

Video Transcript: Global Macro Webcast – 3Q 2023
Paul Mielczarski
Brandywine Global Investment Management
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The past few months have been challenging for fixed income investors. The U.S. 10-year yield has increased about 150 basis points since early May, and bonds have now underperformed equities by more than 16% since the start of the year. However, we do think that going forward there is a compelling case for being long U.S. fixed income, particularly on that one- to two-year time horizon.

What are reasons that we think that? One, U.S. core inflation has declined sharply in recent months and is pretty much on track to reach the Federal Reserve's (Fed's) 2% target sometime next year. Labor markets are rebalancing quite rapidly, which should support wage growth going forward. Global growth is rolling over, really led by China and Europe.

And while the U.S. economy has been quite resilient so far, we do expect to see it slow over the next nine to 12 months as monetary policy lags really start to kick in. Starting with inflation, U.S. core inflation was around 6% this time last year, but over the last three months, core inflation has averaged at a 2.4% annualized rate. Over time, we do expect core inflation to move somewhat closer to 2% sometime next year. And, in fact, if you exclude the impact of shelter and used car price inflation, we are already at 2%. So, the decline in core inflation in the past 12 months has largely been due to normalization of pandemic-related supply distortions. The aggressive monetary tightening has also played a role, but a smaller role in bringing down inflation.

Going forward, we think there's still some additional downward pressure on inflation from supply side normalization and potentially a larger impact of the sort of lagged impact of monetary policy tightening.

Now switching to growth. Global growth actually rebounded quite strongly in the first six months of the year. This rebound was due to a combination of the reopening of the Chinese economy, a reversal of the massive commodity price shock after Russia invaded Ukraine, and continued resilience of U.S. consumer spending. In the past few months, we have seen economic growth in Europe starting to weaken. In China, the housing sector continues to be a significant drag on growth.

For now, the U.S. economy continues to surprise on the upside. We have strong third quarter gross domestic product (GDP) growth and generally very healthy employment growth. However, over the past 18 months, we've had the most aggressive Fed tightening cycle since the early 1980s.

And the key question for investors is really how much of the impact of this tightening cycle is still ahead of us? Estimating the lag between monetary policy tightening and its impact on growth is pretty difficult in a more normal economic environment. But it's particularly challenging in the current economic cycle, which has seen a combination of massive monetary and fiscal swings, COVID-19-related consumption shifts, supply disruptions, and large commodity price shocks. Trying to estimate the impact of each individual shock and to what extent the shocks amplify and offset each other is particularly challenging.

So far this year, we do believe a combination of fiscal policy, supply side normalization, and lower commodity prices have played an important role in supporting economic growth. But going forward, these factors are likely to become much less supportive. Meanwhile, we do find that, historically, a sharp increase in U.S. real yields has led to high unemployment rates over a one- to two-year time horizon in most cycles. Given that real yields have only really started to rise in the second quarter of 2022, we believe a lot of the impact of higher rates on U.S. labor market is still ahead of us.

As I mentioned at the start, the U.S. 10-year yields are up around 150 basis points since the beginning of May. Almost all of this repricing has come from higher real yields. Today, 10-year real yields are at 2.5%, which is the highest level since 2007-2008.

The key question for us is, are real yields now high enough? The 10-year real yield today is much higher than what we saw during 2010s when it averaged around 40 basis points. There are many reasons why we think it's very unlikely to go back to such low yield regime. Between 2000 and a first half of 2008, the 10-year real yield averaged about 2.25%, so slightly below where we are today. In the medium term, we think there's at least some relationship between sustainable level of real yields and the trend growth of the economy. Between 2000-2008, the estimate of trend growth was around 2.8% versus 1.8% today. So, very good reasons why real yields should be lower today than in the early 2000s.

If you look over the past 25 years, real 10-year yields have rarely stayed above estimates of trend GDP growth for long. From that perspective, since we are 50 to 70 basis points above trend GDP growth, we think real yields are already quite attractive. Now, it's obviously possible they go higher in the short term. But we think further increases in real yields are unlikely to be sustainable due to 1. additional drag of economic growth (it's already said the economic growth that's already set to slow) and 2. due to potential for a much sharper correction in equities and other risky assets from rising real yields. And at some point, if we get a combination of both, this could really become self-reinforcing and push the U.S. economy toward a recession.

Finally, we believe that bond valuations are attractive relative to stocks. So if you look between 2010 and the end of 2021, the forward earning yield for S&P 500 Index was on average more than 3% above the yield for U.S. investment-grade bonds. Today, for the first time in more than 20 years, yields on investment-grade bonds are actually higher than yields on U.S. equities. So in a soft landing scenario, we think bonds are likely to generate decent returns, although they may struggle to keep up with stocks. But bonds will outperform equities and other riskier assets quite sharply in the case of a deeper U.S. economic slowdown or potentially some sort of a large financial shock.