Video Transcript: Global Macro Webcast – 2Q 2020
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Good day. I'm Francis Scotland Director of Macro Research at Brandywine Global, and this is our regular webcast we host as we transition from one quarter to the next.

Hard to understate the extraordinary nature of the year so far, and it is barely half over. Election polls in the U.S. hint at the potential for a major U.S. political and policy regime shift ahead. Going into the election, there is a lot of domestic social turbulence and violence.

Tensions between China and the U.S. keep ratcheting up on a number of fronts.

The Chinese Communist Party (CCP) has taken full advantage of the global crisis and its successful handling of the pandemic domestically so far to push hard on a number of frontiers: border clashes with India, security laws in Hong Kong, military readiness over Taiwan—a number of analysts have speculated that China's leaders may be preparing to eventually reclaim all the lands that defined its borders before the communist revolution.

Over in Europe, an historic agreement has been reached that could be the beginning of debt mutualization—a long-held taboo of the rich countries.

Meanwhile the entire world seems to be spewing public debt, yet the demand for this paper seems insatiable given the rock-bottom level of rates—investors don't seem too concerned about it judging from the low and steady level of U.S. long bond yields, the benchmark for the global fixed income market.

It remains to be seen how long the complacency about all this debt will last. There is a chicken and egg aspect to it all; the government can afford to take on the liabilities of the private sector as long as rates stay low. And while the ability to keep issuing debt without lifting rates may be substantial, it is finite and speaks more to current circumstance than the kind of free lunch that believers in Modern Monetary Theory (MMT) espouse. It is going to be hard to turn those taps off.

But the development of the year—if not the century so far—continues to be the pandemic and how we are all reacting to it. For investors, the reactions in the second quarter could not have been more different than in the first quarter. The rally in risk assets over the course of the last three months is quite incredible considering that reports about the virus during the first quarter of the year sent risk assets into a nose dive.

Today, I want to look at some of these trends through the admittedly narrow lens of a macro outlook and some of the insights that might lend for investors looking ahead. This is a one-of-a-kind macro cycle—but, in many ways, it is still a macro cycle, and common to all macro cycles is the interplay between the economic trend and the policy reaction. For most modern economies, when something breaks—normally caused by efforts to control inflation, or a policy mistake, or a financial crisis or some development that leads to a decline in the business cycle and economic recession—policymakers historically react with countercyclical stimulus measures to get the economy back on its feet. Rates go down as budget deficits swell, and that stimulus usually stays in place until things are back to "normal"

or tapers off as conditions approach that state. This sequence of economic contraction, followed by policy reflation, followed by economic improvement has played out a dozen times or more in the last 80 years, each cycle having its own identity.

All these elements are in play once again, and on a massive scale. But the unique nature of this cycle raises a lot of questions about the timing of this cycle and how things ultimately play out.

What is uncommon about this macro cycle are three things:

A. The first thing that makes this cycle unique is the nature of the economic bust. There was nothing wrong about the global economy at the start of the year. A lot of things actually were starting to go right: the Federal Reserve (Fed) had reversed course on monetary policy, the Chinese authorities were stoking stimulus, and we had a trade deal. All the ingredients were in place for a pickup in what had been a very slow end to 2019. So, there was nothing inherently broken or weighing on the world economy.

   Instead, the world economy was basically crushed by the fear that came with the outbreak of the pandemic and the uncertainty about how lethal the virus was. That fear and its impact on business, jobs, and incomes went way up when governments went on lockdowns—the media's handling of the pandemic made things worse, and so did all the mixed messages from the medical community.

   This is probably the key point to emphasize because embedded in any macro outlook or forecast has to be some assumptions about how all this fear evolves. Will it subside, and under what conditions? Or will it morph into something else? So, a big part of the macro outlook is how the pandemic evolves and how we deal with it.

B. The second thing that was unique about this cycle was the scale of the bust. According to the World Bank, it may be the worst sudden falloff in global economic activity in history. The chart shows more countries participated in this global recession than any time in history—more so than even during the Great Depression. The shock was intensely deflationary with high frequency activity variables dropping by 90% during the first quarter, depending on the region of the world. There has been nothing like it seen in modern history—many comparing it to a natural disaster but on an epic scale.

C. The third thing that is unique about this cycle has been the speed and scale of the response. There has been a lot of discussion about this already, so I won't get too bogged down in details, but it's worth noting the highlights: scale, speed, and coordination.

   On scale: The biggest measures of this is on fiscal policy—2% used to be a big fiscal package. Globally the numbers are between 5% and 15% of gross domestic product (GDP) and as much as 50% if loan guarantees are included.

   Two Speed: The Fed's balance sheet ballooned by $3 trillion from the end of February to beginning of June. It took over four years for this scale of expansion after the Great Financial Crisis (GFC). Similarly, it took Congress 100 days to provide15% of GDP or $3 trillion directly to households. It took Congress about 600 days to get to the American Recovery and Reinvestment Act and less than $2 trillion in 2008. Similar aggressive actions have been taken around the world, with the notable exclusion of China.

Third: Coordination. Never before have monetary and fiscal policy acted so decisively together. Although technically not MMT, it feels like it with rates at the zero bound.

