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After three consecutive upside U.S. inflation surprises, bond yields are rising again. The 10-year Treasury yield is at 4.5% today, up 70 basis points since the beginning of the year. After the recent sell-off, we believe bonds offer an attractive risk-reward trade-off for investors.

We still expect the Federal Reserve (Fed) to cut rates this year, even if the start of the easing cycle is delayed by a few months. We think higher inflation prints over the past three months are a temporary setback. And, ultimately, we expect U.S. core inflation to converge toward the Fed's target. While economic growth remains resilient, it is already largely reflected in the consensus forecast. Therefore, it will be difficult for U.S. growth to continue to surprise on the upside going forward.

U.S. core inflation has declined to around 2% by the end of 2023 from a peak of almost 6% two years ago. In the past few months, core inflation has bounced back toward 3%, raising concerns about sticky inflation. However, we believe this is only a temporary setback. The U.S. economy has been very resilient. But a lot of that resilience has come from strong aggregate supply, allowing the economy to grow without putting upward pressure on inflation. Over the past six quarters, U.S. gross domestic product (GDP) growth has averaged almost 3%. But during this period, the unemployment rate has actually gone up slightly and manufacturing capacity utilization has gone down. While headline and employment growth remain strong, we have seen significant progress toward labor market normalization, with lower level of job vacancies, reduced quit rates, and slower unit labor cost growth.

Now around this time last year, most U.S. economists expected that we would be in a recession by now. But the economy has turned out to be a lot more resilient, leading to significant upward revisions of growth forecasts. However, going forward, it'll be more difficult for the U.S. economy to continue to outperform expectations. The U.S. 10-year real yield is around 2.1% today. We believe this is an attractive real yield level, which is largely consistent with the potential growth rate of the U.S. economy.

In addition, with consensus expectations now firmly in favor of U.S. economic resilience, bonds provide investors with positive optionality in case the economy does slow down. Finally, we believe U.S. bonds are attractive versus U.S. equities, with the equity risk premium at the lowest level in more than 20 years. While the equity risk premium has almost no predictive power over a shorter time horizon, it has very strong correlation with future relative returns over five- to 10-year periods. Therefore, for investors with longer-term time horizons, we believe recent move higher in yields offers an attractive opportunity to add to fixed income exposure.