MAY 2021

Growth, rates and inflation

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Introduction

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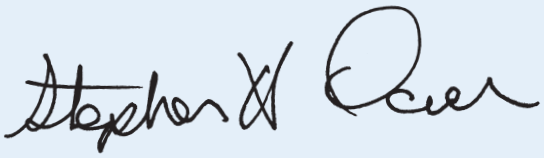
Our investment professionals do not always agree on the path of economic growth, inflation, or other macroeconomic factors. This year is no exception. However, one thing that does seem fairly certain is as global COVID-19 vaccination programs continue, restrictions will loosen—and the strong economic growth we've seen looks likely to continue. With growth has come inflation, and the question: is it temporary, or will it be more permanent?

As the world's economic engine recovers, many are questioning what we can expect ahead for economic growth, interest rates, inflation and the US dollar. In this edition of Macro Perspectives, I posed these and other questions to five of our investment professionals: John Bellows, Ph.D., Western Asset Portfolio Manager; Sonal Desai, Ph.D., Chief Investment Officer of Franklin Templeton Fixed Income; Michael Hasenstab, Ph.D., CIO of Templeton Global Macro, Gene Podkaminer, Head of Research at Franklin Templeton Investment Solutions, and Francis Scotland, Director of Global Macro Research at Brandywine Global.

Key viewpoints

- All of our investment professionals agreed that global growth looks likely to accelerate for the remainder of 2021 but disagree over the pace of expansion in the following years, with growth estimates varying widely across regions. For example, China's economy has recovered from the COVID-19 shock more rapidly than the West, and some emerging markets are likely to also have strong economic growth, while Europe could take longer to recover. Higher growth may bring higher inflation.
- All panelists anticipate an uptick in inflation in the United States this year. However, our managers disagree on the persistence of this trend over the next five years.
- While US interest rates look likely to eventually move up, globally the picture is less clear. European monetary policy, for example, is likely to remain accommodative. Even in the United States, the picture is complicated after extraordinary monetary and fiscal expansion.
- Our managers explore the role of fixed income in a portfolio and reiterate that even during periods of potentially rising rates, bonds can offer: diversification to other assets such as equities; risk reduction; capital appreciation; and income.

There are many examples of opportunities within fixed income, especially with thoughtful research. Spread products such as higher-yielding corporate bonds and emerging market debt could benefit from economic growth and offer near-term investment opportunities in fixed income portfolios.



Contents

Contributors

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Global growth

Stephen: What is your current outlook for global economic growth versus market expectations?

John: We're constructive on the outlook for growth in the United States and globally. We are returning to economic normalcy, and that return is a powerful force that will likely drive above-trend growth rates. These strong growth rates should improve balance sheets, incomes and revenues. Thus as growth returns, a lot of good things can happen for corporations, businesses and individuals.

Sonal: In the United States, the type of growth we're going to see this year will be, dare I say, akin to what we've seen in emerging markets like China in the past. The US economy is poised to experience the highest rates of real gross domestic product (GDP) growth in nearly four decades—with our expectations in the high single digits in 2021—and it would be the key driver of the global economic recovery. The staggering amount of fiscal stimulus, combined with upwards of US$2 trillion in excess savings, could fuel the strongest consumption boom in decades. Beyond this year, I don't see a rapid drop-off in growth in light of the level of sustained stimulus we're seeing in the US economy.

At this time last year, people were talking the "alphabet soup" of what the recovery would look like, with many believing we were going to see an L-shaped recovery and a second coming of the Great Depression. We were quite confident the US economy was strong enough to rebound within a few quarters, and a year later I think what we're seeing is a very V-shaped recovery. Going forward, I believe we are going to see strong growth for a while yet. Overall, we expect that the coming quarters will see a consolidation of a robust recovery in the global economy at large, with Europe catching up in the latter part of the year. Together with vaccinations, fiscal policy will play a key role in this recovery. However, the ability to move ahead with vaccination campaigns is proving to be a key differentiator across countries, which will give the global recovery a significant degree of unevenness.

