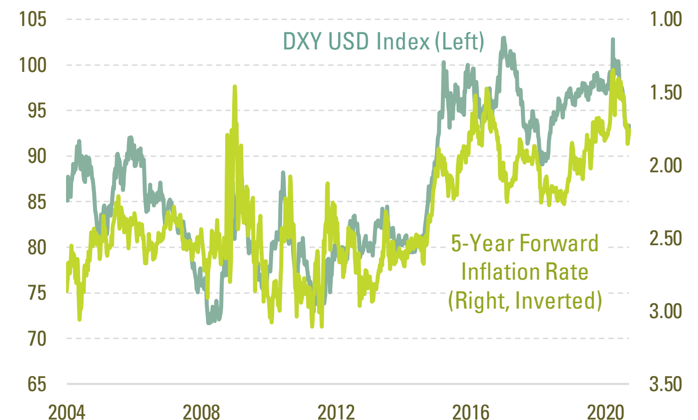
4. THE U.S. DOLLAR OUTLOOK

The global economic and financial outlook over the past 10 years has been dominated by a strong U.S. dollar. In no small way, this situation has contributed to underwhelming inflation performance (see **Figure 8**). In the zero-bound interest rate world in which the Fed believes we operate, the single-most important manifestation of Fed policy will be the U.S. dollar. It is difficult to imagine the Fed achieving its inflation goals or any positive surprises on inflation without a meaningful decline in the U.S. dollar.

There was no mention of the dollar in the Fed's announcement of its shift to an average inflation target. In theory, short-term real interest rates become more negative if inflation drifts up while the Fed keeps policy rates anchored at zero. This is a clear negative for the dollar, other things being equal (see **Figure 9**), and a clear positive for rising breakeven inflation rates.

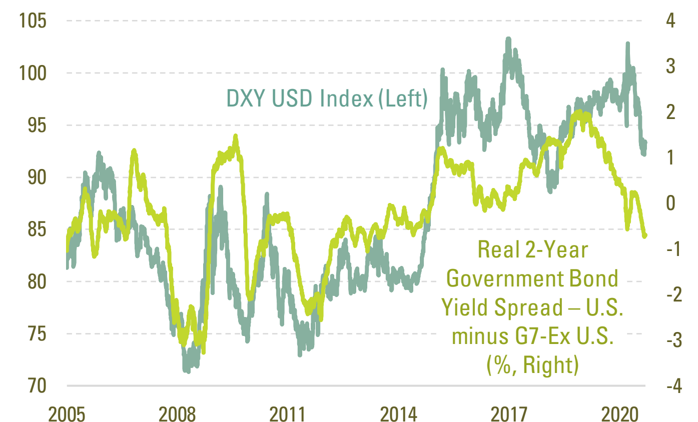
Summary: For 10 years, emerging market fixed income markets have faced the headwind of a stronger dollar. A reversal could be a huge macro driver not just for the next three years but beyond.

Figure 8 USD & Inflation
As of 9/11/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 9 USD & 2-Year Yield Spread
As of 9/9/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP), Macrobond

5. EXOGENOUS DRIVERS

- The U.S. election presents a very clear contrast in economic policies between the Trump and Biden tickets. President Trump has hinted at cuts in the capital gains tax. The Biden economic platform is redistributionist, calling for a reversal of Trump's corporate tax cuts and a significant increase in tax rates for high income earners. The former is stimulative. The latter is repressive.
- The escalating conflict between China and the U.S. is a known unknown. The steady escalation in restricted trade in technology with China is probably the nerve point in this fight. China's dependence on U.S. semiconductor manufacturing equipment and Taiwan-manufactured chips creates a very real economic vulnerability. The increasing risk of an incident in the Taiwan Strait creates the geopolitical vulnerability. A cold war that turns hot is bad for growth.

Summary: While other factors, like policy developments and the progression of the pandemic, are currently taking center stage, these diverse, exogenous drivers remain in the wings. Given their potential to significantly impact the business and liquidity cycles, they will be closely monitored as they develop.

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