Audio Transcript: Macro Duration Views
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Katie Klingensmith [00:00:02] Welcome everybody to Around the Curve, Brandywine Global's conversation with our senior investment experts. I'm Katie Klingensmith, and today I'm delighted to be joined by Paul Mielczarski. Paul is the head of macro strategy here at Brandywine Global, and he shared his 2024 outlook recently. We are going to take advantage of this moment and go a little deeper into what Paul and team are thinking about curves around the world and duration positioning. Welcome, Paul. Get us started with just a brief overview of that 2024 outlook and what you're seeing for US and global growth and inflation.

Paul Mielczarski [00:00:43] So, we are about to get US Q4 GDP data. And if consensus is right, this data will show 2% real GDP growth and 2% core inflation. So, essentially a definition of a soft landing. You know, potentially suggesting a full normalization of the economy after all the pandemic distortions. Now, the question is, can we really maintain this trajectory of trend-like GDP growth and 2% inflation? I think on the inflation front, we are quite confident that the Fed will be able to reach its 2% target. We are seeing goods prices falling as pandemic-period distortions are reversed. You know, we expect lower rental inflation in the CPI data going forward. And we also expect softer service inflation, outside of rents as labor markets normalize. And it's even possible that core inflation could end up undershooting 2% for a period of time. But unless we have a recession, we would generally view it as transitory on the downside, just as it was transitory on the upside. Now, when it comes to the growth outlook, I feel there's a bit more uncertainty. You know, the US economy has been resilient in the past one to two years, but it does face some significant headwinds. Firstly, higher rates are being gradually passed into consumer and business borrowing costs. Secondly, fiscal policy, which has really played an important role in the story of US economic resilience, is likely to be less supportive in 2024, although there's a lot of uncertainty in terms of how much less supportive. And finally, you know, if we look at areas like bank lending growth, that remains very weak. And you do have segments of the economy like commercial real estate markets, which remain under significant pressure. But at the same time, I think there are some very important sources of US economic resilience which are likely to remain in place. For example, if you look at labor supply growth and productivity growth, they have been very strong over the past one to two years, really allowing inflation to normalize without a need for a recession. With real consumer incomes likely to be supported by decent nominal wage growth and falling inflation, it's a little bit harder to see what would cause a sort of a sudden slowdown in the economy. And on top of that, over the past few months, we've had a pretty significant easing in financial conditions, which should, to some extent, boost housing and also business investment. So, I think overall, the US economic trajectory seems to be most likely on a sort of a, or the US economy seems to be most likely on a soft-landing trajectory. But, you know, this is already largely reflected in current market expectations.

Katie Klingensmith [00:04:13] So, I suppose, exactly those market expectations would be reflected in the curve. If we don't have a recession in the US, what are you looking for in the Treasury yield curve?

Paul Mielczarski [00:04:24] I think without a recession or major growth scare, I think we could just see the US 10-year yield sort of trade in a range, maybe somewhere between 3.5 to 4.5%. So, we're roughly today in the middle of that range. On the one hand, you know, with inflation falling sharply and major developed market central banks about to embark on rate-cutting cycles, I think the environment is overall quite favorable for bonds.

But, you know, on the other hand, I think markets are already pricing in roughly 200 basis points of rate cuts from the Fed over the next two years. It's a little bit hard to see them deliver more, you know, without a recession. And if we do have a situation where, you know, a Fed is easing at a time when inflation is coming down, you know, growth is relatively good, that should ultimately reinforce the expectation of economic soft landing. I think if that happens, we would expect to see a steeper yield curve. And, let's say a sort of a 3% fed funds rate, it would be consistent with roughly 4% 10-year yield, which is, you know, around where we are today. Now, you know, stepping back a bit, while we do believe the US economy is ultimately going back towards an equilibrium of around 2% real GDP growth and 2% inflation, we don't necessarily think that the interest rate structure will come back to where we were in the pre-pandemic period. So, for example, if you look at from the start of 2010 until the end of 2019, US nominal GDP growth grew by around 4%. So, that's a sort of 2% real growth, 2% inflation type trend. But during that period, policy rates averaged only around 60 basis points for the whole 10-year period. And 10-year yields were only around 2%. I think going forward, you know, we would expect nominal GDP growth of 4% to be roughly consistent with, you know, let's say 3 to 3.5% average fed fund policy rate and maybe, you know, 4 to 4.5% 10-year bond yield.

Katie Klingensmith [00:06:55] And Paul are you really talking about the near term? Or do you see a different relationship and different kind of level out a couple of years?

