Audio Transcript: Untangling the Sticky Situation with Inflation
May 2, 2023

Katie Klingensmith [00:00:01] Hello, everybody, and welcome to today's conversation, "Around the Curve", Brandywine Global's podcast series. I'm Katie Klingensmith with Brandywine Global, and I have a special guest today. I get to introduce for the first time a new member of the Brandywine Global Fixed Income Team, Paul Mielczarski, who joined us just a few months ago. He is formally the head of Global Macro Strategy, and in that role is able to provide some pretty terrific insights into our investment process on the Global Fixed Income Team. It's been lucky because this year has been really complicated, and Paul comes with a deep background working with institutional investing and working in the global macro space. He joined us from, he's formerly the director of portfolio strategy at Ontario Teachers Pension Plan, and he worked previously as a portfolio manager and a global macro strategist in fixed income and currencies. So given all that background and given everything that's going on in the world, I'm especially excited to welcome Paul today to talk about where we are as we approach the mid-year in 2023. Welcome, Paul.

Paul Mielczarski [00:01:11] Thank you very much, Katie.

Katie Klingensmith [00:01:13] So alas, we started 2023 with a lot of worry, and I think many folks expected this year to be extremely challenging. It's been a busy year. However, growth hasn't been all that bad. What do you think about what some would call a growth upturn so far this year?

Paul Mielczarski [00:01:31] No, absolutely. I think, you know, going into the fourth quarter of last year, it really did look like the global economy was on the verge of a recession. But I think, as you mentioned, you know, over the last six months, we've actually seen a pretty strong rebound in activity. And I think there are really three factors that have contributed to this rebound. One has been the reopening of the Chinese economy. The second factor has been the reversal of the energy shock which hit Europe. And the third factor has been the rebound in real consumer incomes as a result of decline in headline inflation. I think, you know, the first two factors would have been very hard to predict. No Chinese policy expert really predicted that China would pivot so rapidly and remove all the COVID restrictions. I think for Europe, you know, a lot of it was just a question of good luck. Europe had a very mild winter, which helped to prevent this possibility of energy rationing. And this idea, you know, and the third factor in terms of lower inflation supporting consumer incomes. I mean, obviously that's been sort of an important driver for growth. Now, for us, obviously, the key question is, you know, kind of what happens going into the second half of the year and, you know, to what extent the global economy can remain resilient.

Katie Klingensmith [00:02:58] Absolutely. And actually picking up on that third point about the drop in headline inflation. I'd love to explore more your expectations for the Fed and for monetary policy globally. But first, what do you think? What do you expect from inflation in the U.S. and globally?

Paul Mielczarski [00:03:15] U.S. core inflation is still quite high. So in the last three or four months, it's been running at a sort of a 4 to 5% annualized rate, which is somewhat lower than what we saw sort of 12 months ago, but still clearly too high for the Fed to be comfortable. Now, ultimately, I would expect that core inflation will end up somewhere closer to 2 to 2 and a half percent by the end of the year. Now, I have to admit that this transition to lower inflation is taking a little bit longer than I actually expected. But, you

know, I still think that we do end up in that final destination. Now, in terms of what's going to take inflation lower. So one, I think core goods prices. Now excluding the impact of used cars, core goods price inflation is still running at a 3 to 4% rate, which is actually very high because before the pandemic, you know, that used to be zero, if not somewhat negative. Now, given the rapid improvement that we're seeing in global supply chains, lower input prices, falling transportation costs, you know, a decline in some key inputs or the decline in prices of some key inputs like plastics, lumber, semiconductors. I think there's every reason to expect that goods prices will be meaningfully lower in the second half of the year. Now, the second thing that has really boosted inflation has been shelter. Now, we know that market measures of rent in the United States have declined quite rapidly, and house prices are also falling. So there's every reason to expect that shelter inflation measured in the CPI will also decelerate significantly in the second half of the year. Now, the last piece, that's the piece which is most uncertain is kind of what's going to happen to service inflation outside of shelter. Now, if you look at the core PCE measure of services inflation ex-shelter, which the Fed focuses on, it hasn't slowed at all. It's still running at sort of 5 to 6% rate. Now, you know, kind of the good news on that front is we are seeing signs of moderation in wage growth, even though employment growth is still quite robust. Now, why are we seeing that? I mean, the reason why we're seeing it is because in the last 6 to 12 months, we've actually seen a very sharp pickup in labor force growth. And this is due to sort of people returning to the workforce after the pandemic. And also, I think very importantly, you know, a very sharp recovery in immigration. Immigration was very depressed during the pandemic, and now it's really starting to recover.

