Investment Team Update

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Notes on Global Fixed Income Investing

PERSPECTIVE FROM TEMPLETON GLOBAL MACRO

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EXECUTIVE SUMMARY

- Global growth and the US economy appear to be in a bit of a slowdown, but we're not at the end of the economic cycle, in our view. It's slower growth in the US, but not a contraction. We don't see the economic conditions for a major recession, barring some major financial market event.
- The US economy is clearly later in the cycle at this point, but it hasn't reached a state of massive overcapacity because there hasn't been substantial overinvestment. Fundamentally, the US labor market remains exceptionally strong, both cyclically and structurally. It's beyond full employment.
- In our view, reckless fiscal policy, higher wages, tight labor markets and above-potential US growth all point in the direction of higher inflation and ultimately higher US Treasury yields.
- China's role in the world is going through a sea change. Emerging markets are increasingly turning to China for financial support, swap lines and trade agreements to fill the void left by the US turning inward.
- On the economic front, China appears to have the fiscal levers to prevent a deep economic slowdown, unless there is an exogenous financial shock. It has the tools to manage its capital accounts, its exchange rate, its banking system and ultimately its economic growth.
- Economic activity in Europe is slowing. At the same time, the euro area is contending with political discord—rising nationalism, rising populism and simmering frustrations over immigration policy.
- The eurozone is more vulnerable to a financial event today than it was eight years ago. Several structural issues still remain unresolved, and the political environment has only deteriorated. In our view, Europe's vulnerabilities are greater than what the exchange rate currently reflects. We expect the euro to weaken against the US dollar in upcoming quarters.
- The investment prospects in emerging markets are increasingly becoming more about individual country dynamics, rather than a single economic driver binding them together. As investors, differentiation among the countries means less correlation, more opportunities for individual country alpha and more opportunities beyond broad market beta.
- In 2018, we had some hot spots flare up in emerging markets, particularly in Latin America. Now in 2019, not only has regional volatility in Latin America diminished, it has been replaced by broad rallies across the asset classes and sharp appreciations in the exchange rates. Ironically, as much of the world descends into greater populist dysfunction and polarized political landscapes, areas in Latin America are moving in a much healthier political direction.
- Argentina has particularly impressed us with its commitment to orthodox policy. The government passed a bipartisan budget, targeting a primary fiscal surplus that looks like it will be achieved. We believe the government has the right set of talented technocrats in place, along with strong support from the International Monetary Fund (IMF). We continue to have a positive longer-term outlook for Argentina.
- In Brazil, the new government is taking form. The economic team is looking to correct the past model, which was based on extensive state intervention, by shifting the structural economy back toward private sector markets, more transparency, more efficiency and reduced corruption. Brazil's outlook continues to look promising, as the country continues to trend toward unlocking economic potential.
- One of the most important periods of 2018 was the month of October. When interest rates rose, it triggered selloffs in risk assets. Consequently, the notion that an investor could diversify an equity portfolio with long duration bonds in the current market environment was dispelled. The events of October emphasized the need to build a portfolio with idiosyncratic allocations—customized investment ideas that are not correlated to broad market beta.

Global Growth and Protectionist Risks

Global growth and the US economy appear to be in a bit of a slowdown, but we're not at the end of the economic cycle, in our view. It's slower growth in the US, but not a contraction. We don't see the economic conditions for a major recession, barring some major financial market event. The real economy is not massively overheated because we haven't had overinvestment or overcapacity develop to a point where it would need to be cleansed by a recession.

Nonetheless, trade policies have been having an effect. China accelerated its production schedule in prior quarters to get ahead of potential tariff hikes that were originally targeted for January 1. That essentially brought growth forward. But now the accelerated production is behind us, and overall production has reverted back to a lower volume. That's feeding into the global growth slowdown we're seeing.

Overall, the bigger concern is what's being set up for the future. The inability of the US to pass a budget is just one example. The discord in the UK around how to handle Brexit is another example. But these are just manifestations of a deeper problem—rising income inequality around the world that drives populist movements, resulting in populist policies that promise a lot in the short term but build up a lot of debt and don't solve the longer-term issues. Those populist impulses are feeding into external trade frictions between the US and China. Populism is leading to fragmentation around the world, as countries turn inward. That makes it increasingly difficult for countries and central banks to come together to respond to a global financial shock. It's going to be much more difficult to achieve the same kind of coordinated policy responses around the world that enabled us to get through the global financial crisis in 2008–2009. Inward-looking political regimes, trade frictions, nationalism, populism and divided governments all make good governance increasingly difficult.

