Brandywine GLOBAL

First Quarter 2019 Global Macro Webcast - Transcript
The End of Normalization

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Good day. I'm Francis Scotland, Director of Macro Research at Brandywine Global with our regular quarterly webcast and the second recording for 2019. The purpose of this webcast as always is to discuss the macro thinking that underscores some of the positioning in our global fixed income portfolios.

Just to quickly recap our last webcast in January, we discussed the factors which we believe drove the dramatic turn of events in the world economy during 2018. The year had started out on a wave of optimism driven by the broadest most synchronized global upturn the world had seen in many years. The International Monetary Fund, Organization of Economic Cooperation and Development (OECD), and World Trade Organization were all revising up their forecasts at the start of '18. But global growth headed south during 2018 and the year ended on a wave of pessimism—the same agencies were revising down their forecasts and by the end of the year many were wondering if 2019 was going to see a recession. And as we entered 2019, even though U.S. stocks were rallying the U.S. yield curve was flirting with an inversion, which historically is an early but has been a reliable indicator of recession.

In our January webcast we talked about the five main reasons for the negative turn of events:

1. In the U.S., the Federal Reserve (Fed) wanted to normalize and moved too far too fast. It raised rates four times, shrank the balance sheet by hundreds of billions of dollars and was guided by Fed Chair Powell's instincts that the neutral rate was a lot higher.
2. In China, the authorities overestimated the resilience of the economy and shifted back to deleveraging the system. They muzzled shadow bank lending which resulted in a big hit to social financing and turned what had been a large positive fiscal impulse to a big negative drag.
3. Dollar strength was part of the script in 2018, lifted in part by tight money and a strong U.S. economy at the same time that China was slowing—the result being especially punishing for many developing economies and their financial markets.
4. Political uncertainty in Europe in the form of Brexit and the election of populists in Italy did not help the outlook.
5. And lastly, the trade war between China and America while hard to quantify seemed to weigh on sentiment as the year came to an end.

2018 ended with the markets rioting and the global economy slowing significantly.

The U.S. economy—which had been quite strong and resilient for most of the year on the back of the Trump tax cuts—finally re-synchronized lower with the rest of the world as the year went out. China growth slowed sharply at year end and volume growth in world trade came to a virtual halt. And as we were recording this webcast in January, all the economic pessimism and market volatility triggered policy reactions in the other direction. The U.S. Fed did a U-turn on interest rate policy in January and went on hold. China's policy leaders were beginning to lean harder into the slowdown with counter-measures. The dollar dropped a percent or two from its peak in late 2018 to end January. And there was lots of speculation that both the U.S. and China were actively seeking a trade deal.

So we ended our January webcast with the conclusion that based on the trajectory of the transition in policy, that a global soft landing was a more realistic macro outlook for 2019 and into 2020 than something more negative, and given the extent to which a number of risk assets had been washed out at the end of last year, things did not have to do all that much better for there to be some positive surprises.

Updating things now, three months into the new year—the policy shifts continue to move in the direction of encouraging the global soft landing we began to anticipate three months ago.

U.S. monetary policy rate normalization has come to a hard stop. The Federal Open Market Committee "dot plots" have collapsed to no rate increase this year, after flagging 2-4 rate increases only three months earlier. The Fed has announced an early end to quantitative tightening.

We would characterize Fed policy as having slightly overshot the neutral rate and still moderately restrictive based on an analysis of the fed funds real interest rate and the contraction in the balance sheet which is supposed to continue until September. The dot plots have flattened out this year but suggest the Fed is looking for a rate hike in 2020. The money market curve is calling for the Fed to ease, and in our view, there is a good chance this could happen.

There is clearly a tilt going on at the Fed in the direction of dovishness. The central bank is engaging in a review on how best to execute its dual mandate of low unemployment and inflation of 2%. Central to this review is an examination of why the average inflation rate for the past 20 years has been below 2%.

The New York Fed has created a probability of recession indicator derived from the yield curve. Typically, what reverses this probability and steepens the yield curve is a rate cut from the Fed. We are not there yet—waiting for a catalyst. Historically, that often comes from the labor market. Employment conditions are generally robust but the March data reported a loss of 7,000 manufacturing jobs, from the durable goods sector—the first time this segment has posted a decline since July 2017. Part time payroll growth is starting to show some softness as well. These could be early signs of a lagged reaction to the year-end slowdown in the U.S.

