Quick thoughts
Why our managers disagree on inflation, rates, and growth

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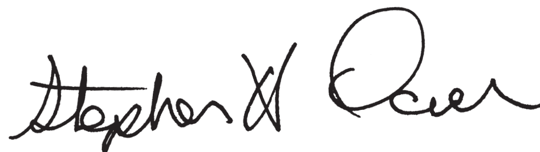
As the world's economic engine revs faster, what can we expect ahead for interest rates and inflation? A recent global macroeconomic investment roundtable with three of our autonomous investment managers found commonalities and disagreements on the path for global economic growth, inflation, and interest rates. Their outlooks also impact how they make allocation decisions. The roundtable participants were: John Bellows, Ph.D., Western Asset Portfolio Manager; Sonal Desai, Ph.D., Chief Investment Officer of Franklin Templeton Fixed Income; and Francis Scotland, Director of Global Macro Research at Brandywine Global. They agreed that global growth will accelerate in 2021, but have disagreements over future growth and inflation, and interest rates and the use of duration in portfolios. Key points include:

- All three of our panelists believe global growth will be significant this year, but there is some disagreement as to how persistent and where that growth will be in future years.
- All panelists agree we will see elevated inflation levels this year.
- Our panel had the greatest disagreement over whether inflation will be cyclical or secular going forward and whether interest rates will therefore rise beyond what is currently priced into the market.
- The panelists agreed that higher-yielding corporate bonds and emerging market debt could benefit from economic growth, offer near-term investment opportunities, and mitigate the effects of rising yields.
- There was some disagreement about whether to use Treasuries and duration as ballast in a portfolio.
- When thinking about fixed income investing, it is important to think beyond rising interest rates and focus on the many ways to get total return, including spreads-tightening.

See an excerpt from the roundtable, on the following pages.



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

John **We're quite constructive on the outlook here in the United States and really for the globe.** We're in a period where we are returning to economic normalcy, and that return to economic normalcy is a really powerful force that's going to drive above-trend growth rates. And those above-trend growth rates are really quite significant. They improve balance sheets, they improve incomes, and they improve revenues, and so as that returns, economic normalcy supports above-trend growth again in the United States and around the world, a lot of really good things are happening to corporations, to businesses, and to individuals. So, we're really quite constructive on the outlook.

Sonal **The type of growth we're going to see this year is, dare I say it, Chinese in nature, likely. We're going to look at high single digits in this year in the United States.** Beyond this year, I don't see a rapid drop-off to those 2%, 2.5% levels in particular, in light of the level of sustained stimulus that we're seeing in the US economy. And I think it's really interesting—at this time last year, people were talking about "Ls", the Great Depression, the "alphabet soup" of what the recovery would look like. And I think that what we're really seeing is very, very V-shaped. So, I believe that we're going to see strong growth for a while yet.

Francis **In our view, the current stimulus really supercharges an economy that was already rebounding from last year's lockdowns. And the March US employment report may be a whiff of what could be in store.** The script continues to rhyme with a rebound that you get after a natural disaster, not the more drawn-out recovery, then expansion in a traditional recession. And by and large, that rebound is playing out around the world, notwithstanding the timing and management of the vaccine rollouts. Global import volumes are completely recovered. PMIs are soaring. In Europe, the surprises are positive, even though they're having problems with vaccinations. Asian industrial production is surging. Here, in my country, Canada, 90% of the employment drawdown has been recovered. Australian employment is at an all-time-new high. So, it really looks like the world economy is recovering very, very strongly.

Stephen You all agree that we will see higher inflation in the short term. Do you think that inflation is short-term cyclical or long-term secular?

John **The market is now pricing in CPI inflation above 2.5%, and as high as 2.75% over the next five years.** So not just three months of higher inflation, but sustained inflation at 2.7%, 2.6% for five years. That is meaningfully above where we've been over the last 10 years and it's meaningfully above the Federal Reserve's (Fed's) targets…I think the market's priced for very optimistic outcomes on both inflation and the Fed. And, if the inflation surge that we see 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 rates market.

