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Global Economic Growth Will Be "Sturdy but Unspectacular," Potentially Enhanced by U.S. Boost Under Trump Administration

Western Asset CIO Says Spread Sectors Will Again be Top Opportunities for Fixed Income Investors in 2017

(Pasadena, CA, January 23, 2017) – Proclaiming that "our best case is that we're looking at sturdy but unspectacular global growth," Western Asset Management Chief Investment Officer Kenneth Leech headlined his quarterly webcast with optimism tempered by downside risk.

"There are asymmetric upside growth prospects in the U.S.," Mr. Leech said. "Markets reacted to those pretty aggressively. The other point is downside risk, always something to protect against. If there is a downside risk in the global growth picture, it would emanate from China."

"I think the uncertainty principle needs to be applied in a very healthy dose here."

The full Western Asset webcast, "01/12/17: Market and Strategy Update with CIO Ken Leech," with accompanying PowerPoint slides, can be accessed via this link:
http://www.westernasset.com/us/en/research/viewwebcasts.cfm?mvar=011217

The global economic recovery continues a "slow but steady" recovery, in Western Asset's view.

"The good news is that global inflation has stopped declining," Mr. Leech reported. "We think U.S. growth and inflation are going to rise with fiscal stimulus. On the other side, central banks – which have been a big force in this global recovery – are becoming a little less accommodative."

"But because policy continues to be accommodative around most of the world, and it's a global marketplace, government bonds will continue to be underpinned by low policy rates. So we do not see the huge surge in interest rates that perhaps some others do."

This will have practical impacts for investors on U.S. and global fixed income markets.

"In this environment, it's going to be tougher to make money in the spread products sectors," Mr. Leech said. "Although our position sizes are much smaller than they were last year, spread products should probably outperform U.S. Treasury and sovereign bonds. That's still our base case. When it comes to spread products though, issue selection, and sector rotation are going to be crucial. It's not going to be a wave of spread product yield spread normalization, like last year."

As for U.S. rates, Western Asset believes they already reflect growth and optimism.

“We have some modest overweights to duration,” Mr. Leech said. “We believe the market is too optimistic about how things are going to play out. We do respect that could be a misjudgment on our part, the upside risk to U.S. growth. We need to be attentive to how fiscal policy changes.”

On the other hand, Mr. Leech said that portfolios must have protection against downside risks.

“Part of our program is not to fully hedge out our lower rated credits and high-yield. If rates were straightforwardly going up, you would not do as well as if you fully hedge them out. But in these risk-off periods, that can be very challenging. You can lose money on both sides if you have short Treasury positions against long, lower quality, higher yielding positions. Some of our duration overweight – I’d call it a soft duration – is actually an underhedged weaker credit.”

“We need to do that because there is, and continues to be, the possibility that we could have a risk-off environment. If that were to happen, the most likely culprit would be the imbalances we see in China and the policy prescriptions that they’re going to have to take in response to that.”

When considering sectors for opportunity, Mr. Leech started with corporate bonds.

“Investment grade corporates have tightened of 37 basis points,” he said. “We think it’s more an income story, more of a positioning story. You have to be more cautious about your overweight. We cut our overweights across our spread products because the valuations are not as powerful and not as attractive as they were last year. But if interest deductibility actually does pass, you’re going to have a much different environment when it comes to the corporate finance.”

“The sectors we are in are metals, and mining and energy. We have been big believers in the banking sector, but the election of Donald Trump helped that process along: a better economy, the possibility of higher short-term rates, the possibility of losing regulations, all bode well for banking. Subordinated bonds could be a particularly attractive sector.”

Western Asset also believes that despite recent tightenings, a case can be made for high yield.

“There was a real fear that high-yield defaults were going to move up on a sustained basis,” Mr. Leech said. “Now predicted high yield defaults fall again. We expect better earnings in 2017. Part of that is the energy story coming back, but prospects for corporate tax reform are also straightforwardly positive for corporate earnings after tax. These underpin the case for high-yield credit. But our focus is more about issue selection and positioning and less about an overweight being carried by the kind of major bull market of spread normalization we saw last year.”

Considering mortgage-backed bonds, Western Asset thinks the housing market is improving.

“House prices are moving up,” Mr. Leech said. “The fundamentals in terms of people being able to afford them are very positive. Delinquencies are collapsing. If we get continued growth, let alone improvement in growth, the pent-up demand for housing can be a positive. That speaks well for the risk transfer market as well as those issues securitized by the housing market.”