Francis: In our view, the current stimulus has supercharged an economy already rebounding from last year's lockdowns. The generally strong recovery in US employment, notwithstanding the April report, points to a rapid return to potential levels of activity. The script continues to rhyme with the type of rebound that follows a natural disaster—not the more drawn-out recovery, then expansion, after a traditional recession. By and large, that rebound is playing out around the world, notwithstanding the timing and management of vaccine rollouts. Global import volumes have completely recovered, and manufacturing is soaring. In Europe, the economic surprises are largely positive, even though some countries are having problems with vaccinations. Asian industrial production is surging, too. In Canada, where I live, 90% of the employment drawdown since the pandemic has been recovered. And Australian employment is at a new all-time high. It really looks like the world economy is recovering strongly.

Stephen: Do you see the continuance of economic growth into 2022 and the following three to five years?

John: As we think about next year and beyond, I'm less convinced we're going to sustain the high growth rates we're experiencing this year. I will outline a few considerations.

To start, the economic reopening is, in large part, driving elevated growth. COVID-19 created prolonged constraints on consumption. As these constraints go away, pent-up demand should drive very high growth rates. However, this reopening is only going to happen once. So that's a very clear example of a one-time adjustment that will not be repeated.

> "There are reasons to be skeptical that this elevated growth rate will be sustained. We are somewhat more cautious on the secular outlook as full economic reopening will only happen once."
>
> **John Bellows**

The same thing could be true of fiscal stimulus. US President Joe Biden's US$1.85 trillion stimulus package is significant. But what's really striking is how fast it has been going into the economy. The stimulus checks were sent out quickly, both to businesses and individuals, and to state and local governments, and they are creating a near-immediate economic impact. In contrast, when you look forward, it's likely that future stimulus efforts are going to be an order of magnitude smaller, both in terms of size and impact, and likely would not add further to GDP growth. There are reasons to be skeptical that this elevated growth rate will be sustained. We are somewhat more cautious on the secular outlook as full economic reopening will only happen once.

Stephen: Where do you see growth outside the United States, and especially in China?

Gene: From a growth perspective, we see a fiscally fueled expansion. While it looks pretty well-established, it's uneven across regions. It is critical to point out that this is not an expansion that is going to impact all countries and all regions the same way. US growth has remained stronger than in other developed markets, fueled by a large amount of fiscal stimulus. In Europe, lockdowns persist, and continue to require policy stimulus. In the United Kingdom, post-Brexit trade adjustment remains a key uncertainty, although the worst of Brexit fears have passed and the economy is reopening faster than some other European countries. Japan appears well-placed to benefit from a cyclical economic rebound, policy continuity and a relatively muted COVID-19 impact. Meanwhile, China's economy has recovered more rapidly from the impact of COVID-19 than the West—but may decelerate later this year—and heightened geopolitical tensions persist. Overall, we believe growth expectations will continue to accelerate as vaccines roll out, even as near-term risks from COVID-19 still persist. I think we all agree there will be a cyclical rebound in global growth this year, and it is likely going to be robust. It is the degree of synchronization across countries that remains uncertain.

Countries with strong vaccine programs—Israel for example—tend to have lower hospitalization rates. That significantly reduces the strain on the health care system, but also enables a much speedier return to pre-COVID-19 levels of activity. We're all hopeful that countries can take up vaccine delivery infrastructure and make sure everybody who wants to, or can, be vaccinated because vaccination eventually will help drive economic activity.

Looking at the policy environment in the United States, United Kingdom and other countries, we see monetary policies remaining very loose. Fiscal policies are going to be accommodative as well, but not every country is willing or able to go quite as far as the United States. This is where that tension between fiscal stimulus and vaccination really meets, and it comes together in the optimistic forecasts that abound. We think the resulting environment will be conducive to strong growth going forward.

