Audio Commentary Transcript: Nothing Moves in a Straight Line
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June 25, 2018

Brian Giuliano: Hi everyone. Today we're going to talk about the macro environment and what's been a very volatile second quarter for the global bond and currency markets. I'm Brian Giuliano, part of the Global Fixed Income team here at Brandywine Global.

Jack McIntyre: I'm Jack McIntyre, one of the portfolio managers on the Fixed Income team at Brandywine Global.

Brian Giuliano: Jack let's start by talking about the Fed and the U.S. economy. Trump's tax cuts have supercharged growth. Economic activity is solid, if not downright strong. This has allowed the Fed to continue tightening—and on the face of it—a 2% fed funds rate. Still, it seems like we have pretty easy monetary policy, right? Especially when you consider where growth is. But that might be viewing things a little too simplistically. You have to think about where we've come from and where we're heading, and the fed funds rate of 2% is 200 basis points off the zero bound from a couple of years ago. We have Libor that's almost doubled in the past 12 months. And by the end of this year the Fed's balance sheet is going to be contracting by 40 to 50 billion dollars a month. So is it possible that this recent market volatility we've seen is a warning shot to the Fed? You know, in other words, is the Fed moving too far too fast?

Jack McIntyre: So, in some ways it could be a warning shot to the Fed. I think the bigger warning shot is the U.S. yield curve. Because, look at how flat that is. The Fed, they've given us the roadmap. They've added that fourth rate hike based on their dots. I'll believe it when I see it, because I think things could actually slow down a little bit to where they actually pull that back. Let's say they continue to power ahead. Well they're going to invert the yield curve. So what are the four most dangerous words in the English language? This time is different. I think Powell kind of suggested that he might not quite listen fully to the signal that the yield curve is telling us. I think I would advise him to, "Hey, listen to the curve." It is telling you, "Don't worry about inflation" or "Let's be a little cognizant of the growth."

Growth today does look good, but we've had a lot of things out there that we need to pay attention to in terms of that might negatively impact growth. And I don't want to sound too negative. I'm not looking for a recession or anything along those lines. I just think the dollar has had a good move here. It's reflected maybe a little bit better growth than actually might materialize. Let's think about the Fed and where we are right now. There is ample reason for them to continue to tighten. The key is to go slowly. There's not enough inflation to get them to start powering. And the last point I would make—and I think it's going to be important—At some point here in the not-too-distant future, the Fed's got to give us a signal that they're going to pause at neutral. I'm not a hundred percent sure what neutral is. I don't think they know exactly what neutral is, but it's higher from here but not significantly higher. But they need to

send a message. They're going to pause and not just sort of power ahead and keep tightening because then you're going to set up for even more of a risk off environment. Not just sort of in the emerging markets but maybe even in the developed equity markets as well.

Brian Giuliano: And you know Jack for all the good things that we can say going on within the U.S. economy, it's crazy to think that 30-year Treasuries still yield the same thing today that they did five years ago during the taper tantrum. To me, that says the longer end of the yield curve is questioning whether or not better growth and inflation are really in the pipeline.

Jack McIntyre: Yeah. I think the longer the curve is focusing on—and we've talked about this before—the sort of structural secular disinflationary influences. The front end is focused on cyclical factors, which is the business cycle that's done better. The Fed should be tightening in here. But the long end is saying, "There are some things out there that suggest inflation is not going to get out of hand." And again that's why it's not going to take too much more in the way of rate hikes for the curve to invert.

Brian Giuliano: Jack, you brought up the dollar a few minutes ago and we've been in the camp that the U.S. dollar topped out back in 2016. We thought pillars of support for the currency had eroded, a multi-year decline was likely. And for the better part of two years, we saw that the dollar came off that lofty level. That is up until about seven or eight weeks ago when the dollar had something of a resurgence. So my question is, Jack, does the recent strength of the U.S. economy—and what I'm going to call it, an "America first" Fed—does that change our outlook on the dollar?

Jack McIntyre: No it doesn't. But you know, I'd be disingenuous if I didn't talk about it. It's been a challenging environment for performance. The thing that we actually have gotten wrong is the direction of the dollar. We actually did increase in U.S. dollars in the portfolio but not enough. And the reason we didn't is because we view this move and U.S. dollar strength as countertrend. So currencies—and it varies—can trend from three, five, seven years typically. But even within those trends there are always countertrend moves. Nothing moves in a straight line. I think positioning got to be a little lopsided. The currency markets decided to shift their focus from relative growth to relative monetary policy. So yeah, the Fed is tightening and, you know, tightening maybe a little bit more aggressively than they told us a few months ago. But meanwhile you look at the ECB. Well, they're going to go slow. Draghi is going to go slow. The Bank of Japan, Kuroda is going to go even slower. So right now, in terms of the developed markets, the Fed is leading the charge.

OK, so the dollar is sort of reflecting that we're seeing some position unwinding. But having said that, we're not changing our view. We view this as a multi-year downtrend. [G20] valuations are still compelling. What makes this cycle a little different is the administration. I'm hard pressed to believe that Donald Trump would want a strong dollar. Actually, a weaker dollar helps a lot of his efforts in terms of improving the trade deficit. I think if the dollar strengthens too much from here, it will not go unnoticed by the administration. I suspect that the rhetoric might ramp up a little bit. But meanwhile, I do think there's opportunity for better growth outside the U.S. The U.S., we have been growing a little better but that's already gotten discounted in the dollar. I don't think that's sustainable.