With global investors thirsty for yield, Mr. Leech discussed the prospects of emerging markets.

“Despite having a terrific year, the last the part of the year was difficult for emerging markets. That is easy to understand with the election of Donald Trump, but the market’s expectation of much higher yields with fiscal policy, that U.S. rates will be raised, traditionally is very tough for emerging markets. In addition, possibilities of protectionism and border taxes can be difficult.”

“But in a world where developed market yields are low by any historical standard, the spread between emerging markets and developed continues to be near what we saw in the Financial Crisis. Those valuations are made even more compelling when you look at currencies, which have been in a bear market for the last four years. Even with last year’s sideways move, currencies relative to developed markets are still at very, very historically favorable levels.”

As for specific countries, “Russia, India, Brazil and Mexico will continue to be our favorites.”

Regarding the U.S. outlook, much will depend on the Fed, and the new administration.

“When we came into last year, the market thought the Fed was going to tighten meaningfully,” Mr. Leech said. “They were actually forecasting four tightenings. That optimism quickly gave way to pessimism as the global recovery faded. The Fed instituted a very dovish pivot.”

“With a new administration, we are looking at the possibility of all sorts of changes from a fiscal perspective. The Fed’s mandate is unemployment and inflation. Unemployment is below where they were forecasting. Inflation is starting to get into their zones, so [Fed Chair] Janet Yellen is saying is they are very close to meeting their objectives, to start this process of normalization.”

“Our thought all along has been that the Fed would look for, and take any opportunity, to inch the fund’s rate up. It really does portray the uber gradual nature of this process that they need to have the economy come in line with their forecast, which is always standard.”

The question, as always, is how fast will the Fed move?

“Uncertainty is probably higher than it would be, which is why some of the inflation expectation numbers have moved up,” Mr. Leech observed. “The market has really embraced the optimism that U.S. growth is going to get better, that fiscal policy is going to help charge growth. We think it may be too far, too fast. We need to see what really happens in these policies as they come.”

“We did take the opportunity, with inflation breakevens a little bit lower, to increase our TIPS position. We think TIPS are an important part of any portfolio, and that’s been a positive from a performance perspective. But this gradual and very constrained inflation expectation environment means that Fed policy will be moving slowly.”

Western Asset also believes U.S. governmental policy changes will take time to implement.

“The Trump proposals are not a surprise, that the Republican sweep would lead to the possibility of implementation of lower taxes,” Mr. Leech said. “Given the political vitriol, this is going be a challenging process that will take significant time. We have less optimism on infrastructure spending being passed on a bipartisan basis than on tax policy, which can be passed on a single party line. The markets have placed optimism based on this fiscal thrust, and I think rightly so.”

“But the first trade coming out of the box, when it was obvious that Trump was going to win on election night, was actually risk-off. That was based on the fear that his trade policy might be damaging. The challenges of a disruption to global trade would be pretty difficult. This is an area we have to be attentive to because the possibility of disruption of the global trade flow could be very difficult for global growth. That is a downside risk that needs to be watched carefully.”

Globally, Mr. Leech noted the surge in policy determination, which he called “really enormous.”

“There’s just unbelievable policy experimentation, between the QEs and forward guidance and negative rates,” he said. “You have to be pretty humble about knowing exactly how that’s going to turn out. Policy experimentation has unintended consequences. It has long and variable lags. You have to be thoughtful about how those things can change and how you react to them.”

“That’s particularly true as we look forward this year and we start to see policy divergence in different parts of the world. In the U.S., we obviously have the possibility of enormous policy change, not just on the economic side, but perhaps even on the foreign policy side. That’s something we’re going to have to monitor closely.”

“So while we have positions and very strong thoughts on how we want to position, we need to be mentally flexible and willing to change as circumstances warrant.”

Inflation and its potential impact on global growth also drew Mr. Leech’s attention.

“The inflation rate and global developed market inflation has finally stopped declining, and that’s a positive,” he said. “That was a big part of the fear of the downside risk last year.”

“But let’s be straightforward: this is an extraordinarily low rate of inflation. The good news is it stopped declining, but we are still on a very, very low global rate. That means we have to be thoughtful of the downside risk. Policymakers, fortunately, are very attentive to those features. You see tremendous policy accommodation coming out of Europe, and a very aggressive policy, which was revamped, coming out of Japan. That can continue to provide power for the global recovery even as the U.S. and perhaps China have to become a little less accommodative.”