Sonal: As I said before, I think this global recovery will be very uneven and differentiated across countries, reflecting both the different speeds in the vaccination programs and the different extent of the policy stimulus efforts. This will have important implications in shaping investment opportunities. The divergence between the United States and Europe will be especially significant. In the euro area, I think growth will probably be fairly strong by European standards, but the recovery will be delayed by the intensification of lockdown measures in the first half of the year. However, I do not see the massive impact to the global recovery that we're seeing in the United States. We need to remember that, at its best, Europe has never been the driver of global growth. As such, Europe's impact on the rest of the world—how fast it grows or how "less fast" it grows—is not as important in some ways. If I look at Asia on the other hand, I think the macroeconomic environment bodes well for the prospects of a strong economic recovery in the region.

Stronger US momentum will add to China's already-entrenched recovery, and to the progress already made in the region in bringing coronavirus infections under control. The robust US and global macro outlooks also make us more optimistic about emerging markets. Stronger global growth should help emerging market countries repair their balance sheets and bolster debt fundamentals. Commodity exporters should be especially favored with a resurgence in prices and improvement in demand.

Francis: A unique feature of the current macro landscape is the divergence between policies in China and the United States. These are two anchor economies in the global economy. The Chinese authorities never applied the degree of policy stimulus the United States did. So China managed to get ahead without a lot of policy stimulus because the government initiated lockdowns earlier and managed them more effectively. Now, China is in the position where it is starting to decrease stimulus.

Looking at the market, I think the Chinese bond market's behavior has been instructive. Going into the pandemic, 10-year Chinese sovereign yields were trading around 3%,

then dropped to 2.5%. As China gained control of the virus and started to renormalize ahead of most other countries, the 10-year bounced back to 3% fairly quickly in the fall of 2020 and has remained near that level since.

China is now starting to focus on reining in leverage. While the domestic economy is not that strong, the export side is lifting a lot of the leading indicators in China. So China's trajectory may be a harbinger for US Treasury yields.

Michael: We expect global growth around 6% in 2021, with emerging markets outpacing developed markets, albeit with wide variations in how specific countries have handled the pandemic, distributed vaccines and managed fiscal and monetary policy. World GDP is likely to moderate in 2022 and 2023 but remain around or above its historical average of the prior decade as the post-pandemic surge reverts to more normalized growth patterns.

The growth outlook for much of Asia looks compelling as several countries have managed the health crisis and their fiscal responses more effectively than other parts of the world, putting them at the forefront of the post-pandemic recovery. Not only are they in a stronger position to recover, they are also better guarded against potential setbacks should COVID-19 variants cause the pandemic to relapse. Fiscal deficits are generally lower across Asia, while interest rates are higher than in developed markets. Regional growth drivers are also aligned with trending sectors such as pharmaceuticals, digitalization, big data and high tech, notably in places like South Korea.

The other major factor in the region is the strength of China's economy and its currency orbit, as regional trade and asset ownership are increasingly denominated in the yuan. China is leading the way in the digitalization of its currency, which has the potential to accelerate its trend toward becoming a reserve currency, challenging the US dollar's dominance. Broadly speaking, China's outward expansion should continue to have a substantial effect on the global economy, as seen in its "One Belt, One Road" initiative, its financing of capital markets in other parts of the world, expanding trade and growing its territorial influence. Policy continuity and the opening of its bond markets to foreign investors should also have a stabilizing effect regionally that we expect to be supportive of growth across Asia.

Inflation and interest rates

Stephen: Do you think inflation is likely to be a short-term, cyclical event or a long-term, secular shift?

John: I think it is important to first look at what the market is anticipating, and at current bond market valuations. Bond yields have moved up significantly year-to-date—the 10-year US Treasury note was yielding around 0.90% at the start of the year and reached 1.75% at its peak in March. The market has priced in an acceleration of inflation—and a fairly significant one—over the next few years.

The market is now pricing in Consumer Price Index (CPI) inflation above 2.5% over the next five years. Not just three months of higher inflation, but sustained inflation above 2.5% for five years. That is meaningfully above where inflation has been over the last 10 years, and it is meaningfully above the Federal Reserve's (Fed's) own inflation targets. If the inflation surge anticipated over the next three to six months is not permanent, and instead proves transitory, I think we can see some adjustments in the bond market.