The US Economy and Fed Policy

The US economy is clearly later in the cycle at this point, but it hasn't reached a state of massive overcapacity because there hasn't been substantial overinvestment. There is a slowing, but not an imminent collapse, in our view. Fundamentally, the US labor market remains exceptionally strong, both cyclically and structurally. It's beyond full employment, while at the same time both legal and illegal immigration have been restricted by the current administration. Consequently, wages continue to trend higher. We expect inflation to trend higher as well. Tariffs and trade policy should also continue to add to structural price pressures, in our view.

At the same time, the fiscal deficit is getting larger as both political parties appear eager to spend more money and deal with problems later. As the deficits trend higher, the US Treasury has to fund more and more debt. Meanwhile, the Fed is no longer buying US Treasuries and China is no longer buying as well, so yields get pushed higher to find new clearing levels. In our view, reckless fiscal policy, higher wages, tight labor markets and above-potential US growth all point in the direction of higher inflation and ultimately higher US Treasury yields. The danger is that the Fed now appears inclined to delay the normalization of rates. That delay perpetuates asset price distortions, in our opinion, and allows them to continue to build. That puts markets at a greater risk for more volatile corrections when we eventually get to the end of the cycle. We think the Fed needs to stay on course with policy normalization.

China's Role in the World

China's role in the world is going through a sea change. Part of that is being driven by US protectionism, and the economic vacuums it creates in Latin America, Africa and Asia. China is filling those gaps—we're seeing increasing influence from official state and non-state investors in these markets. Emerging markets are increasingly turning to China for financial support, swap lines and trade agreements to fill the void. Notably, central bank swap lines with China are growing. It was probably inevitable that China's economic influence in the world was going to trend higher, but the US turning inward has accelerated that pace.

On the economic front, China appears to have the fiscal levers to prevent a deep economic slowdown, unless there is an exogenous financial shock. It has the tools to manage its capital accounts, its exchange rate, its banking system and ultimately its economic growth. It's a highly controlled government, with highly consolidated and centralized power, and extensive influence throughout the business and non-business sectors of the economy. That range of control can provide short-term economic stability. China demonstrated that capacity when it bled reserves a few years ago. The "hard-landing" scenario that investors have feared is probably not around the corner, in our assessment. However, ongoing government control of an economic system presents longer-term questions. It's never been attempted at this scale, and it's not clear whether it can work indefinitely. Those are longer-term concerns, however. In the next year or so, we expect China's economy to moderate but not collapse, barring a major external financial shock.

European Headwinds and Political Risks

Economic activity in Europe is slowing. At the same time, the euro area is contending with political discord—rising nationalism, rising populism and simmering frustrations over immigration policy. Far right and anti-establishment parties are growing in popularity, whether it be in Germany, Italy or Belgium. In France, President Emmanuel Macron's low approval ratings look like a referendum against his ongoing support for EU integration and orthodox policy. That's concerning, in our opinion. A significant level of public sentiment is shifting away from the idea of a common Europe. If there's a pullback on political coordination, it will only become harder to keep the monetary union together.

The eurozone project was essentially a political concept with economics bolted on to make it work. But the lack of a fiscal union makes the monetary union very difficult to maintain longer term. Growing fiscal imbalances are testing the political cohesion. We don't see the same political will to bail out countries with fiscal imbalances like there was during the credit crises in 2011. That makes the eurozone more vulnerable to a financial event today than it was eight years ago, in our view. Several structural issues still remain unresolved, and the political environment has only deteriorated. In our view, Europe's vulnerabilities are greater than what the exchange rate currently reflects. We expect the euro to weaken against the US dollar in upcoming quarters.

Idiosyncratic Opportunities Across Emerging Markets

The investment prospects in emerging markets are increasingly becoming more about individual country dynamics, rather than a single economic driver binding them together. The old thesis was that a strong China would pull all emerging markets higher, and a rollover in China would drive them all down. But that's no longer the case. The drivers are more internal to each country—the state of fiscal policy, business policy, trade policy, social policy, etc. Those factors drive financial market returns and economic activity throughout emerging markets. We look for countries that are going through positive structural transformations, while avoiding countries where policy is deteriorating. It's a test of whether a country can stay the course by rejecting short-sighted populist policies in favor of longer-term visions. Countries that have been able to stick to that path have often been able to stand firm against the "risk-off" cycles across the asset class. As investors, differentiation among the countries means less correlation, more opportunities for individual country alpha and more opportunities beyond broad market beta.