Katie Klingensmith [00:06:06] So those three factors make a lot of sense. But you started out the answer to that question with the projection that we could get inflation below 3% at the end of the year. It's been pretty sticky. Why has it been so sticky? And might you be wrong on some of those factors?

Paul Mielczarski [00:06:21] Absolutely. Look, I think I have more confidence on the first two factors in terms of goods price inflation, because I just feel like it's just a question of natural lags, you know. Some of these factors favoring lower goods price inflation, they just take time to work themselves through into, you know, actual lower CPI prices. I think for shelter, again, you know, I think there's a very strong relationship between owners' equivalent rent, house prices, and some of these market measures of rent. And again, it's just a question of lags. I admit there's more uncertainty around service inflation. But I feel like the combination of the factors that I mentioned, plus on top of it, the fact that if you look at commodity prices, they have really come down quite sharply over the last 6 to 9 months. You know, I think these are the factors that should help to drive inflation lower. And even I think 3%, you know, I think we end up going beyond 3%. I think it's going to be somewhere closer to, you know, 2 to 2 and a half percent. It's just a question whether it happens before end of this year or whether it's sort of something that happens in early 2024.

Katie Klingensmith [00:07:35] Alright. Well, that's certainly very directional. What do you think the Fed needs to see? There's been a lot of conversation about lags and Fed patience. What do they need to see to at least stop talking about potentially tightening monetary policy?

Paul Mielczarski [00:07:49] Absolutely. So, look, I mean, a few days, even three or four days before the Silicon Valley Bank collapsed over the weekend, Jay Powell was signaling that the Fed will need to raise rates by 50 basis points in March and potentially do a lot more in the coming months. You know, at that time, markets were basically pricing in peak

Fed policy rates closer to five and three quarters, almost as high as 6%. That has really changed as a result of the regional banking shock, where now there's an expectation that the May hike next week is going to be the last rate hike, with Fed policy rates peaking, you know, just a little bit north of 2%, sorry, 5%. Obviously, you know, the inflation picture hasn't changed at all over the last six weeks. But what has changed is this regional banking shock that we are dealing with. And clearly, the Fed does expect that the regional banking shock will create a meaningful drag on growth in the second half of the year. But there is a lot of uncertainty in terms of how much. So I think for now, they would rather go in a wait and see mode and sort of assess how much of a drag the regional banking shock is having on the economy and also how quickly inflation is actually moderating.

Katie Klingensmith [00:09:15] So even if the Fed waits, rates are pretty high. How likely do you think that the U.S. can actually avoid recession this year?

Paul Mielczarski [00:09:26] Look, I mean, you know, I think there's a decent chance that we avoid a recession. And by that I mean we basically end up with a period of below-trend growth but without a significant increase in unemployment rate. That typically that's what defines a recession. I think overall, I'm probably leaning to the idea that, you know, there's a slightly higher probability that we do end up with a recession later this year and early 2024. But I do admit it's a close call. Now, in terms of, you know, your question of how we potentially avoid a recession. I think what we could see is effectively like a series of rolling slowdowns that don't quite overlap. You know, if you look at housing investment, we've already had a very sharp downturn, which would be typically associated with recession. You know, we've seen quite a bit of weakness in business investment. You know, we've seen quite a bit of weakness in manufacturing sector. But at the same time, service consumption has been very strong. You know, just because of pent-up demand from sort of rebound from COVID, you know, excess savings, you know, sort of generally it's been supporting service spending. And you could see a situation where as service spending slows in the second half of the year, some of these other sectors which have been depressed start to recover. So as a result, you just end up with these offsetting shocks which give you below-trend growth, but you don't end up in an actual recession.

Katie Klingensmith [00:11:04] You mentioned the shock to regional banks. And between the higher rates and lack of credit because of that shock, you think credit availability will be important for growth?

