

# Macroeconomic Update

## Bond Yields Rise as Inflation Falls

One of our key macroeconomic calls for 2023 was that U.S. inflation would fall toward the Federal Reserve's (Fed's) 2% target. That seems to be playing out with the core Consumer Price Index (CPI) averaging 0.2% month-on-month for the past three months, the equivalent of a 2.4% annualized rate. We expect this trend to continue in the coming months. This time last year, core inflation was above 6%.

Yet despite clear evidence of moderating inflation, U.S. 10-year Treasury yields have surged more than 130 basis points (bps) over the past four months. Repricing of nominal yields has almost exclusively been driven by higher real yields. Investors have ditched U.S. recession forecasts as strong third quarter gross domestic product (GDP) growth has given an impression of economic resilience in the face of the most aggressive Fed tightening cycle since the early 1980s.

The 10-year Treasury Inflation Protected Securities (TIPS) yield reached 2.5% at the start of the fourth quarter, the highest level since 2007-2008. Are real yields now high enough?

The 10-year real yield today is much higher than during the 2010s, when it averaged around 0.4%. During that decade, real yields were suppressed by weak investment demand, post-Global Financial Crisis debt deleveraging, investor risk aversion, fiscal consolidation, and central bank quantitative easing programs. It is highly unlikely we will go back to such a low real yield regime, in our view.

Between 2000 and the first half of 2008, U.S. 10-year real yields averaged 2.25%, roughly where we are today. Are we only just returning to a more normal environment? We believe there is at least a loose relationship between sustainable levels of real yields and the trend GDP growth rate. Between 2000 and 2008, the Congressional Budget Office (CBO) estimate of trend GDP growth was around 2.8%, which compares with 1.8% today. It is possible that adoption of artificial intelligence (AI) will lead to acceleration in productivity growth analogous to what we saw in the mid to late 1990s. That is not a given, and there is great uncertainty about both the size and timing of AI's potential economic impact.

The real yields are now 50-70 bps higher than the CBO's estimates of potential growth. In the past 25 years, 10-year real yields have only been above CBO potential growth around 10% of the time. From that perspective, real yields seem attractive today, even if we believe there are structural factors, e.g., rising government borrowing, climate change related investments, demographic factors, that could bias real yields higher over the coming decade.

## Monetary Policy Tightening Impact Muted or Delayed?

Brandywine Global's investment framework is based on the idea that large moves in bond yields and currencies create economic responses that ultimately lead to cyclical mean reversions. So far, the U.S. economy as well as equity, credit, and real estate markets have



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held up remarkably well in the face of a 250 bps increase in U.S. 10-year real yields over the past 18 months.

Estimating the lag between monetary tightening and its impact on growth is difficult in a more “normal” economic environment. It is particularly challenging in the current economic cycle, which has seen a combination of massive monetary and fiscal swings, COVID-related consumption shifts and supply-side disruptions, and a 1970s style commodity price shock. Estimating the impact of each individual shock and the extent to which the shocks amplify or offset one another is particularly challenging.

Fiscal policy has undoubtedly played a role in U.S. economic resilience this year via a cost-of-living adjustment (COLA) in January, employee retention credit (ERC) payments, robust state and local government spending, and subsidies for investments in manufacturing facilities via the Inflation Reduction Act (IRA) and CHIPS and Science Act. Additionally, households have drawn down on excess savings built up during the pandemic.

Supply-side normalization has also been an important factor supporting growth this year. For example, global auto sales and auto production are up sharply over the past 12 months as chip shortages have eased. The U.S. labor force is growing rapidly, to a large extent driven by a post-COVID rebound in immigration. Finally, the reversal of last year’s commodity price shock has played an important role in supporting real household incomes and spending.

We believe these growth-supportive factors have, to a large extent, already played out. Fiscal policy will become less supportive going forward with the resumption of student loan repayments and spending caps imposed as part of the debt-ceiling agreement. Global auto production has largely normalized before the impact of the current United Auto Workers (UAW) strike. While there is likely remaining pent-up demand for autos, we expect it will be, to some extent, offset by record high prices and very elevated financing costs. A sharp rise in oil prices due to OPEC+ output cuts will weigh on consumer spending over the next one to two quarters.

Going back to monetary policy lags, we find that historically an increase in U.S. real 10-year yields has coincided with slower employment growth after around 12 to 18 months. As real yields started to rise in the second quarter of 2022, we believe the bulk of the impact of higher rates on employment growth is still ahead of us.

Despite making significant progress toward its inflation goal, the Fed believes it needs to maintain restrictive policy settings. Based on the latest Federal Open Market Committee (FOMC) forecasts, it seems the Fed expects to achieve an economic soft landing with tight monetary policy. We are surprised that the Fed sees the need for a 2.6% real federal funds rate at the end of 2024, with 2.5% core Personal Consumption Expenditures (PCE) Price Index inflation and an 70 bps increase in the unemployment rate from the cyclical low. Such an aggressive approach increases the risk of a policy mistake.