I think the other thing that is notable is that the market is now pricing in the first interest-rate hike from the Fed in December of 2022. That could happen, but in order for that to happen, the US unemployment rate would need to drop significantly, and we would need to see the aforementioned above-target inflation expectations be realized on a sustained basis. When I think about how the market is priced—for higher inflation and for early Fed tightening—it strikes me that the risks are pretty asymmetric to the downside in terms of inflation coming in somewhat lower than expected, and a rate hike being realized somewhat later than anticipated.

Turning next to the outlook. With regards to inflation, as economies reopen, there is clearly going to be a lot of pent-up demand and supply constrained sectors. After getting vaccinated, people want to go out to eat again, but not many new restaurants opened over the past year—

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>
> **John Bellows**

many closed for good. That will lead to a demand-supply imbalance that may push up prices in the next few months. What comes after that is harder, and likely to be more consequential. It is not obvious that inflation will be sustained at that high level. To the contrary, it seems more likely that it will fall back down after a temporary surge. If you think about the US economy pre-pandemic, the US unemployment rate was low—3.5% in December 2019. Growth was okay and fiscal policy was easy. The US administration at the time had just enacted a big tax cut. Yet the headwinds from debt and from demographics, and importantly from technology, all put downward pressure on inflation. Those headwinds have not gone away and may reassert themselves after this year's reopening runs its course.

I think it's possible that as we go forward, the world will start to feel more like 2019, at least from a macroeconomic perspective, and that's certainly not priced into the markets. I think the market is priced for sustained higher inflation, and higher interest rates. But if the anticipated inflation surge over the next three to six months is not permanent and instead proves transitory, I think we can see some adjustment on both those dimensions in the market. While the US might see GDP growth of 7%–8% this year, it seems likely it will decelerate next year to maybe 3%. It would be very uncommon to have inflation continuing to accelerate when you have GDP growth decelerating that sharply.

Gene: Inflation has been on the minds of most market participants as the economy ramps up amid a combination of loose monetary policy and accommodative fiscal policy. When we look at the base effects and the recovery in commodity prices, we see that boosting headline inflation. Our view is that while inflation is going to move higher, it's unlikely to become problematic. We believe inflation will likely be pulled higher by demand, but we also think it is premature to call an end to globalized production, which has dampened longer-term inflation trends, as the profit motive remains strong.

On interest rates, it is pretty clear central banks remain largely accommodative but are also keenly aware of the downside risks and also the risks of policy errors. The crisis measures policymakers have taken supported the recovery and kept liquidity flowing. Our expectation is for fiscal stimulus to continue to support economic activity, and that outweighs persistent regional divergences and concerns about inflation. Focusing on the medium-term growth outlook and with inflation unlikely to be problematic, we maintain an optimistic stance toward riskier assets. That's our takeaway when we look at the growth story, which is strong, and interest rates, which central banks are keeping low.

Francis: The consensus view is there is going to be at least a transitory pickup in inflation, and the surprise could be perhaps higher inflation than people are expecting. The global supply chain was damaged by the pandemic and related lockdowns—the problem is it could get worse before it gets better as the world reopens. Inventories are low. We know there are order backlogs, commodity prices are up, and the breakeven inflation rates have risen higher now, in some respects, than at any time since the global financial crisis.

From a bond market point of view, a lot of investors have embraced the view the economy is going to be strong this year. And as a result, inflation is going to pick up for a while. Treasury yields have basically normalized back to pre-pandemic levels, and US bonds look attractive for foreign investors with the Fed likely to keep hedging costs next to zero. So it would not be a surprise to see the market stabilize near current levels for some time; obviously, if there's a setback in the pandemic, yields likely would move lower again.

The long-term inflation outlook really cuts to the heart of the credibility of the Fed's new approach to achieving its inflation goal. I think to answer the question about where the long-term inflation outlook is, one of the important elements to consider is what happens to the US stimulus payments. One possibility is that people start to relax as the pandemic dies down, and they release some of those cash holdings and start to spend the money.