Brian Giuliano: So this dollar strength of late, it's exposed some trouble spots within emerging markets. Like Argentina. Like Turkey. And you could argue some of these markets maybe deserved a little bit of a shake out, given some of the fundamentals there. The local-currency emerging market index is actually about to post one of its worst quarters on record. Yet as I look out the window, emerging markets seem to be in relatively healthy shape. Fundamentals for the most part are solid. This isn't 2013. It's not 2015. So what's going on here?

Jack McIntyre: Yeah, so you're absolutely right. And it's interesting that you have 2015 which was just a few years ago and in 2013 with the taper tantrum. I think markets tend to have short memories, thinking "OK, the Fed is tightening. OK, we need to start selling EM." Valuations are still compelling but I would marry that with—as you pointed out—underlying economic fundamentals. I think 2017 was the rising tide lifts all boats, sort of, in EM. And that's not going to be the case. The markets have to discriminate. Other countries, in terms of the EM universe, have actually better compelling economic fundamentals. Current account deficits have been improving. Inflation remains tame, and might tick a little bit with some of the weakness in the currencies. But we don't think that's the start of new trends.

I'd look to China because it is the most important country to look at in terms of analyzing any particular emerging market because China has such a huge footprint. It's one of our pillars that we've talked about why we like EMs. A stable prospering China is one of those, along with stable commodity prices. What's been a little bit interesting this cycle is the U.S. dollar’s rally but commodity prices haven't really sold off to the degree that they would have in other cycles. That tells me global growth is still on solid footing. Demand for commodities is still robust. I think when we work through this—and ultimately we're viewing what's going on in the emerging markets as creating an opportunity—because there's a big disconnect. We think markets have gotten too negative, and again, a part of this is that when you had these risk off environments, liquidity tends to seize up and exacerbates the price action. At some point, there will be a catalyst for emerging markets to settle down. I think that catalyst is going to come about with maybe the Fed sort of telling us they're going to—I don't want to say back pedal because that's too strong—but just kind of pause a little bit when we get a little bit closer to neutral rate.

Brian Giuliano: You mentioned China. And let's pivot for a second and talk maybe a little bit more about trade. And as you look around the world, you think about just the trillions of dollars of merchandise trading globally. Even if we include the latest proposed tariffs by Trump, the overall value of goods being affected by these tariffs, it's relatively small. So are people overreacting to tariff concerns? What's going on here?

Jack McIntyre: The issue with tariffs is not where we are today. If I could wave a magic wand and say, “OK the tariffs have been proposed, done, we’re moving forward” we would have a huge relief rally in risk assets. Well that's not realistic because the issue with tariffs and underlying this trade tension is "what's the next step?" You know, where are we going to sort of unfold? The best case scenario would be—and I'm going to focus on China because that U.S. and China trading relationship is the most important as opposed to U.S. and Europe. It's important, but in terms of setting the overall tone for risk-

off or risk-on, is U.S. and China. Ideally, we're going to get to a point where both sides agree, but you have to drill down a little bit. Because I think when you look at the U.S. side of things, you've got some characters in play. So the globalists I think are Kudlow and Mnuchin. Obviously with Kudlow, who has health issues, he's been quiet. Mnuchin has been pretty quiet. I think at some point he should sort of become a little bit more vocal and kind of talk about the negative things associated with trade tariffs and certainly if we go down a trade war. So that leaves Navarro, Lighthizer, and to a lesser degree Ross kind of driving the show in here.

As long as that's the case, you will probably be a little bit still skewed toward risk-off, but our view is that these guys ultimately—this is part of the negotiating process—and at the end of the day that we're going to not go into a trade war because that's not going to help anybody. Trump likes a strong U.S. economy. He likes a strong equity market. He wants a smaller trade deficit in the U.S. Well what's the solution to a lot of that? It's a weaker dollar. He can't have it all from that standpoint. So in some ways I think this is still the political posturing unfolding. You know it's interesting, look at Chinese equities, they were down 13%. Maybe China is going to start to blink here and maybe not necessarily fire another shot across the bow in terms of threatening to raise more trade tariffs.

Brian Giuliano: Jack, we talked about the U.S., we talked about the dollar, emerging markets, China. We haven't spent any time on Europe. I want to give you a quick minute to talk about what's going on in Europe. And a lot of attention lately has been focused on Italy and deservedly so. But in my mind it's something of a known unknown at this point. So, I want to ask you about something that's not getting enough attention. And that's Germany and Angela Merkel. Merkel right now—people don't realize—she's fighting for her political career. Jack, what are the chances she loses her job and what's that mean for Europe's outlook?

Jack McIntyre: Yeah I think it's potentially very important. So yeah you're right. Italy is the poster child for too much debt not enough growth. I can understand the stress associated with Italy. Germany is unique. Because fiscally, they are on very, very solid footing and growth wise, they are doing well. To me, it's another example of the shift towards populism. You know, like Brexit. It was Trump. Now Merkel's kind of getting swept up in it as well. So it does have huge implications for the eurozone experiment, is how I would kind of classify it. You know what I mean by that? Well OK, so we've got the one monetary policy. The ECB. We've got one currency. What's been missing is sort of the one fiscal union. And Merkel was kind of an advocate of that, as is Macron. With Merkel out of the picture, I don't think Macron is strong enough to move the eurozone forward towards getting that fiscal unity. Without that, the prospects of the euro trading up to—whatever the number is, 140-150—are diminished significantly. It means that the euro, probably structurally, is going to be on the weaker side of things. And again lining up with our portfolio, we are underweight euro and European currencies in general.

Brian Giuliano: All right, well thanks Jack and thanks everybody for listening. Please don't hesitate to contact us if you have any questions.