Paul Mielczarski [00:07:06] Look, I think this is more of a, let's say, one to two-year time horizon. And that's where sort of, you know, the question comes back, could we have a more meaningful growth scare. In which case, I think it would be, you know, it's very conceivable that at that point in time, markets would price in, you know, even more aggressive Fed rate cuts and even lower 10-year yield. But without that growth scare, you know, we generally feel that, you know, 4% 10-year yield is roughly the right zone for, you know, bond yields to be in.

Katie Klingensmith [00:07:43] There has been periodically a focus on quantitative tightening. How much does the Fed's continued policy, at least at this point, of letting assets run off its balance sheet impact to the curve?

Paul Mielczarski [00:07:58] Sure. So I guess the bottom line is, the Fed really wants to ensure that the balance sheet runoff at some point does not create major distortions and dislocations in the short-term funding markets. And but the Fed wants to be preemptive in their balance sheet management strategy. You know, they don't just want to wait for these large dislocations to show up, but they really want to anticipate and make changes ahead of time. I think previously, you know, so let's say three to six months ago, most investors expected the balance sheet runoff to end sometime around Q4 this year. But sort of the latest signals from the Fed suggest that it could happen a little bit sooner, you know, perhaps then starting in Q2, you know, maybe we'll finish in Q3. I think on the margin, it would be somewhat supportive for fixed income. But it's unlikely to have a really meaningful impact.

Katie Klingensmith [00:08:59] We all got really worried about this term premium concept the latter half of last year, but it seems like that's passed from the constant chatter. Do you think the term premium really impacts the US Treasury environment?

Paul Mielczarski [00:09:16] Look. Absolutely. I think as you mentioned, there was a lot of discussion about term premium in Q3 and October last year when US yields surged towards 5%. And, you know, we had a little bit of, you know, where there was a significant

relief rally on that front. In November, the Treasury refunding plan that reduced issuance at the long end, you know, which basically helped to compress term premiums in the short term. But I think ultimately, this relief is likely to be temporary. You know, because it's going to be the, sort of, the trajectory of the US deficits that will drive the medium-term bond supply outlook. Now, you know, what is the impact of rising bond supply? And you can really look at that from two ways. One is the more direct impact on term premium, which is the additional compensation that investors require for holding long-duration bonds instead of Treasury bills. And again, you know, in the medium term, we would expect this to, you know, kind of gradually, like term premium, to go up. And then secondly, you know, where we would really expect to see the impact of supply to show up is through swap spreads. You know, so over the past two years, 10-year Treasuries have cheapened versus swaps by around 15 to 20 basis points. And that's in large part due to rising US Treasury supply. And we really expect this sort of trend of US Treasury underperformance versus swaps to, you know, to continue on over the next, you know, 5 to 10 years in response to growing supply and, you know, very elevated fiscal deficits.

Katie Klingensmith [00:11:19] So, some of those factors are certainly playing out in other countries, too. We've been constructive in the US and UK duration but less so in some other countries. What's the global context?

Paul Mielczarski [00:11:29] Sure. So, I think as you mentioned, you know, we've generally been overweight duration in the US and UK and underweight duration in eurozone and Japan. Now that decision is driven in part by relative interest rate spreads where US and UK bond yields are generally quite high versus other parts of G10 from a more of a historical context. But it also, you know, our bias to be overweight US duration also reflects a view that at least part of the recent US economic outperformance was a function of a much more aggressive fiscal stimulus as compared to other regions. So, as this impact of fiscal stimulus starts to reverse, you know, we would expect to see at least some convergence in relative growth between the different regions. The other market we are focusing on a lot at this point in time is Japan. And in our long-only portfolios, we have zero allocations to JGBs. In portfolios which allow us to go short, we have sold JGB futures. Now, you know, as a starting point, we do believe there's been a sort of a structural regime change in Japanese inflation trends. So, if you look at between, let's say, the mid-90s until before the pandemic, inflation in Japan on average was running at about -0.3%. So, you have this persistent deflation for around 25 years. But for the past two years, inflation in Japan has been above 2%. Part of it, for reasons which are sort of similar to the rest of world, some, you know, a little bit more specific for Japan. And, you know, we do believe that inflation is likely to remain close to BOJ's 2% target over the next few years going forward. Now, it is very likely now that Bank of Japan will hike rates sometime in Q2 or even potentially in March for the first time in 17 years. You know, over the next one to two years, we could see Japanese policy rates potentially rising towards 50 basis points to 1%, which doesn't seem like a big deal. But just for context, current 5-year Japanese bond yield is only 26 basis points. So, in the world where we do see a potential path for policy rates to move towards this, you know, 50 basis points to 1% range, we do believe that Japanese rate markets are really not priced for this inflation regime change.

Katie Klingensmith [00:14:33] You mentioned at the beginning that you think that this is a pretty constructive environment for bonds, and you had also noted in your outlook that it is a moment where active positioning is important. What sectors do you like?