Under that scenario, I'd say there's a pretty good chance the US dollar weakens and then the Fed would realize

its inflation target. I think a lot of the inflation outlook really speaks to the credibility of the Fed's new approach to achieving its mandate. I don't think we can have great certainty right now on the long-term inflation outlook. However, I do think we have to monitor what happens to savings, and the demand for dollar liquidity.

Sonal: I see three factors involved in the inflation equation. The first is that at no point in the last 30 years has the US federal government increased debt by over 30% of GDP in a two-year period, and that's even before Biden's new infrastructure bill is brought into the equation. It's an unprecedented onslaught of fiscal stimulus for an economy that has already demonstrated its ability to rebound. Number two, of course, is the Fed itself. The current round of quantitative easing (QE) is larger than QE1, QE2, and QE3 combined. The Fed has communicated it is not planning on pulling back in terms of policy accommodation regardless of the magnitude of fiscal stimulus and will let inflation run "hot" above target for some time. And third, we have vaccines, which are key to a resumption in more normal consumer behavior and broad economic reopenings.

Any one of these three factors would justify current market pricing of inflation, in my view. Currently, we have all three. Since what we're seeing in terms of policy is different from anything we've seen in 30 years, it wouldn't surprise me if we saw an outcome on the inflation front that was also different from what we've seen in the last 30 years. I'm not talking about runaway inflation in the high single digits, but it's quite feasible to see five years of inflation exceeding the Fed's 2% target on average. We see a broad-based V-shaped economic recovery, which implies commodity prices are also well-supported and could translate into a continuation of the rising input costs we've seen since the recovery started.

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>
> **Gene Podkaminer**

The Fed has said inflation is transient, but what is transient? Is it two months? Three months? Is it a few quarters? Is it a few years? I think that's where the question really comes in, and I'm more inclined to think that transient inflation might last a bit longer than many market observers are currently anticipating. Also, the view that higher inflation will be a transitory phenomenon hinges importantly on the assumption that inflation expectations will remain anchored; but, when inflation moves clearly above the 2% target and the Fed keeps a loose monetary stance, as it has committed to do, will inflation expectations really remain anchored? I wouldn't be so sure; this is an important shift in the monetary policy paradigm.

Gene: The Fed plots out its expectations for interest rates going forward. It is pretty clear to me that the Fed and other central bankers have communicated a willingness to raise rates in the future, but should those expectations be pulled forward? We don't think so. We think that the economy still has a way to go before it is really necessary to tighten monetary policy. Interest rates probably won't rise until the end of 2022, or potentially beyond. What does this mean for the environment for fixed income? The amount of stimulus that has been injected into the global economy is truly staggering. It is beyond anything that we've seen over the last several decades, and we need to appreciate what that stimulus is going to do to portfolios.

Sonal: I want to note that I do not anticipate a constant acceleration of inflation, but I do see inflation staying at a slightly higher level than it has been over the past decade. And I would agree that, of course, we're not going to get 15% of GDP fiscal stimulus year after year, but the impact of fiscal stimulus doesn't go away immediately. It's not as if the government is actually going to be retiring debt, so we will have a fiscal overhang along with a monetary overhang. I feel the impact on prices and economic activity might be a little more sustained than just a couple of years.

Francis: Sonal is absolutely correct—we've never had fiscal policy in the United States like this, but we have had it in other countries. China went into the global financial crisis with a consolidated government balance of zero. And if you look at the consolidated budget deficit today in China, it's closer to –15%. Japan has been running an average fiscal deficit for the last 20 years of about 6% or 7%. Now the United States is moving in this direction.

It is also important to keep in mind going into this pandemic, the buzzword was secular stagnation. We were dealing with the forces of demographics depressing aggregate demand, and technology and globalization boosting aggregate supply. All these factors were working to contain inflation. In addition, the Fed was worried about raising interest rates too soon. Now we're moving into an environment where fiscal policy in the United States is joining the rest of the world, so you would expect inflation to be a little bit higher on a trend basis than what it otherwise would have been. How much higher, I guess, remains to be seen. We are looking for transitory inflation and then we'll see what comes afterward.

