

# Trading Places: Congress, the Federal Reserve, and the Global Economy

Francis A. Scotland |

Democrats have traded places with Republicans in the U.S. House of Representatives—restoring the kind of political gridlock that the U.S. system of government was designed to manage. The organizational structure of the government was conceived to limit the power of any one of the three branches of government from implementing radical change without bipartisan support. All of which means that the ability of the Executive Branch to move forward with what's left on the pro-growth supply-side agenda has been compromised, if not completely checked—at least for the next two years. There is talk of bipartisan support for sizeable public infrastructure, but it is hard to believe that traditional Senate Republicans aren't already nauseous about the bloat in government, the national debt, and the deficit. It would be a surprise to see Senate Republicans vet big, new House Democrat-led spending programs without offsets somewhere else.

The good news for investors is that gridlock on Capitol Hill could help end the current confusion at the Federal Reserve (Fed)...in time.

Fed Chair Powell did a monetary flip flop a few weeks ago and opened the door to October's market volatility when he said "we're a long way from neutral at this point, probably." The hawkishness caught the market off guard because he had given the impression that "neutral" was a lot closer only a couple weeks earlier after the September Federal Open Market Committee (FOMC) meeting.

Powell is not an economist nor beholden to any particular economic school of thought. He is a pragmatist, which probably explains his monetary volte face. The latest reports of stronger gross domestic product (GDP) and rising wage numbers boosted his confidence in the idea that rates are too low relative to growth and need to go up more than the Fed was thinking even a month ago. This year's uptrend in bond yields might be another factor behind his change in thinking. In the past 10 years, bond yields wilted with the slightest wobble in equities. So the Fed may see this year's change in market correlations as another red flag signaling the end of the era of ultra-low interest rates and the beginning of a more rapid normalization in policy conditions. The judgment call in all this is the sustainability of the U.S. growth surge and the inflation risk. Historically it has always been a challenge for the central bank to get the interest rate setting right, but this time around, the Fed is making things harder on itself by shrinking the balance sheet at the same time.

Most agree that the era of ultra-low global interest rates is passing. The more critical question is how fast global rates normalize. In the U.S., the Trump tax cutting agenda has complicated the issue by rocketing American GDP growth higher, which could easily bias/pressure the Fed into thinking a rapid normalization is appropriate.

## The Pace of Normalization

But there are a host of reasons for believing that normalization will play out over a very long time frame, maybe years.

*First, there is still a big glut of savings and shortage of spending in the global economy.*

It was the collapse in U.S. household spending and bust in credit demand a decade ago which originally led to the elevator drop lower in global real bond yields. China no longer had a hungry borrower for its surplus savings so the global rate structure tanked. In the 10 years since that event, U.S. households have never recovered their appetite for debt. Household credit growth is still below personal income growth, it remains below the level of credit growth which prevailed at the trough of every preceding recession in the last 50 years,

and the personal savings rate has stayed elevated. Nor is there any lack of savings in the U.S. corporate sector based on profit margins. China's savings rate has remained high over the last 10 years as well, forcing policy makers to look for alternative uses of its surplus as domestic growth has slowed from double to single digit. Most of the effort to absorb this domestic savings surplus has come from government borrowing, which has led to higher debt-to-GDP ratios, a steadily widening budget deficit, and a reduced current account surplus. Beijing is not happy with these trends and uses every pick up in the economy to reverse course.

In the meantime, there is no sign of absorption anywhere else in the world. The trend in Europe's combined current account surplus has risen steadily since 2008 on the back of the German-led drive to austerity. And Japan's current account is back close to historic peak levels as a share of GDP. As for the emerging world, the International Monetary Fund (IMF) reports that the median current account balance of 12 emerging market countries with deficits has been cut in half from a collective deficit of over 3% of GDP in 2015.

*Second, there is just too much debt around the world to believe that rates can normalize quickly with economic impunity.*

This year's emerging market stress has again revealed the fault lines in local dollar-denominated corporate debt. What's different from 10 years ago is that the developing world comprises over 60% of global GDP, so slower growth in these regions has global repercussions. Household debt levels in Canada, Sweden, Australia, Norway, and New Zealand are far in excess of the levels that existed prior to the U.S. real estate bust. Macropprudential measures have reduced the boil in real estate but these are markets with no latitude for a meaningful rise in borrowing costs, or a slide in property prices that would result from too heavy handed a policy response. In Europe, commercial banks and the peripheral economies remain saddled with excess government debt. The European Central Bank has driven rates to a level below growth rates in most countries but there is almost no room for rate increases before the debt arithmetic reverses as seen recently in Italy.

