Macroeconomic Commentary

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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.

SHAKING UP THE GLOBAL PARADIGM

The investment outlook these days has investors shaking their heads as they try to rewire the process of assessing tail risks that seem to be coming from all directions: the U.S.-Iran cyberwar; icy U.S.-China trade and technology relations, Taiwan and the South China Sea, Brexit, European populism, North Korean missile tests, Hong Kong riots, and the U.S.-Russia retreat from the 1987 Intermediate-Range Nuclear Forces—to name a few. There are a lot of distractions and it is easy to lose perspective on the big picture. Needless to say, handicapping or modeling all of these moving parts is challenging. Among these risks, we believe assessing a 25% tariff on all U.S. imports from China could tip the world economy into a recession.

In our opinion, global liquidity is still the major driver of risk because of its effect on growth rates and market returns, both of which were in retreat in 2018 and spilled into international markets, dampening **global liquidity** and strengthening the dollar. At the midway point of 2019, the manufacturing slowdown may be on the precipice of turning into a manufacturing recession. Global growth has continued to slow but the June global Purchasing Manager Index (PMI) data is about as bad as it gets without a major recession. Importantly, a Federal Reserve (Fed) policy pivot has continued to gain traction, which would support liquidity and eventually growth. The Fed and European Central Bank (ECB) have abandoned normalization and turned dovish. China continues to dial up more policy stimulus. Central banks in Australia, Chile, India, Malaysia, the Philippines, and Russia have cut rates. Money supply measures are basing out in most regions of the world. We expect more to come. The bull market in the dollar has been checked—at least for now—with the broad dollar index roughly where it was last November. The trade war between the U.S. and China seems on hold, possibly until the U.S. general elections.

Many investors see the divergence in U.S. equities and bond yields as a macro inconsistency: one suggests recession, the other an extension of the global business cycle. The latter interpretation suggests that markets anticipate a soft landing. The equity risk premium is rising. The natural consequence of lower inflation and lower bond yields is higher equity multiples. The key to insure this outcome is that policymakers move far and fast enough to validate expectations, or the global economy starts looking up.

WE'VE SEEN THIS BEFORE

The current global slump is the third since the G20 first took policy action to propel the global economy out of the Great Financial Crisis (GFC) in 2009. All three down episodes since that time have been triggered by policy:

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For Institutional Investors Only

1. The first post-GFC slump centered on the European sovereign debt crisis in 2011-2012 and was triggered by the Trichet-led ECB's mistaken decision to raise rates.
2. The second slump in 2014-15 was caused by China's attempts to deleverage its economy which produced the biggest commodity bust in decades.
3. The slump since early 2018 is a by-product of multiple policy decisions: the Fed tightened too much last year, the "sugar high" of the combined effect of the U.S. fiscal thrust and tax cuts, Chinese authorities hit the fiscal brakes too soon, and protectionist rhetoric and tariffs undermined trade and corporate spending.

The misjudgement reflected in all these policy decisions was the belief that the post-GFC period of subdued growth, below-target inflation, and lackluster credit creation would finally be put to rest once enough time had passed and conditions could "re-normalize" back to something that looked more like pre-2008. Unfortunately, the above trifecta put a damper on global growth, and we believe that swift and prescriptive action from the Fed and Chinese authorities may be able to stabilize growth. Policy stimulus counter-measures managed to reverse the first two slumps.

1. The 2012 slump ended with America's open-ended quantitative easing, Draghi's "Do what it takes" approach in Europe, and Abenomics in Japan.
2. The 2015 commodity bust ended with China's aggressive fiscal stimulus and the Fed decision to postpone raising rates.

Now, for a third time, policymakers are beginning to swing towards stimulative counter-measures, or at least end their restraint.

THE FED—BEHIND THE CURVE, TIME TO CATCH UP

In hindsight, the wisdom of appointing a lawyer to run U.S. monetary policy begs the question whether the justice system would be as well served by installing an economist on the Supreme Court. Humiliated by markets at the end of last year, Fed Chair Jerome Powell abandoned plans to normalize interest rates back to a neutral rate he mistakenly judged to be much higher. In addition, what was to be a mechanical unwinding of the balance sheet will now end sooner than planned. Even after these changes, the unambiguous message from the inverted yield curve is that the Fed is behind the curve and needs to catch up. We agree.

Historically, the Fed ultimately has always behaved rationally. We doubt this time will be different and anticipate easing actions lie ahead. The Fed stayed put at the June meeting with Powell claiming the central bank wants more time to assess the data. From our perspective, he runs the risk of increasing the probability of a recession—which has already been flagged by some leading indicators—while waiting for lagging indicators to slow. Currently, we believe that U.S. real gross domestic product (GDP) growth has moderated back below 2% roughly in line with the Fed's view, which may explain the Board's more sanguine stance than the message from the yield curve. However, non-financial corporate profits contracted in the first quarter based on the national income accounts, and gross domestic income is running significantly slower than GDP. The June payrolls report was better than the weaker ADP data, but wage and price inflation trends have been unambiguously soft. In addition, the level of the Conference Board's Consumer Confidence Index ended last year near historic highs but has since retreated *on a rate of change basis* this year to below zero in June, which nevertheless is in sharp contrast to the large decline in business confidence. A spillover into general consumer confidence would radically and quickly alter the Fed's current outlook.

CHINA—SUCCESSIVE APPROXIMATION, NO BIG REFLATION

China's slowdown has been an important driver of the slump in global economic growth—along with the related trade and tariff issues—since early 2018. The cause of this slowdown was a retreat from fiscal stimulus to restraint and an all-out attack on shadow bank lending; growth in the latter has plunged from a peak of 20% to -10% currently.