Sonal: I would add a couple of things here. First, I never agreed with the idea of secular stagnation in the first place. For example, aging populations typically depress supply more than demand, which does not work to contain inflation; and now, some of the factors mentioned by secular-stagnation advocates have already moved into reverse, for example, globalization. Second, I don't think that Japan is a relevant comparison for the current US fiscal policy experiment—Japan's economy was plagued by zombie corporates and a hobbled financial system, and indeed, loose fiscal policy in Japan failed to boost not just inflation but also growth. In the United States, we now see a gigantic fiscal stimulus unleashed on a healthy economy and a healthy financial system, and the consensus expectation is that this will give a major boost to growth—quite a different picture, with very different implications for inflation.

Duration

Stephen: What are your thoughts on duration within portfolios and the need to build diversified portfolios?

John: We think it remains crucial for investors to construct diversified portfolios, because in our view, diversified portfolios potentially can deliver a more attractive return and volatility profile. Similarly, investors that have diversifying positions in their portfolios typically can afford to be more assertive in the sizing and pursuit of their risk positions, thereby potentially leading to higher long-term returns.

Diversified portfolios are built from assets that are negatively correlated. We think that interest-rate risk (duration) remains the most reliably negatively correlated asset for spread sectors (e.g. corporate credit, structured credit and emerging markets). The negative correlation follows from the flight-to-safety behavior of investors who demand safe assets during times of market stress. It also follows from the behavior of the Fed, which is explicitly committed to supporting the economy during periods of contraction by lowering interest rates. We think these fundamental drivers of the negative correlation will remain in place, even at low yield levels. And accordingly, we think duration will remain an important part of investors' portfolios.

Sonal: At this point of the economic cycle, we are not very inclined to extend duration in our portfolios, but I do think, in principle, that is exactly the right thing to do. While the increase in yields has exceeded even our ahead-of-consensus expectations, I think risks remain skewed toward a further above-consensus rise and more steepening of the yield curve to come, so limiting duration exposure remains a key element of our investment strategy. While nominal GDP still lags its pre-COVID-19 trend growth path, in real terms we are set to exceed where we were pre-crisis in the second quarter. If I look at the real GDP growth path, I believe US Treasuries can go somewhat higher than where they are right now. So I would say "yes" in terms of the concept of adding some duration to offset spread risk, but not quite yet, because I think there is more steepening to come. We are still slightly optimistic about the outlook for risk assets and would favor shorter-duration assets with relatively less sensitivity to rising rates. We do favor a somewhat longer duration profile in Europe, as we see less inflation and interest-rate risk there than in the United States.

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>
> **Sonal Desai**

Currency

Stephen: What are your teams' views on the dollar?

Gene: We ask ourselves, how does the flow of fiscal stimulus from some of the advanced economies in North America and in Northern Europe impact emerging markets and other regions, be it through emerging market debt (EMD) or terms of trade? All these things are wrapped up into the currency decision. It is a very challenging question to understand how the different policies of different countries match up and then ultimately how that gets transmitted into their currencies. My impression is the United States would be perfectly happy with a weaker dollar. I think Europe would also be happier with a weaker euro. However, as the pace of global growth accelerates in other regions, and the differential to the US narrows, we may see the dollar depreciate.

Sonal: On the issue of the US dollar, I would just note that there are two competing tensions. If what dominates is the impact of fiscal easing, then I think the dollar deteriorates. But if what dominates is the growth differentials, with the US growth being very, very strong, then I think that will mitigate, to some extent, dollar weakness.

Francis: The long-term inflation outlook really cuts to the heart of the credibility of the Fed's new approach to achieving its inflation goal, and I think for the Fed to achieve its inflation goals on a longer-term basis, the US dollar needs to go lower. The dollar is only a few percentage points below where it was pre-pandemic, despite this multi-trillion-dollar expansion in the Fed's balance sheet. That stability, relative to the amount of money that's been printed, suggests there's a big demand for dollar liquidity, which we associate with this spike in the savings rate and the big increase in the money supply figures. Trillions of dollars of cash have been saved up by household and business.