Mr. Leech noted that global growth, while positive since the Financial Crisis, has been slowing.

“The reason people are thoughtful about why that growth rate has been slow by any historical standard and has had difficulty breaking out, obviously, are some of the real strong headwinds,” he said. “One we highlight is debt loads around the world, that have really been an impediment to growth. That’s still the framework we need think about the secular slow growth environment.”

“While we see optimism coming from the U.S., we think about how that’s going to play out in the context of a global environment. Global growth looks more favorable and is becoming much, much more sustainable, about 3 percent, but that’s still not a strong measure by any means.”

The reason Western Asset remains worried about the downside is the story of China.

“We need to be very attentive to their economy because it is such a big percentage of the year-to-year change in the growth rate of the global economy,” Mr. Leech explained. “The Chinese growth rate is slowing. I think the Chinese want growth to slow. That’s in a perfect world, a perfect transition that the Chinese are trying to accomplish between an export and an investment-driven economy, and one that’s going to be more consumption and export-led.”

“The challenge, of course, is this is a pretty ambitious project to transition the economy like that. There are imbalances they need to correct. Last year, as their growth rates started to really slip, there was tremendous fear that this actually could turn into a very disorderly kind of slowdown. That process culminated in the bottom of the spread product market in February of last year.”

“I’d say fear of a potential Chinese crisis or recession, in addition to the commodity price declines, led to a 20-month credit bear market. It basically meant that the credit cycle is kind of interesting. While people talk about the credit cycle in the U.S. being the same as the business cycle, what we really saw was a

bear market in the credit cycle – not because the U.S. business cycle had problems, but because the global environment was so challenged."

However, Western Asset thought fears of a Chinese or global recession were overblown.

"You really have to be thoughtful about the policy levers that China has," Mr. Leech said. "As a country, they do not have maybe some of the impediments a messy democracy has, to move macro policy levers very aggressively when needed. In late 2014 through 2015 and 2016, even as growth was slowing, policy was moving from a very accommodative level. Interest rates were being dropped. Reserve requirements were being cut. Fiscal policy was being moved into action. Deposits for home buying were also being relieved. Macro prudential policy being put into place in addition to monetary and fiscal policy. All these levers were moving very, very aggressively."

"That's why our thought was the reasonable prospect that Chinese growth not only would stabilize but would actually turn up. That is, in fact, what happened, and it helped those spread product markets have the opportunity to rebound aggressively."

Turning to Europe, Mr. Leech said it became part of the solution instead of part of the problem.

"Growth steadied last year, coming in maybe around one percent, three quarters. That is similar for this year in prospect: 1.75 percent to 2 percent growth rate, positive growth that steadied. Peripheral risk has declined. While there's certainly some challenges, specifically in the banking system, risks have been mitigated by the fact that growth in core Europe has really improved."

"Having said that, inflation remains extraordinarily low," Mr. Leech said. "That means policy will remain extremely accommodative. While there's been a lot of talk of tapering, [European Central Bank President Mario] Draghi was very clear that tapering is not a concept he would consider in terms of the ECB being ready to stop purchases. They have cut the size of those purchases, but it's an ongoing process meant to be in place as long as inflation remains low."

"The other thing that really helped last year was that the Brexit risks turned out not to be as dire as many people thought. But as we look forward in 2017, this process continues to have a lot of complications and challenges. There's an awful lot of uncertainty around the Brexit process, and there are downside risks not only for the U.K., but obviously for Europe. This is another area where the uncertainty premium needs to be pretty thoughtful as we look at growth."

That led Mr. Leech to focus on a question that does not get the day-to-day headlines.

"Demographics, the aging of societies in developed countries, is a real challenge to productivity growth," he declared. "It's one thing to have fiscal stimulus. It's another to have that translate into change in worker productivity. We have been living with those burdens the last few years."

He also sees a newer challenge coming to the fore in the deceleration of globalization.

"The political developments over the last year with some of the elections – certainly Brexit and the election of Donald Trump – portend the possibility that the process may be slowing down. Those political wins also introduced a tremendous amount of uncertainty. The ascendency of nationalism we see all over the world is powerful not only from an economic but a political perspective. That has to be watched very, very carefully. It certainly means that the financial interwoven dynamic we have all been accustomed to in the globalization process of the last 30 years has elements of risk and discontinuity in policy, which are very difficult to predict."

