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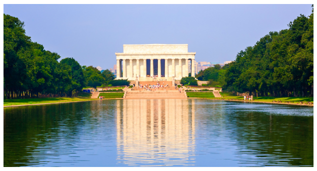


Reflections on Meetings in Washington, D.C.

J. Patrick Bradley |

Introduction

Fall is a great time to visit the nation's capital, Washington, D.C., and it also marks the time when the Institute for International Finance (IIF) holds its annual membership meeting, as well as the annual meetings of the International Monetary Fund (IMF) and World Bank. Given the array of corporate and government officials who participate in these meetings, investors get some insight into the global economy and how these public and private sector stakeholders view risks and opportunities. While synthesizing the output of the IIF meetings is a herculean task, three themes stood out to me:

1. The economic gloom
2. The future effectiveness of central bankers and monetary policy
3. The growing support for Environmental Social and Governance (ESG) factors and climate change

These three themes will factor heavily into how investors think about the global landscape and our industry in 2020 and beyond.

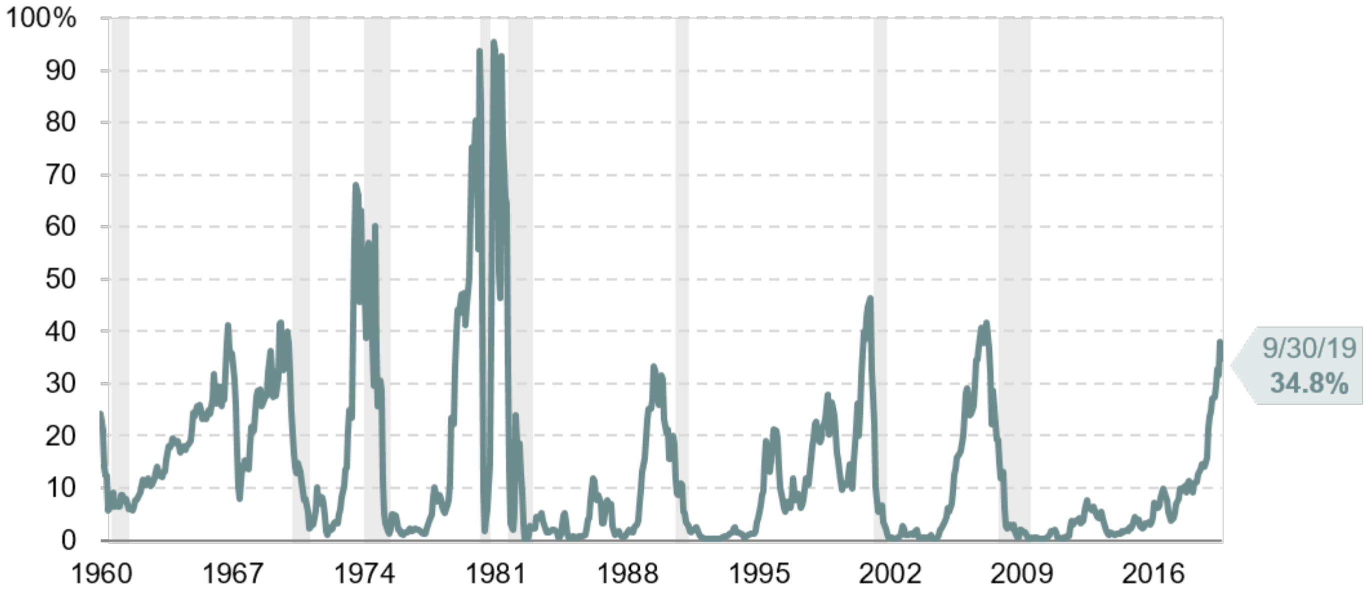
The Economic Gloom

Of course, a certain amount of gloom hovered over these meetings. After all, the global economy has slowed, with some countries—notably Germany—skating on the edge of recession. China and U.S. trade relations have created an uncertainty over the global outlook. The IMF seemed to confirm the gloom with the release of its growth forecast, which is just 3.0% for the full year 2019. In general, forecasters all over the world are reacting and lowering growth forecasts.

However, is the environment all that bad? Sure, the global economy has lost some momentum and talk of recession—even in the U.S.—abounds. A focus on financial variables appears to validate the recession fear, as Chart 1 below shows.

Chart 1: New York Fed Recession Probability Model

Probability of a U.S. Recession Predicted by Treasury Spread, 12 Months Ahead, As of 9/30/2019



Source: Federal Reserve Bank of New York / Haver Analytics

Breeching the 30% probability barrier according to the New York Federal Bank's model has harkened a recession in several past cycles, as I've previously noted. This model is based on the Treasury yield curve. However, the yield curve is now steepening, and looking at the 10-year Treasury yield less the 2-year yield, the curve briefly inverted and has since turned positive. Past recessions have witnessed a sustained inversion and the flat yield curve, which now affects many developed economies, may instead owe more to the years of unconventional monetary policy.