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>
> **Michael Hasenstab**

Michael: We expect weakness in the euro and US dollar on excessive fiscal and monetary policies, against currencies in countries with strong trade dynamics, current account surpluses, better fiscal management and stronger growth potential, notably in Asia. Much of the advanced world is running deficits that are unequalled since the post-World War II reconstruction era, with governments deploying record levels of fiscal support. Widening income inequality and economic damage from the pandemic will likely necessitate additional fiscal spending and ongoing monetary accommodation, increasing longer-term structural risks and weakening the dollar and the euro. We expect the euro to weaken against the dollar on negative rates in the euro area and greater headwinds to growth and reflation efforts across Europe. However, countries that have managed their fiscal policy, debt levels and monetary policy more effectively, and that have good trade dynamics, resilient growth drivers and current account surpluses are poised to see currency appreciation against the US dollar. We're seeing a number of attractively valued currencies in Asia, including the Chinese yuan, South Korean won and Indonesian rupiah, as well as in Northern Europe against the euro, such as the Norwegian krone and Swedish krona.

Opportunities in fixed income

Stephen: Where do you see opportunities within the fixed income market and how do they impact your allocation decisions?

John: We think it makes sense to be exposed to credit risk, both in the United States and globally—and that means overweights in US corporate credit. We've rotated a little into below investment-grade in bank loans as well, but the emphasis is having exposure to corporate credit to benefit from the return to economic normalcy. I think emerging markets also deserve some consideration. Some emerging markets are recovering better than others, but if we are right in our views on global growth continuing to recover, eventually we think that recovery makes its way into emerging markets. We also think it is important to have some diversification. It is very rare that recoveries proceed in straight lines. Thus to keep the volatility of a portfolio low and manageable, we look for negatively correlated assets or assets that are negatively correlated to risk positions. We think US Treasuries remain the best candidate for that; US Treasury yields have been rising in what has broadly been a risk-on environment.

Francis: So as this year has unfolded, the macro story speaks to declining economic risk, which implies going further out on the limb of risk in the corporate bond space. The credit team at Brandywine Global is finding lots of opportunity in high yield. If we look at the emerging markets, it's really interesting what has happened in the asset class.

Interest rates or bond yields in the emerging markets include a solvency risk premium as well as a duration component. The backup in yields that we've seen in the Treasury market has played out in a lot of emerging markets too. The risk premium has not deteriorated at all in respect to the improvement in the global economy. But we've seen some backup in yields as a result of the rise in what's considered the global risk-free yield (the US Treasury), which we think is creating more opportunity in some of these markets. The big call, I think, is on the US dollar. If the Fed truly intends to be successful in achieving its inflation goal—which is an average inflation rate of 2%—we don't think that can happen without another leg down on the dollar, which would really play to a non-dollar exposure in global fixed income.

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> **Francis Scotland**

Sonal: We also continue to see value in corporate high yield, despite the tightening spreads, in large part because of the continued importance of income. In the current environment, as Francis noted, you do need to go down the credit spectrum a bit to try and find that value in high yield, which we continue to do. We think, however, that investors must be very opportunistic; we are seeing value even all the way down to the single Bs and even some CCC-rated bonds, but one needs to be very selective. Because of the underlying strength in the economy, we don't see a big pickup in defaults this year. And that is important from a credit perspective. We do see the US Treasury yield curve steepening further for what I would consider as benign growth reasons, so we remain shorter duration in our portfolios.

In term of corporate bonds, we have opportunistically gone into and out of sectors that have COVID-19 exposure and have been beaten up a lot. There are some areas that are complicated, such as health care. However, we have found opportunities there as well. It is extremely important to do the individual corporate-by-corporate analysis, and that is something our credit team takes very seriously. And I would also note that otherwise more broadly, we are looking to position ourselves somewhat defensively. Clearly for all the reasons that have been stated, you want the yield, but on the other hand, we recognize that spreads have come in quite a lot.

We also continue to like municipal bonds, despite the richening of the asset class with record inflows so far this year. Again, it is a combination of very good fundamentals—muni credit quality really didn't deteriorate though the whole of last year—combined with the massive federal support between the different support packages going toward state and local governments. All of that is positive. And finally, if we're looking at the tax-exempt space, clearly taxes in the United States are likely to go up. So from an individual investor perspective, I think munis can continue to be a very attractive space.