Latin America: Argentina and Brazil

In 2018, we had some hot spots flare up in emerging markets, particularly in Latin America. Part of that was driven by elections in Brazil, Colombia and Mexico, and part of that was related to broad risk aversion across emerging markets in August. We also had a partial crisis develop in Argentina driven by speculative attacks and misinformation on funding concerns. But Argentina's exchange rate and financial markets stabilized by the end of the year. Now in 2019, not only has regional volatility in Latin America diminished, it has been replaced by broad rallies across the asset classes and sharp appreciations in the exchange rates. Ironically, as much of the world descends into greater populist dysfunction and polarized political landscapes, areas in Latin America are moving in a much healthier political direction. Countries like Argentina and Brazil have endured bad economic policy in recent decades and seem determined not to repeat those mistakes. We're seeing steadfast commitments to orthodox economic policy in those countries. It's become harder to find that kind of policy discipline around the world.

Argentina has particularly impressed us with its commitment to orthodox policy. The government passed a bipartisan budget, targeting a primary fiscal surplus that looks like it will be achieved. It's been a long time since Argentina ran a primary fiscal surplus. Notably, all these reforms are being done by an administration that faces an election this year. These are tough economic decisions that can be politically risky—in fact, they forced a recession. Nonetheless, these are the right policies for the long-term growth of the country and the long-term health of the economy. It's a commitment to the longer-term economic restoration of the country. Ultimately, that should be rewarded, but it does require some political courage and some political risk in the near term.

Fortunately, the shift toward orthodox policy has largely gained support across much of political landscape in Argentina. It goes beyond President Mauricio Macri. Opposition politicians that have advocated something extreme or unorthodox have not been polling well, despite the economic slowdown. That's an encouraging sign. We believe the government has the right set of talented technocrats in place, along with strong support from the IMF. We continue to have a positive longer-term outlook for Argentina.

In Brazil, the new government is taking form. The most telling signs come from the economic team that President Jair Bolsonaro is putting in place. These are highly trained economists. They're looking to correct the past model, which was based on extensive state intervention, by shifting the structural economy back toward private sector markets, more transparency, more efficiency and reduced corruption. We expect to see key economic legislation get passed in the upcoming term. Pension reform remains at the top of the list and is still achievable. If that happens, it will set Brazil on a much stronger trajectory—an improving debt dynamic instead of ongoing deterioration. Brazil's outlook continues to look promising, in our view, as the country continues to trend toward unlocking economic potential.

Asset Class Correlations and Embedded Interest-Rate Risks

The last 10 years have seen a pretty unique period of financial returns. We don't think investors should get too accustomed to those dynamics always existing. Interest rates and inflation aren't always going to be low. Bonds and stocks don't always make money at the same time. When we look at the changing social, political and economic landscape, we think it's pretty clear that the next 10 years aren't going to be like the last 10 years.

One of the most important periods of 2018 was the month of October. Correlations and portfolio diversifications were tested. When interest rates rose, it triggered selloffs in risk assets. Consequently, the notion that an investor could diversify an equity portfolio with long duration bonds in the current market environment was dispelled. In broad terms, the simultaneous declines in both bonds and equities in October highlighted the need for active management. The events also emphasized the need to build a portfolio with idiosyncratic allocations—customized investment ideas that are not correlated to broad market beta. It's easy to get market beta through passive strategies these days. But October proved it's a lot harder to get alpha. Overall, there is a lot of interest-rate risk embedded in general investment portfolios beyond US Treasury holdings. It's present throughout fixed income, as well as equities. That makes it highly important to avoid complacency on interest-rate risk—it's present throughout the asset classes.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size, lesser liquidity and lack of established legal, political, business, and social frameworks to support securities markets. Derivatives, including currency management strategies, involve costs and can create economic leverage in a portfolio, which may result in significant volatility and cause the portfolio to participate in losses (as well as enable gains) on an amount that exceeds the portfolio's initial investment.

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