Reversing the economic slowdown has been the goal of policymakers since-mid 2018; however, China's leaders remain steadfast in their opposition to the kind of full-bore fiscal/credit reflation which re-energized the local and global economy in 2009, and again in 2016. The reason why is because China's leaders don't want to boost leverage.

Instead, a range of measures have been taken to stabilize growth including:

- Increased infrastructure investment spending—which is where last year's fiscal retreat was concentrated.
- Lowered interest rates, reserve requirements, and taxes.

- Increased bank directives to lend to the small and medium enterprises where productivity is the greatest but access to capital the poorest.

Chinese officials have also reformed the tax system with income tax cuts and reducing the business value-added tax, which are long-tailed growth initiatives. The results have been mixed. The fiscal impulse is gradually building but the monetary data have yet to stage much of a reversal. Positives include the Organization for Economic Cooperation and Development (OECD) Leading Economic Indicators (LEI) for China, which have been rising all year, and the Shanghai Composite which is well off last year's lows. The latest NBS manufacturing PMIs remain unchanged for June and off the recent lows. Although Markit PMI export orders are in a clear uptrend, they remain within a narrow range just below their historic averages.

THE TRADE WAR—ESCALATION ON HOLD

We don't think it is a coincidence that last year's growth slump seemed to intensify around the same time that the U.S. put a ban on selling components to China's ZTE corporation in April 2018. Relations with China have cooled on many fronts since then. The levying of tariffs and threat of protectionism has affected business confidence, willingness to invest in China, and has limited corporate capital spending around the world. By some metrics, global trade is already in recession and May/June economic data lurched lower as the trade rhetoric heated up.

At the June G20 meeting in Osaka, the two protagonists called a temporary truce. China and the U.S. agreed to re-engage in trade discussions and avoid any new tariffs without reversing existing tariffs. The absence of a negative is a positive. The Trump Administration has focused on where it considers China to be engaging unfairly with the U.S. and has been using tariffs regulations as incentives for achieving compliance. These dispute points are unlikely to be resolved anytime soon but President Trump also wants to win the next election. He needs a strong economy and financial markets to achieve that goal. So, a window of stability in the global trade wars seems likely to prevail for the next year or so.

THE EMERGING MARKET STEP UP

To sum up: the Fed has ended tightening and is expected to ease, China's leaders will add incremental stimulus if needed, and the trade war is on pause for now. The policy pivot is moving in the right direction. The real issue is that the scale of counter-stimulus seems slight in comparison with previous episodes. Central banks are globally trying to assess the risk of the manufacturing slump spilling over into other sectors of the economy. Simply stated, central banks do not want the manufacturing PMIs to descend into the mid 40s. The Fed is still balking. China wants to avoid a big credit push. And the temporary agreement between the U.S. and China was to defer extra tariffs, not unwind the old ones. Meanwhile, Europe is embarking on another policy initiative to stabilize the surprising growth slump in the region. We believe the bottoming out process is underway in order to stabilize the slowdown in global growth and eventually provide a soft landing.

One important development in global data trends is the relative outperformance of emerging countries outside of China. The OECD LEI for member countries plus the six major non-member economies is slowly turning on a rate of change basis while the G7 measures continue to retreat. In addition, emerging market manufacturing PMIs have been relatively flat since early 2018 and persistently above 50 while the same metric for advanced economies has trended to just below 50. The reason for this relative performance is not perfectly clear. The collection of countries that have actually cut rates in recent weeks has been mainly emerging markets and there is considerable latitude for more easing given steadily falling inflation and stable currencies. In addition, there is anecdotal evidence of companies reconsidering production in other countries outside of China. Stimulus and growth from the emerging area of the world could turn out to be a major component of the soft landing outlook which seems embedded in asset prices.

RISK AND SOME VERY LONG-TERM THOUGHTS

It is rare for the Fed not to cut interest rates when commodity prices are weak. The near-term risk in the outlook is that policymakers do not do enough. If policy changes are too slow too in response or not by enough, volatility will pick up.

Unfortunately, central banks in the major economies are still the only game in town when it comes to counter-cyclical economic policy. Fiscal policy is tapped out: budget deficits are already big in the U.S. and China and neither Europe nor Japan want their deficits bigger. Credit ratings agencies encourage emerging countries to balance their budgets. But central banks do not have much ammunition left and many, including the Bank for International Settlements, warn that further rate cuts are counter-productive

The result could be that policy impotence drives politics towards increasingly radical attempts to stir up economic activity. There are plenty of signs of this pressure building. Populist uprisings in Europe are tilting towards better growth at the expense of balanced budgets. Musings about firing the Fed Chairman is more than simple presidential exasperation with the stance of monetary policy. It is a sign of increased political pressure to

drive growth. Institutional roadblocks are the biggest barriers for radical change. The nominations of Waller and Shelton bring two more doves to the Federal Open Market Committee. Christine Lagarde's nomination for ECB President—another lawyer—opens the door for more creative measures to stimulate. The re-birth of Modern Monetary Theory (MMT) could be a big step in a more radical direction for central bank policy. Central banks usually only buy bonds to affect growth by manipulating interest rates and the time value of money. The focus provided by MMT has the central bank effectively funding anything the government wants. If radical policy implementation were to occur down the line, it could foster radical investment and economic outcomes in the distant future.

CONCLUSION

For the framework of our forecast to play out, the reflation trade must be renewed and seep into the manufacturing sector, which will need support as a new rate cutting cycle begins around the world and plays out throughout the balance of 2019. While a weaker U.S. dollar will be a key factor in reviving global liquidity to support a longer global growth cycle, policymakers—namely the Fed and Chinese officials—will determine whether we see a global soft landing later this year.

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