**Video Transcript: Global Macro Webcast – 4Q 2019**
**Francis Scotland**
**Brandywine Global Investment Management**

**January 28, 2020**

**An Overview of Our Macro Outlook**

The main message in our current macro thinking is that last year was a transition year from something worse in 2018 to something better in 2020. The world economy has been in a growth slump since early 2018. But in 2019, policymakers around the world began to react with varying degrees of policy stimulus. So, it follows that the global economic profile should improve relative to last year.

As we have commented several times in recent webcasts, the latest slump since 2018 was the third deceleration in global economic activity since the Great Financial Crisis (GFC) in 2008.

- The first instance was in 2011 when European Central Bank (ECB) President Trichet thought the crisis was over and raised rates, Federal Reserve (Fed) Chair Bernanke prematurely ended balance sheet expansion, and China's policy leaders flipped the switch on fiscal and credit policy from the massive stimulus program of 2009 to massive restraint. The result was a rapid slowdown in the global economy and the onset of the European sovereign debt crisis.
- The second instance was in 2015 when the Fed raised rates and ended balance sheet expansion while China's authorities again attempted to rein in credit growth. China's policymakers did not cut rates, but they shrank the balance sheet of the central bank in order to sterilize policy in an attempt to contain capital outflows and a weaker currency. This combination of policies helped create the biggest commodity bust in 80 years and a U.S. profit recession led by the energy industry.
- The most recent slowdown in the world economy has again been triggered by policy tightening initiatives. Incoming Fed Chair Powell tried to normalize U.S. monetary policy conditions too far, too fast in 2018. Simultaneously China's leaders demolished shadow bank lending growth, which at its peak was responsible for almost half of all new credit lending. Adding to the barrage of anti-growth economic policy was the U.S. China trade war. As a result of these measures, global growth has slowed for two years, led by recessions in global manufacturing and world trade volumes.

What reversed the first two growth slumps was a significant reversal in economic policy from tightening to easing.

- In 2012, ECB President Draghi reversed policy, cut rates, and expanded the balance sheet. The Fed engineered open-ended QE while the Chinese delivered another significant positive credit impulse. The global economy stabilized and then growth picked up.
- Similarly, in 2016 the Fed put interest rate increases and policy normalization on ice while Chinese authorities engineered the biggest credit reflation since the 2009 stimulus program. The result was the strongest most synchronized global explanation in many years.

- And now again for the third time, in 2019 policymakers have flipped the switch in the other direction and started to stimulate. Time lags are long and variable, but it is ironic that business and investor surveys continue to flag recession as a major worry for 2020. History is quite clear in suggesting that the information risk lies in the other direction. Global growth will be better 12-18 months from now, possibly significantly.

**Policy Should Serve as a Tailwind in 2020**

The cumulative buildup of stimulus over the course of the last 12 months in addition to autocorrecting market mechanisms, while unusual compared with the previous two cycles, is substantial and significant.

First, the Fed did a major U-turn in policy last year. Instead of raising rates as it was warning all through 2018, it cut rates three times and has reflated the balance sheet. By the time it is done, it could be close to its previous peak. There is much debate over whether this is the same as quantitative easing. This misses the bigger picture: the Fed is giving cash to the system instead of draining it. In addition, Fed Chair Powell has declared a high bar for raising rates anytime soon based on a more symmetric approach to its inflation target. The ECB has resumed balance sheet expansion while the Bank of Japan never stopped, so the combined balance sheets of the world's major central banks are once again expanding instead of contracting as it did in 2018 and early 2019.

Second, the Chinese authorities have attacked its slowdown with a barrage of measures aimed at curbing the slump without re-gearing the economy. The overall credit impulse falls short of what we saw in 2012 and 2016, but the correlation with global growth measures like the PMI is impressive.

Third, the Phase I trade deal was announced January 15, deescalating trade tensions. With the U.S. only exporting $130 billion to China currently, the addition of another $200 billion in only two years sounds unrealistic without China shifting import allocations from other countries. Still the agreement dials back the risk of a recession that might have happened if the trade war had escalated any further, and it is a pretty big positive boost to the U.S.

Fourth, one of the most unusual features of the currency policy stimulus has been the slide in the policy rates from emerging countries, in spite of what have been weak currencies most of the last two years up until August. The weakness in world inflation seems to have broken the inflation pass-through effects from a weaker currency that might have previously caused policymakers in these economies to raise rates. Given the significance of these economies in the world economy, this source of stimulus could be very significant. Since the GFC, the emerging markets economic cycle has tended to front-run the economic cycle in the developed markets, and it seems to be happening once again.

Fifth, a consensus is developing for a shift to proactive fiscal policy. Europe is really the only major economic region with the latitude to use this on any scale and will be slow to implement, However, the push for a switch to more green technology in Europe seems more focused than elsewhere and could be accelerated with fiscal policy. But even in other countries, fiscal policy is in play in late 2019—Japan's cabinet approved a $122 billion fiscal package to support growth in the economy.