Paul Mielczarski [00:11:15] Absolutely. And, you know, obviously, if you look at overall equity markets, they've recovered quite strongly from a time that Silicon Valley Bank collapsed. But if you look at index of U.S. regional bank shares, you know, they're still down 30%, and we have seen no recovery. You know, so clearly, equity investors are quite concerned about the impact on bank profitability of the shock. You know, as many economists have pointed out, regional banks are a very important source of credit for the U.S. economy, particularly for small business. And they've become much more important over the last 12 to 15 years, basically since the global financial crisis, where large banks have basically reduced their loan books and smaller and medium-sized banks have really come in to fill and, you know, fill in that gap. So overall, I do expect to see a pretty meaningful tightening of credit conditions over the next 6 to 9 months. But it's just a question of magnitude. And I think outside of banks, there's sort of really three areas that I am very much focused on. One is commercial real estate. Second one is levered loans. And the third one is private credit. Now, obviously, there's been a lot of discussion about commercial real estate and, you know, some of the risks around offices. You know, the only thing I would add to this discussion is that 20 to 30% of bonds backed by commercial

real estate are floating-rate instruments. So they see a direct hit from a sharp increase in the fed funds rate. And the share of floating-rate origination was actually running as high as 40 to 45% in the last few years. So this combination of falling collateral prices and sharply rising interest costs, you know, certainly is going to put a lot of commercial real estate investors in an uncomfortable position. Now, when it comes to levered loans and private credit, what I'm worried about is just the fact that sort of 12 years ago, you know, these asset classes individually were worth sort of 3 to $400 billion each. Today, they are worth 1.5 to 1.6 trillion each. So we've seen very rapid growth both in private credit and levered loans. You know, you've seen generally seen a decline in credit quality. And importantly, both private credit and levered loans, again these are floating rate instruments. So you're only going to see sort of the full impact of, like the most aggressive tightening Fed tightening cycle we've seen since the early eighties, we are only going to see that in the second half of the year.

Katie Klingensmith [00:14:11] It's interesting that the structure of the economy, how interest rate sensitivity is really varied.

Paul Mielczarski [00:14:17] Absolutely. And there's some areas with it's less so. You know, if you look at U.S. housing market, you know, most households have 30-year fixed mortgages. So they really haven't seen the impact of rising policy rates. You know, it's quite different for countries like Canada and Australia and some of the Scandinavian economies where the pass-through from higher policy rates to mortgage costs is much quicker. But there are certain areas in the U.S. credit world, and I mentioned private credit and levered loans, which you know, they are very vulnerable to higher policy rate costs.

Katie Klingensmith [00:14:59] Absolutely. Well, we started out talking about some factors outside of the U.S., some positive surprises coming out of Europe and China. Do you feel like those regions or others could potentially be supportive of the global economic and the U.S. economic outlook?

Paul Mielczarski [00:15:15] And, you know, they have been the last 4 to 6 months. I think going forward, you could certainly see service spending in China, Europe, Japan being supportive for global growth. I think there's still some pent-up demand. You know, obviously in the case of China, you just reopened. But even in the case of countries like Japan, a lot of the COVID restrictions and restrictions on tourism are just being lifted right now. So there is still pent-up demand in these economies. You generally see elevated level of excess savings. You know, in the U.S., those excess savings have been drawn down. But in some of these other economies they haven't. So that's clearly one factor which, you know, sort of this is pent-up demand for service spending outside of the U.S. Is one factor that could support global growth.

Katie Klingensmith [00:16:09] Alright. Well, I want to bring this all together with a couple of final questions. Just taking a look at the U.S. curve and other financial markets, what do you think is priced in right now?

Paul Mielczarski [00:16:21] Yeah, I mean, it's a very good question, which we debate all the time. I think overall my conclusion is that markets are largely pricing in some form of soft landing and a growth recovery in 2024. So firstly, if I look at equity markets, U.S. equity markets, you know, the equity risk premium versus bonds, it's still very low. It is at historically low levels, which is certainly not consistent with the idea that you could have a recession later in the year. You know, if you look at consensus S&P 500 earnings estimates from Wall Street analysts, they basically suggest that corporate earnings have