We continue to like emerging market debt too, given the strengthening macro backdrop. In contrast to the 2013 "Taper Tantrum," the largest issuers' external positions now are healthier and the pandemic has, in many cases, led to stronger current account balances. Emerging market assets continue to look pretty attractive to us, given the stronger outlook for the global economy and the reflationary benefits this will bring in terms of balance sheet repair for most emerging market countries.

Implications for asset allocation

Stephen: Gene, how are you positioning the asset allocation in your portfolios?

Gene: We believe it is important to have assets in a portfolio that provide diversification against the eventuality that there might be low growth or high inflation expectations—that things may play out differently. When we look at the way we put together equities, fixed income and some of the alternative assets, we find it useful to challenge our base assumptions about portfolio construction and ensure that we have assets in the portfolio that provide inflation protection, for example, in addition to those geared strictly at economic growth.

We still remain moderately bullish equities. Equities require a sustained economic recovery to offset the anticipated normalization of valuations. However, as vaccines roll out, there's great hope of accelerating economic activity globally, although this may be largely built into investors' expectations. With fixed income, we're moderately bearish, and that reflects long-term valuation concerns, even as term premiums have risen. Corporate bond spreads have become compressed, but central bank support is unlikely to end anytime soon. There's a very strong temptation to load up on equities—especially in an environment like we're seeing now—and completely ignore fixed income, given what we've discussed about the future of interest-rate movements. Loading up on equities would ignore the very real diversification and risk reduction benefits that bonds, especially high-grade bonds such as US Treasuries, provide in a portfolio.

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>
> **Gene Podkaminer**

When we look at the correlation of different types of fixed income to equities, it looks very clear to us that those types of fixed income that contain equity-factor exposures, like high yield or loans, or even some emerging market

debt, are more highly correlated with the equities in a multi-asset portfolio. If we want to maximize diversification and minimize risks, we need to be conscious about investing too heavily into spread products. Many investors shy away from the low-yielding and potentially poor-returning government bonds, and instead flock to high yield. However, there's a substantial dose of equity exposure embedded in those products and looking at the portfolio through a factor lens is really helpful in understanding that.

By understanding the relative importance of growth, inflation and interest-rate policy, and when we combine those with factors that are specific for equity and fixed income, we are able to budget how much risk our portfolios ought to take.

Stephen: John, we all learn that as Treasury interest rates go up, bonds go down and vice versa. Can you update us on why that's not the complete picture when it comes to investing in bonds?

John: It's important to consider income when evaluating the role of bonds in a portfolio. Income can be a steady and reliable source of returns. It can also be a diversifying source of returns for portfolios that are more dependent on price volatility.

In the current environment, bonds provide income from two separate sources: first, the additional yield of a bond over comparable Treasury securities (i.e., "the spread"); second, the upward-sloping yield curve. Note that both sources can generate returns even in a rising rate environment. As we saw repeatedly during the last Fed rate hiking cycle, if yields are rising gradually, or if yields are rising as expected, the income from those two sources can be powerful enough to offset any price depreciation, so that a bond portfolio can have positive total returns even as yields rise.

Returning to a theme we touched on earlier, it's also important to remember the negative correlation of duration and spread sectors. If bond yields are going up because the economic outlook is more favorable, then it is likely the case that corporate credit risks are declining at the same time. In this case, we could potentially see some spread-tightening in corporate and structured credit, which would provide yet another source of returns to offset price declines due to rising yields.

Many investors wrongly associate rising yields with negative returns in bonds. They are likely underestimating the importance of income, and they are possibly also forgetting about the negative correlation and potential spread tightening. A more complete analysis, one that incorporates at least those two factors, would likely come to a different conclusion.

Notes

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All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds adjust to a rise in interest rates, the share price may decline. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Interest rate movements may affect the share price and yield. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed. Because municipal bonds are sensitive to interest rate movements, a municipal bond portfolio's yield and value will fluctuate with market conditions. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value.

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