To Mr. Leech, this means that investors must be flexible, and willing to be reactive.

“Decisions may need to change because the possibility of these types of political changes, and some of the volatility associated with those, are probably going to happen as the year unfolds.”

This uncertainty led him to revisit China’s potential downside regarding global risks.

“Last year we were optimistic that the fear of China might be misplaced,” Mr. Leech said. “I do not want to overstate, because we are not in the China collapse or crash camp by any stretch of imagination, but the optimism that Chinese growth has become better is probably a little bit overdone. Chinese growth going forward needs to slow. The key risk is it may slow too fast.”

“The positive of the policy prescription that China put into place obviously meant that growth steadied and was terrific for the global marketplace. The consequences they now have to deal with are meaningful though. That’s why you see policy changing directions.”

“When you look at the growth of credit to GDP, it’s been explosive. That has also led to a property run-up in prices. Policy in China already is working to try and attenuate both of those, and that’s obviously having a little bit of a dampening effect.”

“More importantly, they have been losing reserves. They obviously have a tremendous stockpile, so you don’t want to overstate this in terms of any kind of calamitous event. But from the Chinese perspective this is an alarming development, one that they want to keep under control.”

The Chinese thus have clamped down very aggressively, Mr. Leech reported.

“They are continuing to clamp down on individual businesses getting money out of the country. You’ve seen capital controls instituted, being tightened, with stronger enforcement and review. You’re going to see more of the same as the Chinese try and get this problem under control.”

He also noted that the trade balance with China stands at a record almost with United States.

“That’s important because Donald Trump made that a key point of his administration,” Mr. Leech said. “How is the administration going to react to that? Is there going to be a political challenge? Even without that, the yuan has been weakening. These elements should be considered as possible risk cases, but not because we’re forecasting dire developments.”

“Our strong belief is that Chinese authorities have no interest in major devaluation of the yuan. The story line of China is that growth is good. Policy is being moved to keep growth good.”

“There’s a party congress coming later this year where a lot of the political pecking order will be decided, and there is probably no greater incentive to keep the economy on course than the political necessity going into that Congress. That’s why markets are believing that growth and policy for China are positive. Some of the problems we are mentioning may not be this year’s problems, or even next year’s problems. They are not imminent. But markets don’t always wait.”

“These challenges are growing. Imbalances are growing. The probability of a major break may be small, but the difficulty the market has with those problems are high. With the U.S. Federal Reserve poised to tighten, and the U.S. administration poised to discuss trade and foreign policy issues in a more challenging way, there is a possibility of discontinuity we need to watch.”

And yet, after analyzing a wide range of factors, Mr. Leech’s outlook was generally optimistic.

"The good news is that the global recovery is on a firmer footing certainly than last year," Mr. Leech concluded. "The downside inflation fears have abated. That's positive. Challenges to the prices have already caught up to that story. You still need to be cautious, particularly given the kind of the extraordinary nature of the policy and political changes we may be seeing."

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About Kenneth Leech
Ken Leech is Chief Investment Officer of Western Asset Management Company. He joined the firm in 1990. From 1991 to 2014, assets under management grew from just over $5 billion to $466 billion. Mr. Leech leads the Global Portfolio, US Broad Portfolio, and Macro Opportunity teams. From 2002 to 2004, he served as a member of the Treasury Borrowing Advisory Committee. In 2014, Mr. Leech and the Western Asset team were named Morningstar's US Fixed-Income Fund Manager of the Year for the Western Asset Core and Western Asset Core Plus Funds. He was inducted into the Fixed-Income Analyst Society Hall of Fame in 2007. Mr. Leech is a graduate of the University of Pennsylvania's Wharton School, where in four years he received three degrees, graduating summa cum laude.

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Founded in 1971, Western Asset Management is one of the world's leading fixed-income managers with $444.5billion in assets under management as of September 30, 2016. From offices in Pasadena, Hong Kong, London, Melbourne, New York, São Paulo, Singapore, Tokyo and Dubai, the company provides long-term, value-oriented investment services for a wide variety of global clients, across an equally wide variety of mandates. The firm is a wholly owned, independently operated subsidiary of Legg Mason, Inc. To learn more about Western Asset Management, please visit www.westernasset.com.

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