A focus on real economic variables paints a less threatening picture. For example, U.S. consumers exhibit strong fundamentals. The pall hanging over the economy relates to the threat of a trade war, as China and the U.S. try to determine their future relationship. Yet, trade talks are starting again, and the U.S. has indicated the prospects for a deal, albeit produced in phases, are excellent. The U.S. believes a deal could be signed at upcoming meetings in Chile. As a result, there may be more reasons to be guardedly optimistic rather than excessively pessimistic. Next year the IMF expects growth to pick up, with the U.S. slowing and growth spreading out to other parts of the world.

Future Effectiveness of Central Bankers and Monetary Policy

By far the most provocative theme to emerge was a seemingly unanimous view that monetary policy was losing effectiveness, that loan demand was becoming less sensitive to lower interest rates, that sustainable economic growth was not the forte of central banks. The continued use of unconventional monetary policy has left developed market central banks with little ammunition left to fight off a real recession. The danger is the potential buildup of risks due to unconventional monetary policy, including negative interests, which affects banks, pension funds, and insurance companies.

Monetary policy has taken on a role that it may be ill-equipped to play; this was the message delivered by the head of the Bank for International Settlements (BIS), Agustín Carstens, at the release of its annual report in late June 2019. He used the metaphor of a backstop for the proper role for central banks and monetary policy. Central banks should respond to serious economic problems and not just try to produce growth. Unconventional monetary policy, at the end, transmits its impact through the exchange rate, making the policy simply "beggar thy neighbor."

Many speakers at the IIF conference echoed Carstens's sentiments and believed that a confluence of policies

should be employed to stoke growth, and those policies should include fiscal policy by those countries that have fiscal space. Macroprudential policies should be added to the quiver. However, the policies should not be mere pump-priming but act in concert with structural reforms to lift economies' potential growth rates. For example, China may be slowing—a natural evolution from earlier pell-mell growth—but its policymakers have taken steps to reform the economy and shift it toward consumer spending and services and away from manufacturing. On the other hand, South Africa remains a work in progress with respect to marrying policy and structural reform.

Governments, in the view of many, have an unprecedented opportunity to ignite fiscal policy and integrate it with monetary policy. Low inflation and interest rates afford the opportunity for governments to borrow in support of policies that may be better able to produce cyclical and structural economic growth and expand the potential growth rate. Emerging markets still appear to have monetary latitude given generally high interest rates and relatively low inflation. Many IIF session participants simply believed that monetary policy for developed economies is less effective in the absence of fiscal policy. There was also a widely held expectation that the European Central Bank's (ECB) Christine Legarde will lobby for fiscal policy. In sum, there is a growing belief that these policies must act in unison.

ESG and Climate Change Get Support

Discussions about ESG factors and creating sustainable plans were a leitmotif across speaker panels. Policies in boardrooms and governments appear to be shifting toward more greener initiatives. For example, around 60 countries have a goal of zero carbon emissions by 2050. De-carbonization is a driving force, with some countries instituting a carbon tax.

Policies will certainly be influenced by sustainability forces, which could impact investment and lending behavior to certain sectors of the economy. The green bond market has swiftly grown to $500 billion and could likely still grow further; this year, France is the leading issuer of such bonds. Investors increasingly desire investments that address sustainability and are in line with their green goals. Smith College just announced a goal to divest its fossil fuel related investments over the next 15 years and it will not make any more investments in this sector. Lending institutions and underwriters may also be reluctant to support such sectors of the economy. The continuation of such trends promises to change the composition of an economy and impact wealth distribution.

Spending on such policies could be a source of demand for an economy, as both corporations and governments pursue green policies. However, these policies are not costless. For example, employees in sectors that falling out of favor or becoming obsolete will be negatively affected—this displacement will likely have to be addressed by governments. Central bankers believe climate change has to become a part of the monetary policy discussion, since it has the potential to create financial stress on an economy. In fact, the BIS created and manages a green bond fund in which central banks can invest. Despite the rising prominence of ESG factors, there is a need for agreed-upon definitions. Furthermore, many U.S.-based companies and investment managers must reconcile the fact that the U.S. withdrew from the Paris Climate Accords, and grapple with what kind of role the U.S. will have in this space. Since these questions have yet to be answered, a private sector solution seems most likely for the U.S.

Incidentally, Brandywine Global has integrated ESG factors into our investment analysis for some time, and a couple of my blogs on the topic can be found here and here. We will also continue to implement ESG factors in our broader business decisions and operations, by following the same examples we expect of our investment opportunities.

Final Takeaways

I isolated just a few of the future "lessons" that struck a chord with me at this gathering. A session- by-session review would be overwhelming and probably counterproductive. After all, this is a blog post and not a treatise. As a result, many other forces were not discussed, even though these are also are significant factors that affect the future economic environment, like the U.S. elections and the political backdrop, the related global grip of populism, rising geopolitical tensions, demographic trends, and financial regulation policy and the effect on banking institutions—just to name a few. Yet I walked away from the meetings with three takeaways that resurfaced during my time in D.C.:

1. **There are reasons to be less gloomy about the global economy**
2. **Monetary policy will no longer be the only game in town and likely will work in concert with fiscal policy**
3. **ESG policies will grow in importance**