Lastly there are the autocorrected market mechanisms themselves. Past weakness in oil prices historically has provided a big boost to global growth. In addition, the lagged effect from falling long-term interest rates is feeding through to interest-sensitive sectors, like house sales and starts, which are recovering in the U.S. Similarly, real estate prices in hot metropolitan areas of Canada and Australia are on the march once more as are real estate prices in the U.K., although that may have more to do with the resolution of Brexit uncertainty.

In our last webcast in October, we suggested that there was enough stimulus in the pipeline for the world economy to stabilize. Data since that time confirms our October views that a trough has been reached in the global cycle.

The real question for investors is the character of the expansion that follows this year. Will it be strong enough to steepen the U.S. yield curve or will it be more muted?

**Contributing Factors to the Global Economic Recovery**

The characters of the improvement in growth we see for 2020 are pretty important for financial markets.

Obviously, a V-shaped rebound in the global PMI could be expected to lift bond yields higher, while a flat more drawn-out recovery in this measure of the global business cycle would imply the same for bond yields. The U.S. is significant because leading indicators for the rest of the world have already turned up. The U.S. is the only one still titled lower for the time based on the growth rate in the U.S. Leading Economic Index (LEI), which included the yield curve as one of its components.

Equity markets seem to be telegraphing a V-shaped bounce, at least for the U.S., based on the correlation between the U.S. stock-to-bond ratio and the Institute for Supply Management Index (ISM) index. Just looking at the nature of the ISM index itself, rebounds are never gradual, they are always pretty spiky. Similarly looking at the correlation between the ISM and U.S. real GDP growth, a rebound in the former usually leads to a rebound in the latter. Where would it come from? After a long, drawn-out downturn in manufacturing and trade, just inventory re-accumulation could give you a meaningful snapback.

Based on this configuration, it would not be a surprise to see U.S. growth bottom out below 2% early in the year before rebounding above 2.5% by the end of the year. Global growth could be a percent or more higher by the end of the year as well.

The risks attending that outlook are numerous. In addition to the myriad sources of geopolitical churn, domestic political risk is back in the U.S. with the upcoming election. The Democratic nomination process could be drawn out and inject a lot of uncertainty—possibly stalling any rebound. Similarly, any new attempts by the Chinese authorities to de-lever could result in a softer profile. The outbreak of the Wuhan coronavirus is another source of potential economic destabilization, which could keep things in check longer. Another 1918-like pandemic would be a major black swan—but just the fear of contagion could act to cool off any incipient strengthening in the cycle.

But among the economic risk factors, the main one is probably the dollar. A healthy rebound in global economic activity is not likely unless the dollar is flat to lower. Meaningful rebounds in the global economy

have been associated with mild but extended periods of dollar softness or shorter more intense periods of dollar weakness. The Fed's decision to expand the balance sheet in combination with the relatively strong growth trajectory in the emerging markets world reduces the prospect of a strong dollar, but it remains a risk nonetheless in the view of the trade deal with China and possible developments during the U.S. election.

**The Start of a New Decade**

There are plenty of new themes in play for this decade, none possibly more significant than the capital allocation and asset implications of a concerted reaction to climate change and the pursuit of environmental sustainability, the speed with which the world tries to move to a low-carbon based economy, and environmental, social, and governance's (ESG) role in this reallocation of capital.

As for more traditional macro factors, the big one is probably the outlook for credit growth in China over the next 10 years. In many ways the last 10 years have been dominated by the collapse of the U.S. debt supercycle across American households. For the last 10 years, the story has been credit growth in America, particularly in the household sector. Households for 40 or 50 years ratcheted up their borrowing and spending, creating mounting debt to income ratios. And with the GFC great financial crisis that all ended and we've been deleveraging the household sector now for 10 years. So much so that even though governments and corporate borrowing has increased, total debt to GDP ratio in the United States has been flat for 10 years. And that is principally the major reason why interest rates have been moving lower. Over the course of the last 10 years, as this reduction in the American household borrowing and spending profile for most of these the past 10 years, policymakers in the rest of worlds have been leaning into this macro force with countervailing stimulus in order to try to offset it.

And for most of the last 10 years, policymakers around the world have been trying to offset the economic impact of weakness in U.S. household credit demand with countervailing stimulus through fiscal and monetary measures. Nowhere has the credit offset been more cranked up than in China, where the reduced profile in U.S. borrowing and spending meant a colossal decline in the market for China's production and associated domestic deflationary pressure. China has responded for the last 10 years by ratcheting up its total credit-to-GDP ratio by over 100 percentage points, the bulk of this coming from increased leverage in the corporate sector—a consequence of China's approach to credit allocation through administrative guidance rather than a price mechanism. This steady ratcheting higher in Chinese credit growth is coming to an end. China's leaders acknowledge the declining marginal benefit of this process, the build-up of non-performing loans in the banking system, and the increased size of People's Bank of China claims on the banking system.

What this implies is that rock bottom interest rates are here to last—at least for the foreseeable future. The implication is an intense competition for growth, sustained high multiples on companies able to persistently generate cash flow, and a global economic cycle that could be drawn out for several more years.