Francis **The consensus view is that there's going to be at least a transitory pickup in inflation, the surprise could be perhaps higher than people are expecting…**I think to answer this question about where the long-term inflation outlook is, one of the important elements is what happens to those (stimulus payment) savings. 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 with the Fed on full throttle.

Sonal **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 which was also different from what we've seen in the last 30 years.** So again, I'm not talking about inflation in the high single digits, but to say that could we see five years of the Fed more than meeting its 2% target on average? I would say that's quite possible, it's very feasible. And all of this, of course, happens at a time when we do see a V-shaped recovery, more broad-based, which implies you do have commodity prices also well-supported. So, I would say I agree, right now, the Fed indeed has said inflation is transient. 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 might last a bit longer than we are currently anticipating.

Stephen **Where do you see opportunities within the US fixed income market? How does that impact your allocation decisions? Where are you seeing opportunities in the fixed income market now, including duration positioning as a diversification strategy, and sectors?**

John **You want to be exposed to credit risk, both in the United States and globally.** So, that means overweights in US corporate credit...So we've rotated a little bit into, a little bit below investment grade in bank loans as well, but really the emphasis is having exposure to corporate credit to benefit from that return to economic normalcy. I think emerging markets also deserve a comment. Emerging markets have perhaps recovered less, but if we're right on global growth continuing to recover, eventually we think that makes its way into emerging markets…We think it's really important to also have some diversification…It's very rare that recoveries proceed in straight lines. And so, in order to keep the volatility of the portfolio low and manageable, you want to look for negatively correlated assets or assets that are negatively correlated to those 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.

Stephen **John, a follow up question. You push back on what you see as the misperception that rising rates are bad for bond portfolios. So, we've all learned that simple Treasury interest rates go up, bonds go down, back, and forth. Can you update us on your thinking on why that is not a complete way to look at bonds?**

John **When you think about the role of bonds in portfolios, a lot of it is about income.** Income is a steady source of returns. It can be a diversified source of returns for portfolios that are more dependent on price volatility for returns, and that income can be really meaningful. You get income from spread, you get income from the upward-sloping yield curve. And so, even if prices go down because yields rise a little bit in bonds, you still have that income as a source of returns. And in a lot of environments, yields are rising gradually, or yields are rising as expected, because the forward yield curve is upward sloping. That income will still generate enough return to actually give you a positive score on your bond portfolio. So, you have to remember, bonds are as much about income as they are

about price volatility…If bond yields are going up because, generally speaking, the economic outlook is more favorable and it's affecting Treasury yields, and it's likely the case that those corporate credit risks are actually declining. And so, you can get some spread-tightening there which is offsetting what might be happening in Treasury. So, I'd start with the income observation that ends up being a very important source of return in any bond portfolio and can, in a lot of environments, be more important than the price volatility. And then second, I would look at the negative correlation. We've been in periods where negative prices on Treasury bonds can correspond to positive total return on bond funds because the credit is improving at the same time.

Francis **So as this year has unfolded, the macro story speaks to declining economic risk, which speaks to a play of going further out in the level 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's happened there…Interest rates or bond yields in the emerging markets include a solvency risk premium as well as a duration component. The backup that we've seen in the Treasury market—Treasury yields over the last year—has played out in a lot of emerging markets, too. So, the risk premium has not deteriorated at all in respect of the improvement in the global economy. But we've seen some backup in yields as a result of the rise in the global risk-free yield, which is the Treasury creating, we think, more opportunity in some of these markets. The big call, I think, is on the US dollar. As I said in some of my remarks, 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.

Stephen **The weighting of bonds in the high-yield index is composed of, obviously by definition, the companies that need the debt the most which might not be the better investments. Where do you see opportunity, specifically in high yield now?**

Sonal **So, we have opportunistically gone in and gone in and out of sectors which we look at for having COVID-19 exposure, which got beaten up a lot.** There are areas which are complicated, such as health care. However, we have found opportunities there as well. It's extremely important to do the individual corporate-by-corporate study, and that is something which our 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 which have been stated, you want the yield, but on the other hand, we recognize that spreads have come in quite a lot.

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