Meanwhile, U.S. growth in the fourth quarter of this year is likely to hit a pothole created by combination of the payback from very strong third quarter consumption growth, resumption of student loan repayments, UAW strike, and supply-led increase in oil prices.

In 2024, we expect lower U.S. nominal GDP growth due to both lower inflation and softer real GDP growth. Global growth is already rolling over outside the U.S. Weak composite purchasing managers’ indexes (PMIs) in the eurozone and the UK point to a prolonged period of below-trend growth with a rising risk of outright economic contraction. In China, where the housing sector continues to drag significantly on growth, the decline of housing-related activities is putting severe pressure on corporate and local government balance sheets. Although the Chinese authorities may be able to prevent a severe financial crisis, weak Chinese growth will provide an additional disinflationary impulse to the global economy.

The bottom line is that we believe that further significant increases in real yields from current levels are unlikely to be sustainable due to:

1. additional drag on economic growth that is already set to slow
2. potential for a much sharper correction in equities and other risky assets, particularly given elevated equity price-to-earnings (P/E) multiples, relatively tight credit spreads, commercial real estate vulnerabilities, and private asset market valuations that have not adjusted to a structurally higher yield environment

At some point, both reasons (1) and (2) could become self-reinforcing, potentially pushing the U.S. economy into a recession.



## Strategy Implications

There is a compelling case for being long U.S. fixed income. Core inflation looks to be on track to reach the Fed's 2% target. Labor markets are rebalancing rapidly, which should result in lower wage growth. Global growth is rolling over, led by China and Europe. While U.S. growth has been resilient so far, we expect growth to slow as monetary policy lags kick in. U.S. real yields are high relative to trend GDP growth. Fixed income is attractive relative to equities, with U.S. investment grade bond yields above the U.S. equity forward earnings yield for the first time in 20 years, based on the Bloomberg U.S. Corporate Bond Index versus the S&P 500 Index.

We like the intermediate part of the U.S. curve because yields are attractive, the Fed is probably done raising rates, and the focus will shift to the timing of the easing cycle. Although the Fed is hawkish for now, that could change quickly once we see clear signs of labor market weakness. The intermediate part of the curve is less sensitive to uncertainty surrounding the appropriate term premium and the effects of long-term increases in government debt on equilibrium rates. In a soft-landing scenario, 5- to 7-year bonds are likely to generate decent returns, although they may struggle to outperform cash. However, they potentially will rally strongly in the event of a deeper slowdown in growth or a larger financial shock. We also like duration in the UK, as the economy is clearly slowing in response to aggressive Bank of England policy tightening.

We have a medium-term bearish view on the U.S. dollar (USD). We believe that the dollar is expensive on a range of valuation measures. While in the short term USD is being supported by relative growth differentials and a hawkish Fed, over the next 9 to 12 months we expect USD carry advantage to disappear.

To a large extent, current U.S. growth outperformance reflects exceptionally stimulative fiscal policy compared to other G10 economies. While that is providing short-term support to the dollar, in the medium term it should result in structurally larger

current account deficits and persistent growth headwinds from pressure for fiscal consolidation.

In our fixed income portfolios that allow foreign currency exposure, we have a barbell strategy that combines long positions in select emerging market (EM) currencies with a long Japanese yen (JPY) position. We believe certain EM currencies offer a mix of attractive valuations, positive balance of payments dynamics, and historically high real short rates. Meanwhile, JPY is extremely cheap both versus USD and other G10 currencies. There has been a regime change in Japanese inflation dynamics, and current monetary settings are clearly no longer appropriate. The possibility of currency intervention should prevent further significant weakness in the yen.

For our global bond portfolios, we increased exposure to EM local currency bonds leading into the third quarter of 2022, primarily via select Latin American (Latam) markets, including Mexico, Colombia, and Brazil. At the time, these markets offered very attractive yields both in absolute terms and relative to U.S. Treasuries. We expected EM inflation to fall sharply in 2023, in response to lower commodity prices, post-pandemic normalization of goods price inflation, and preemptive central bank policy tightening. EM local bonds have done very well over the past 12 months, strongly outperforming G10 markets. In absolute terms, Latam bond yields are still quite attractive, particularly as inflation falls. However, the valuation case relative to Treasuries could become less compelling if further increases in U.S. real yields destabilize risk assets such as EM fixed income.

Finally, we are quite cautious on corporate credit as credit risk premiums are relatively low and do not reflect the potential for a deeper economic slowdown over the next one to two years. Instead, we find agency mortgage-backed securities (MBS) much more attractive as they offer higher yields than investment grade bonds but with no default risk and lower return volatility.

Brandywine Global calculations are based off of publicly available current economic data.

The **Bloomberg US Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers.

The **S&P 500 Index** is a broad measure of U.S. domestic large cap stocks. The 500 stocks in this capitalization-weighted index are chosen based on industry representation, liquidity, and stability.

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