Since the outbreak, we have all become addicted to big data because the regular data are too slow to capture the frequency of what is happening. What these data show is that after crashing in February/March, to all intents and purposes, the world economy bottomed in April/May.

- China was first in and first out. While relatively limited in its use of fiscal and monetary policy, the ability of its authoritarian government to lock the country down and then get everyone back out has produced a V-shaped rebound.
- Europe has been more successful than the U.S. in reopening without large outbreaks of new infection, which has produced similar V-shaped rebounds there as well.
- The U.S. has had the least success with reopenings in terms of keeping the pace of new infections under control. V-shaped rebounds were in full swing in May and June, but high frequency data trends show activity tapering off into late June and early July due to social distancing measures, re-closings, and restricted behaviors as the infection rate surges.

So what's next?

As I said earlier, embedded in any macro outlook are assumptions about the pandemic and how we deal with it and the outlook for countercyclical stimulus applied by governments.

The lockdowns were never implemented to kill the virus, only to prevent the healthcare system from being overrun. By definition, it has stretched out the infection period. The basic assumptions embedded in our base case macro outlook is that even though the pandemic may or is likely to re-emerge in waves, we will both learn to live with it and science will overcome it.

There has never been a more concerted attack of the global scientific community on a disease. We either learn to live with it, or a medical solution will be found. For our base-case macro scenario, we think both outcomes are likely.

In the interim, we believe that policy will remain enormously reflationary. This is important where in countries like the U.S., policy has propped up what would otherwise be depressionary-like conditions. The chart shows how important the transfer payments are to U.S. households. Twenty million Americans receive some form of government support. Without a rebound in the economy and jobs, activity could go over the cliff in Q3 if support is not sustained. If we include the forthcoming support from Congress, the U.S. budget deficit may have expanded by $5 trillion or 20% of U.S. GDP this year. Positive for the short run, we expect it to continue for as long as needed—the longer-run story may be different.

The further one looks out into the future, the more likely the case builds for what could eventually turn out to be quite a strong rebound. Easy financial conditions operate with a long lag and the collapse in yields has a well-established record of stimulating growth.

Similarly, monetary policy has been highly stimulative, not just in developed world but entire world again, historically correlation with eventual improvements in world activity.

The rally in gold is one way of capturing the scale of policy reflation at play. It is closely connected to the Treasury Inflation-Protected Securities (TIPS) yield, negatively, and reflects the opportunity cost of

holding fiat money. So, think of the rally in gold as a measure of how reflationary fiat monetary policy has become.

As to how successful that policy stimulus is in terms of reflating the world economy, the single best gauge is probably commodity prices, which has a good record of correlating with world GDP.

Pulling gold and commodity prices together, in some ways this chart sums it up best. Under normal circumstances, policy reflation initiatives, as reflected in gold, eventually get a bid in the real economy, and a catch-up in the CRB Index indicates the world economy is gaining traction. That might be starting to happen given the V-shaped rebounds we are seeing here. And the scale of the catch-up could be enormous. A classic catch-up in the CRB back to levels predicted by gold would be a 50% move in that index and suggest an eventual powerful rebound in the world economy. That is really a testimonial to the amount of stimulus in the pipeline, and the potential for a global rebound if—big if—we overcome fear holding the economy and activity back. Either way, this chart hints at some major macro developments in the future.

The ratio of CRB to gold has also been a reasonable indicator of the business cycle influence of U.S. long bonds, a benchmark for global fixed income. So, any steepening in the yield curve needs to see the world economy gain more traction.

Many analysts and investors have noted the exceptional nature of money growth this cycle. Unlike the GFC, there has been no collapse in credit, leaving many to wonder if this is more inflationary than deflationary. It's too soon to say, but much of the credit pickup has been due to revolvers and drawing down of credit lines—highly defensive. So, it really comes back to the confidence question and when people start feeling safe again. But for now, our view is that the stimulus is anti-deflationary. Breakeven inflation rates have only just recently returned to levels that existed in February, indicating that central banks have successfully insulated against a broad-based deflation.

Also, we know that in a zero-bound dollar-denominated world, reflation and inflation require a weaker dollar, much weaker. It may be starting to happen but has not played out yet.

On the supply side, the Fed has moved to alleviate any dollar shortages, as it did in the GFC, only much faster.

And there is no rate support for the dollar anymore. A gradual pickup in global growth should alleviate dollar demand even further reinforcing this process. The Fed has given every indication that it is all hands on deck, they have discussed openly Yield Curve Control (YCC) as a possible policy option, so there is little sign of a premature end to Fed efforts to support the economy.

So summing up the macro outlook—mindful of the probability of the pandemic staying with us for some time to come—we assume that we are going to learn to live with it and that science at some point will help us overcome our fear and a new normal will emerge. In that window, we expect policy to remain fully supportive. Growth may surge and then retreat as the pandemic evolves, but other factors held constant, the case for the world economy to build momentum seems to increase the further in the future we look. As for the balance of the year, we expect maximum policy support from central banks as we enter what looks like a contentious period leading into the American elections this November and what could be related market volatility.

Thanks for taking the time to listen in.