Macroeconomic Update

Paul Mielczarski
Head of Global
Macro Strategy

Election Uncertainty Challenges Bond-Friendly Fundamentals

The macroeconomic backdrop is becoming increasingly favorable for G10 bond markets after a difficult start to the year. Hot U.S. inflation prints in the first quarter raised doubts about the Federal Reserve's (Fed's) ability to cut rates in 2024. However, more recent data shows a resumption of the disinflationary trend. Meanwhile, growth in the U.S. slowed in the first half of 2024. Further weakness may be in store as the economy adjusts to high interest rates and reduced fiscal support.

Overall, we expect slower nominal gross domestic product (GDP) growth across G10 economies. In turn, this slowdown will enable central banks to lower policy rates from restrictive levels, supporting bond market returns. Moderation of U.S. growth together with less restrictive Fed policy should be negative for the U.S. dollar.

However, the market outlook is clouded by high policy uncertainty ahead of the U.S. election. In the coming months, market fluctuations will become increasingly driven by opinion poll shifts. In our view, the most consequential uncertainty is around future U.S. trade policies.

When it comes to portfolio strategy, it is unclear if risks associated with election uncertainty are adequately compensated. Therefore, reducing portfolio risk may be prudent. Additionally, we believe it makes sense to focus on positions that stand to gain from the medium-term economic outlook and are less likely to be impacted by the U.S. election outcome.

Growth and Inflation Continue to Moderate

During the past two years, significant progress has already been made in reducing inflation. The upside surprises in U.S. first quarter inflation were concentrated in the service sectors, in which the lags with economic activity are particularly long. In essence, high inflation in these sectors is the result of shocks from two to three years ago, rather than current economic conditions. Goods price inflation, which responds faster to current demand/supply imbalances, is already back to its pre-pandemic run-rate. The unit labor cost growth rate is slowing, reflecting labor market rebalancing and faster productivity growth. Meanwhile, shelter inflation should continue to decelerate in the months ahead due to more benign market rent trends.

U.S. GDP growth has slowed to below 2% in the first half of 2024, after a strong second half of 2023. We expect continued moderation in U.S. economic growth going forward as well as a rebalancing of its relative drivers. Government spending and service consumption have contributed disproportionately to GDP in recent years. We should see lower growth contributions from these sectors in the future. Monetary policy is restrictive and a headwind to economic growth. This tightness is reflected in soft private sector credit growth, stress across parts of commercial real estate markets, rising credit card delinquencies, and weak small business confidence surveys.

It appears that recession risks are relatively modest at this point, particularly if the Fed cuts rates later this year. However, we recognize that the current economic cycle is unique and without obvious historical comparisons. In light of this this lack of past parallels, we are open-minded about recession risks and are closely monitoring economic data. It is possible that a large slowdown in service spending together with less fiscal support could potentially lead to a deeper retrenchment in labor demand and a higher unemployment rate. The labor market has shown mixed signs recently, with healthy headline employment growth contrasted by a rising unemployment rate, soft survey indicators of employment, and falling temporary help employment. It is noteworthy that the Fed expects the unemployment rate to finish the year at 4%. Since unemployment is already slightly above this level, further softening in the labor market could trigger a more aggressive easing cycle.

Trade Policy Uncertainty

Our biggest concern regarding the upcoming U.S. election is trade policy. Former President Trump has proposed a 60% tariff on imports from China and a 10% tariff on imports from other countries. If this proposal is implemented, the U.S. effective tariff rate would reach its highest level since the 1930s. Even if half of the proposal is implemented, 70 years of U.S. trade liberalization will be reversed. To what extent these proposals are a negotiation tactic is unclear. It is clear, however, that both Trump and trade officials from his first administration believe tariffs can reduce the U.S. trade deficit, raise government revenue, and create manufacturing jobs. Additionally, they believe tariffs can be imposed without Congressional approval, including on countries with which the U.S. has free-trade agreements.

The introduction of broad-based import tariffs would result in a one-time increase in prices but would have a relatively limited impact on medium-term inflation. At the same time, we would expect a large negative shock to global growth that would disproportionally impact U.S. trading partners. Even if higher tariffs have a modest direct impact on U.S. GDP, they will worsen the economic slowdown already underway. Ultimately, we expect large tariff increases to lead to lower bond yields, with higher inflation breakevens more than offset by lower real yields.

Typically, when a large, closed economy increases tariffs, its real exchange rate should increase. That was indeed the case when the U.S. increased tariffs on Chinese imports during the first Trump administration. In the event of a Trump victory in November, the U.S. dollar (USD) is likely to rally, especially against currencies most sensitive to global trade growth. The Trump administration may wish to weaken the dollar, which is already quite strong. In the absence of the Fed's cooperation, it is unclear how that can be achieved on a sustained basis.

Strategy Implications

We are overweight G10 government bonds, focusing on the U.S. and U.K. With inflation moderating across developed market economies, central banks in the eurozone, Canada, Sweden, and Switzerland have already cut policy rates. The Fed is priced for 175 basis points (bps) of rate cuts over the next three years. If our inflation view is right, the Fed should be able to deliver what is priced into the money market curve, starting with two 25bps cuts later this year. It is very unlikely that the Fed will need to hike rates again in this monetary cycle. But we could see a number of scenarios in which policy rates are cut more aggressively than what is priced in. In the event of a deeper slowdown in growth or a large sell-off in risky assets, bonds offer an attractive asymmetry and portfolio protection.

We believe that any bond market sell-off resulting from a Republican clean sweep in November would be short-lived. The extension of Trump's 2017 tax cuts is already expected by investors. It is unlikely that we will see significant net easing of fiscal policy, especially if broad-based import tariffs are imposed. A small minority of Republican senators could limit fiscal policy flexibility and block potentially unorthodox central bank appointments. A large negative shock to global growth would more than offset the short-term inflationary impact of tariffs.

The outlook for currency markets is more complex. On one hand, the USD is expensive across a range of valuation measures. The U.S. economy is slowing and possibly converging with other developed market economies while the Fed is about to cut interest rates. These factors would argue in favor of being short the dollar. On the other hand, Trump's election victory could lead to a stronger USD on the back of tariff fears. We have reduced our USD short position, in part due to the uncertainty related to the U.S. election.

We also continue to like local currency bonds in Mexico, Colombia, Brazil, and South Africa. While bonds in Mexico and Brazil have recently underperformed due to medium-term political concerns, these markets and others offer historically attractive nominal and real yields. South African bonds have benefited from the formation of a national unity government. Abstracting from political uncertainty, macro fundamentals for emerging market (EM) local currency bonds are generally supportive. Inflation across EM continues to trend lower. The Fed monetary easing cycle should allow EM central banks to gradually normalize still elevated policy rates. We generally believe EM bond markets are less vulnerable to U.S. election shocks than EM currencies.

Corporate bonds have benefited from strong inflows into credit products with 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 potential economic or market shocks. Opportunities remain within credit given the high all-in yields, but careful selection and active management is imperative. From a broad asset allocation perspective, we prefer U.S. agency mortgage-backed securities, which offer attractive spreads but with more defensive portfolio characteristics.

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.