Paul Mielczarski [00:14:46] I think that I would highlight just two areas in particular. So, one is select emerging market government bonds. You know, for example, Mexico's a sort

of a good example where Mexican government bonds, they offer attractive nominal and real yields, both in absolute terms and relative to Treasuries. Inflation in Mexico is gradually converging towards central bank's target. And as the Fed cuts rates, this will allow Mexican central bank to normalize its policy settings, which are still very restrictive. So for us, you know, duration in Mexico and Brazil and Colombia, perhaps in South Africa, these are areas which we still find quite attractive. Another area which we continue to like are agency mortgage-backed bonds in the US, where spreads versus Treasuries are still very attractive from a historical perspective and much more attractive than investment grade bonds where spreads are generally quite tight. And generally, agency mortgage-backed securities do quite well in periods of lower interest rate volatility, you know, this sort of like a rangebound environment that I mentioned earlier on. So, this is something we anticipate going forward. And then we think by being long agency MBS is a good way for us to position for that environment.

Katie Klingensmith [00:16:30] So, to change the subject a bit. Already everybody, including market participants, is talking about the US election. It's obviously way too early for us to be speculating around outcomes, but yet, they're already part of the market conversation, especially in context of duration. How do you think about the US elections at this juncture?

Paul Mielczarski [00:16:54] So, I think the first important distinction is that what really, you know, what will matter is whether, you know, not just which party wins the White House, but who will control the Congress. So, if one party controls both seats of power, that would increase the risk of even wider fiscal deficits than we are projecting today. And obviously, the starting point is, you know, we're already running very large fiscal deficits, particularly given where the unemployment rate is at the moment. So, you know, if we do have a Republican-controlled White House and a Republican-controlled Congress or a White House and Congress controlled by the Democratic Party, I think overall, we do think that would potentially lead to somewhat higher term premiums and somewhat longer, somewhat higher long-end rates just for this risk of even more aggressive fiscal policy settings. Now, the first Trump administration was always obviously very aggressive in its use of trade tariffs as a policy tool. And, you know, we think we would be likely to see that again if President Trump is back in the White House. Now, additional tariff barriers could potentially put a number of both emerging market and developed market economies at risk in terms of their growth perspective. And at the same time, potentially additional tariffs could boost inflation in the short term, which would, you know, could see a sort of a reversal of some of the progress that we've seen on inflation in recent months. And then finally, Jay Powell's term as a Fed board chair will end in May 2026. So, whoever wins the election will obviously have an opportunity to nominate a new chair and shape the leadership of the Fed. And I do think that the risk is that under a Trump administration, you could end up with, let's say, a more unorthodox Fed chair. And that could potentially have some significant implications for the US bond yields and the currency as well. And then finally just to finish off, look, the fact that we are having this highly unpredictable election later this year, I think on the margin makes us a little bit more cautious in terms of the kind of the level of our risk-taking.

Katie Klingensmith [00:19:39] Thank you for that very complete answer. Well, there are a lot of factors driving our overall investment thesis and specifically around where we want to be on which curve. Just sum it up for us, Paul, where do you see the most interesting opportunities, the biggest takeaway points when thinking about duration?

Paul Mielczarski [00:19:58] Sure. So look, I think to me the bottom line is that we are likely to go through a period of bond market consolidation, you know, with yields potentially--at least US 10-year yields--trading sideways for a period of time. So, I think as I mentioned earlier, I do find the more interesting opportunities could come from relative curve and cross-country positions as opposed to large directional bets on the US 10-year yield. You know, from a curve perspective, we generally do think that the US curve is likely to steepen, either in a soft landing or in a recession scenario. So, we kind of, you know, do being favored being positioned more in, sort of, the short end to the intermediate part of the curve and maybe a little bit more cautious around the long end. And, you know, from a sort of cross-market perspective, we do think overall US and UK duration, we do see that as quite attractive, relative to other regions. And, you know, we do think that select emerging markets, particularly in Latam, still offer attractive investment opportunities. Now, you know, even though I said that U.S. 10-year yields could sort of end up trading in more of a sideways range, you know, unless we have a major growth scare. I do still feel that from an asset allocation perspective, US bonds are quite attractive, particularly versus equities. The current 10-year real yield is around 1.8%, which is roughly in line with the expectation of trend real GDP growth. At the same time, US equity risk premium is at its lowest level in at least 15 to 20 years. So, even if bond yields range trade around current levels, I do think there's a compelling case for at least gradually reducing equity allocations and increasing bond allocations.

Katie Klingensmith [00:22:14] Thank you so much, Paul Mielczarski, for sharing your views about 2024, and for taking us on a deep dive around our duration positioning. Thank you very much.

Paul Mielczarski [00:22:24] Thank you, Katie.