*Third, normalization means multiple compression not just for stocks but for all income earning assets and potential contractions in net worth.*

The biggest excesses that have emerged from the ultra-low rate environment have been in asset prices; the fastest ticket to slower growth would be a big compression in net worth. The existential threat posed by normalization is that there is no place for investors to hide and October's volatility provided a whiff of what happens if normalization is too fast.

## The U.S. Up, The Rest of the World Down—For How Long?

Despite the arguments for a slow normalization, the Fed's domestic focus is on the tax-cut fueled pick-up in U.S. GDP growth and wage inflation. The global economy is feeling the pressure as the Fed tightens the screws: dollar liquidity is getting scarcer and more expensive. One size does not fit all and growth is slowing just about everywhere in the world except in the U.S. This divergence in growth between the U.S. and the rest of the world—especially in China—is perhaps the most striking aspect of the current global macro profile. The Fed is raising rates. China is cutting them. So far Powell has reacted with a shrug, dismissing the slowdown in the rest of the world as insignificant or not his problem. But the surprise could be that in a year's time the U.S. and the global economy have traded places.

The U.S. economy is not an island, capital markets react to divergences and the blowback from the global economy has started. In October, the U.S. equity market finally joined the selloff that was spreading across the rest of the world. Cyclical have been trampled relative to safety, with investors signaling that U.S. growth may have peaked. The retreat in the stock-to-bond ratio also argues for the beginning of a pullback in the ISM manufacturing index, an early indicator of GDP growth. Domestic inflation could surprise to the downside, suppressed by a strong dollar and retreating commodity and energy prices. The CRB Raw Industrials Index has dropped almost 10% this year, often a prequel to peak profits. The Fed rarely raises rates—and has never shrunk its balance sheet for that matter—when this index is contracting, but has been doing both all year.

Divergences have developed domestically as well as globally. Housing is the most important pipeline for interest rate trends into the economy and activity in this sector has come to a halt despite the pent up demand reflected in household formations. New home sales have fallen 13% since last year and the growth rate in pending home sales has been negative since early 2017. U.S. auto sales have been flat ever since late 2015 when the Fed first started raising rates. Rising gasoline and oil prices have been another drag on spending

power. And even business fixed investment is beginning to moderate as the initial effects of the tax cuts begin to dissipate.

All this suggests there is a good chance the U.S. could trade places with the global economy by this time next year. Congressional gridlock means low odds of the U.S. government reacting to softer domestic growth with new stimulus measures. So slower U.S. growth should push the Fed back to thinking about a slower pace of normalization if not a complete retreat from balance sheet reduction. Any easing in the price or scarcity of dollar liquidity gives a big lift to global growth with Chinese policy stimulus still in play in the background. And if President Trump and President Xi can just give each other a hug and pretend to make up in Buenos Aires, then the case for trading places next year could be bulletproof.

*Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.*

©2024 Brandywine Global Investment Management, LLC. All Rights Reserved.

#### Social Media Guidelines

Brandywine Global Investment Management, LLC ("Brandywine Global") is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Brandywine Global may use Social Media sites to convey relevant information regarding portfolio manager insights, corporate information and other content.

Any content published or views expressed by Brandywine Global on any Social Media platform are for informational purposes only and subject to change based on market and economic conditions as well as other factors. They are not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Additionally, any views expressed by Brandywine Global or its employees should not be construed as investment advice or a recommendation for any specific security or sector.

Brandywine Global will monitor its Social Media pages and any third-party content or comments posted on its Social Media pages. Brandywine Global reserves the right to delete any comment or post that it, in its sole discretion, deems inappropriate or prevent from posting any person who posts inappropriate or offensive content. Any opinions expressed by persons submitting comments don't necessarily represent the views of Brandywine Global. Brandywine Global is not affiliated with any of the Social Media sites it uses and is, therefore, not responsible for the content, terms of use or privacy or security policies of such sites. You are advised to review such terms and policies.