already bottomed, or EPS estimates are already bottomed. And we're going to see a pretty robust recovery going into the second half of the year and in 2024. If you look at credit spreads, you know, again, there are some areas which are a little bit more elevated, but again, not really pricing a meaningful risk of a recession. Now, the one area which potentially could, market which could potentially price in a recession risk is fixed income, just given the very significant inversion of the curve. And historically, that has been a leading indicator for future recessions. Although, again, to me, it's still debatable whether fixed income markets are truly pricing in this recession, and so the equity markets and credit markets are not. Another possibility is that basically what bond markets are pricing in is the idea that inflation is going to fall sharply over the next 1 to 2 years--and as inflate--without an actual recession. And as inflation falls, that potentially allows the Fed to cut rates to two and a half, 3%, which is what they see as the long-term neutral rate. Which is why you end up with this yield curve inversion, particularly between current three-month rates and let's say interest rates 3 to 5 years out. So, overall, I guess, you know, in summary to your question, I still feel that most asset markets are priced in for a soft landing.

Katie Klingensmith [00:18:37] Alright. So asset prices are suggesting a soft landing. It seems like you're reasonably optimistic that we'll get a soft landing or a recession that's not too dramatic. But are there outside factors or inside factors that you're watching that could trigger an ugly scenario?

Paul Mielczarski [00:18:54] I think, you know, the reason why, as investors, we really care about timing of recessions. As a macro investor, trying to predict, trying to anticipate a recession is really important. And the reason why is because if you have a portfolio of stocks, bonds, other risky assets, you generally want to hold them. But the only time you don't want to have them is during recessions. If you can find a way to effectively avoid recessions in that portfolio, you would generate fantastic assets, hugely outperforming the market in the long run. So again, from a market perspective, the timing of a recession matters. Now, why does it matter? The reason why it matters is because in recessions, a lot of relationships become non-linear. So outside of recessions, you tend to see sort of steady growth in the economy, which leads to steady growth in earnings, which leads to steady increase in asset prices. And in recessions, these relationships become much more non-linear. You know, corporate profits fall. That leads to decline in employment, that leads to decline in consumer spending, that leads to corporate defaults, that leads to tightening of financial conditions. You know, how it all plays out becomes very uncertain. That's why generally, you know, market volatility during recessions, it's much higher than outside of those periods. And then so trying to predict, you know, is it going to be, what kind of a recession is it going to be? You know, is it going to be mild? Is it going to be not so mild? I'd take all these predictions with a grain of salt. And then the other relevant point, too, is a recession could be mild, but certain sectors could be impacted more meaningfully. For example, in 2001, we had a recession where GDP maybe contracted 0.2, 0.3% from a peak. So it was the mildest recession we've ever had. But the S&P 500 fell almost 50%. Corporate earnings were down 20, 25%. And, credit, corporate defaults were up quite meaningfully. So just because you have a mild GDP recession doesn't necessarily mean that you have a mild earnings recession.

Katie Klingensmith [00:21:19] Absolutely. Alright. So Paul, you've joined the Brandywine Global Fixed Income Team, and we invest in bonds. Given all these factors, where does this leave you in terms of your views on duration?

Paul Mielczarski [00:21:32] Sure. Look, I think in the short term, U.S. yields could continue to range trade. I mean, ultimately, since the start of the year, we've been in a sort of a three and a quarter to just about 4% range. And we could just stay in that range at least for a bit longer, as we really assess the fallout from the regional banking crisis and how quickly inflation actually falls. But more broadly from a sort of let's say a 9 to 12-month time horizon perspective, we do have a bias to be at least somewhat long duration, somewhat long U.S. duration, both outright and relative to other G10 markets. Now, why do we think that? I think ultimately we do expect that in the second half of the year, you're going to see quite meaningfully lower nominal GDP growth in the United States. Now, this could be coming from lower inflation. This could be coming from lower growth or some combination of both. And overall, that will be supportive for U.S. duration. Now, this idea of kind of having this elevated recession risk, and we can assess the probabilities. At 40% is it 50%, is it 60%? It is very hard to handicap. But that risk is quite meaningful. And I think overall that definitely warrants at least some overweight allocation towards U.S. fixed income.

Katie Klingensmith [00:23:08] Well, thank you so much. It has been my pleasure to host this conversation with Paul Mielczarski. And certainly our pleasure at Brandywine Global to welcome him to the team. Thanks, Paul.

Paul Mielczarski [00:23:18] Thank you very much, Katie.