In China, there continues to be a cumulative build-up of measures aimed at shoring up the economy and a shift in the focus away from deleveraging. Policy ease actually started in 2018 with the central bank reversing the Shibor rate increases of 2017 and lowering reserve requirements. The green light was given on renewed infrastructure spending under the public private partnership program. Policy anxiety has produced more stimulus this year with personal and corporate tax cuts, consumption tax reductions and increased fiscal outlays—all of which has triggered a renewed positive fiscal impulse.

Of greatest significance could be two recent initiatives. One is the directive from the State Council to lower the cost and increase the availability of financing to small and medium-sized companies. These companies have historically been unable to get access to credit at competitive rates which has impeded economic growth and kept the savings rate artificially inflated. The other recent initiative has been to expand urban hukou or residency permits for 100 million migrant workers by 2020 for cities 1-2 million in size. The impact on property and urbanization rates could be quite significant.

So a lot of the factors playing to the slump in the world economy during 2018 ended or began to reverse by the end of March:

- After rising over 10% in 2018, so far this year the dollar has been flat.
- Political uncertainty continues in Europe but the probability of a hard-Brexit seems to have dissipated to almost zero.
- Lastly, it seems that the U.S. and China are gearing up for some kind of agreement on the trade war, another development which would lift a cloud, at least partially on the global economic outlook.

During the first quarter we saw asset markets move in sympathy with these developments and the prospects for a soft landing. Risk assets rallied including global bourses, corporate bonds, and emerging market sovereign bonds. At the same time, however, yields plunged on developed country bonds before starting to reverse early this quarter. German Bunds made headlines in March as they traded through zero, boosting global sovereign debt with a negative nominal yield to over $10 trillion. In the U.S., the slope of the yield curve was flirting with an inversion depending on how you measure it, an early but reliable leading indicator of a possible U.S. economic recession.

So, the macro issue for the balance of the year and into 2020 is still whether policy makers have done enough to reverse the negative influences from 2018 and achieve a global soft landing. Our base case is that they—focusing on the U.S. and China—have and that they will continue to put in enough stimulus to bring an end to the current slump in global growth.

The Chinese authorities want to stabilize domestic growth. In the U.S., we are looking for the economy to mean-revert back to trend which is closer to 2%. We are looking for signs of stabilization in the global economy in the context of the U.S. sliding back to trend growth from its above-trend-pace of 2018 and the Chinese economy picking up from its below trend growth of last year. The net of these developments would be an end to the global slump and possibly a modest pick up late this year and into 2020.

Early indications seem to be moving in this direction but the economic data validating this outcome may not be visible until the second half of the year.

- The growth rate in the OECD leading economic indicators has turned up and leads global gross domestic product (GDP) by about six months or so. If this turnaround is sustainable it would imply a pick-up in global GDP growth in the second half of the year.
- And consistent with this macro outlook is that the stabilization in global growth is coming from outside of the U.S. as the American economy mean reverts lower back to trend.
- Recent more constructive data out of China has helped sentiment and suggest China's economic deceleration may already be over.
- A rebound in the U.S. stock-to-bond ratio would be constructive for the global PMI composite if sustained.
- It is still early but some indicators of global trade suggest an early-year inflection upward from last year's slump.
- In the U.S., the flattening in the yield curve is a yellow flag on the economic outlook. But financial conditions have improved significantly, based on the St. Louis Fed financial conditions index, and the rebound in share prices implies some stabilization in purchasing managers index. As we noted earlier, if employment—as the lagging indicator—begins to soften a little it could produce another reaction from the Fed.
- In the emerging world, the gradual rise of short-term policy rates in 2018 to buffer the rally in the U.S. dollar is clearly over and an easing cycle is now unfolding. This may be one of the elements acting to sustain what has been persistent absolute and relative strength in the emerging market PMIs, both manufacturing and services.

The main risk to this scenario of a global soft landing is that it just takes longer for the world economy to pick up than we think. In China the authorities do not want to re-leverage the system. In America, even though monetary policy has become more dovish, the bias revealed in the dot plots reflects the concern that tight labor markets and rising wage inflation will create a more generalized inflation problem.

The attitude of the authorities at the moment seems to be one of successive approximation to policy stimulus—not wanting to overdo it—but mindful of the sluggish global economy; all of which could turn out to lead to a plodding and underwhelming expansion but that would also imply a much longer lasting global expansion than many are considering at the moment.