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Global Economic Growth Remains Encouraging, Yet Soft

Emerging Markets and Spread Sectors Top Opportunities for Investors in U.S. and Global Fixed Income, Says Western Asset CIO

PASADENA, JULY 19, 2017 – In a third-quarter 2017 market and strategy update webcast, Western Asset Management Chief Investment Officer Ken Leech was upbeat, emphasizing that while slow by historical standards, worldwide economic growth is improving, U.S. growth and inflation may be moderating, and central banks – the U.S. Federal Reserve (Fed) and European Central Bank (ECB) prominent among them – are signaling paths to normalization.

"Global economies are continuing to mend," Mr. Leech reported. "That is the major takeaway: we still are in a global growth upturn, even if it's soft. Core inflation remains persistently low."

"We are still a little bit surprised at how low inflation is. That suggests that this path to policy normalization that we're all talking about is going to be very, very slow. That means Treasuries and sovereigns will remain underpinned by low policy rates. We don't see any major or sharp rises in the near-term. That won't be the best opportunity set given the low rates we see there."

"Spread sectors, therefore, would continue to outperform; our bias being a little bit outside the United States than inside the U.S.; and particularly emerging [markets] as our opportunity set."

Mr. Leech was also quick to note that caution is needed, "but we remain optimists."

"Valuations in many spread sectors are a little less compelling," he said. "This is going to be probably a little bit more of a bumpy road ahead and we need to be pretty thoughtful."

A replay and the webcast's PowerPoint slides can be accessed via this link http://www.westernasset.com/us/en/research/webcasts.cfm.

For 2017, Mr. Leech said, "We moved our growth rate forecast for the first half up to 2 percent to 2.5 percent, matching the Fed's forecast. Probably still less than many market participants."

"We are thinking we may have to downgrade that forecast … The upturn we were hoping for, while it was a little bit of pickup, is starting to moderate. Not trying to be dramatic by any means or suggest any big change in the picture, but the upward thrust, just looks to be a little bit less."

"Our working forecast for the second half is much more in the 1.5 to 2 percent range. That is a downshift from where we've been, but in line with where the economy's been over the last five years."

One of Mr. Leech's major themes was the impact of inflation – or its relative weakness.

"One offset we have to be thoughtful about in terms of how capital markets evolve, is the fact that global inflation, while increasing from a low level, is still very subdued," Mr. Leech said. "In the commentary of many central bankers, they are struck by how subdued inflation has been, despite what might have been expected given some of the pick-up in growth level."

"We see the global backdrop improving on the U.S. side, actually we see a little bit of moderation in the U.S. growth and inflation outlook. I think the U.S. economy is OK, but maybe a little bit of a downshift from some of the optimism we saw at the beginning of the year."

Another theme for Mr. Leech was central banks starting to signal a path toward normalization.

"They all would like to get from that uber accommodative stance to a less accommodative stance," he said. "Obviously the Fed has already started on this process and they continue to signal that they want to continue that path. As you look around the world, I think that is going to be the key issue for all of us, how that process unfolds going forward."

As for investment opportunities, Mr. Leech said, "Government bonds are still probably the least attractive sectors. Spread sectors should continue to be the best for fixed-income investors. They should be able to outperform sovereign and Treasury bonds over the medium and longer term."

Given global growth that "is still very, very soft by historical standards," Mr. Leech noted, "the good news is that the fear that global growth was decelerating, and might actually move down too sharply, gave way to optimism as global growth has picked up."

To Mr. Leech and the Western Asset Management team, "the big negative," the big headwind that continues to be intractable, is the debt burdens they see all around the world.

"Good news since the [Financial] crisis: debt burdens were taken off the private sheets, onto the public balance sheets, where they could be financed and carried more easily," Mr. Leech said.

"But debt burdens are still higher than they were during the crisis. This continues to be an impediment to growth. We've seen the inflation outlook. We have been hopeful that bottom was in last summer, that deflation fears were arrested and we can go forward. But this is why we need to be thoughtful about too much optimism, about too fast a pick-up in growth."

"Some of the fears around Brexit and the Trump Presidency, fortunately, have abated after the French elections," he said. "Some of the fears that we were going to have some kind of global trade war or too much nationalism have been resisted, which I think is a positive."

Mr. Leech noted that global spread sectors, following even last year's tremendous rally, really put in a terrific first half of the year.

"We were overweight spread sectors," he said. "In every one of these spread sectors, with the exception of U.S. mortgage-backed securities, the big story has been lowering our overweights in U.S. sectors and increasing our overweights in non-U.S. sectors. The big theme has been emerging markets. We still believe that's the biggest opportunity set available for investors who can take advantage."

Mr. Leech said the Western Asset team sees value in subordinated banking debt and is avoiding the retail sector.

“The banking and finance sector continues to be one of the biggest beneficiaries of the Trump victory. Dodd-Frank and the Basel Accords are still very positive in terms of keeping leverage, capital ratios and risk-taking constrained. But application of those regulations will be much lighter, much more favorable in our view. Higher short rates and better growth, also positive.”

“I’d say one of our big stories, both in investment-grade and high-yield, has been our absolute desire to be totally out of the retail space,” Mr. Leech declared. “We are almost totally out of the retail space. That’s been a sector that as we all know has been a very, very difficult situation.”

By contrast, Mr. Leech pointed out that high-yield bonds have had “a terrific run.” Moderate growth, low inflation and central bank caution have been “a really favorable backdrop.”

“Non-energy, non-commodity defaults are at very, very subdued levels. Really, the lowest levels we’ve seen in quite some time. That is why high-yield has been able to rally so successfully.”

“That big beta compression trade should be behind us,” he said. “We have been reducing our high-yield overweights very substantially, probably the lowest level of overweights we had. We’re not negative on the sector. We’re not looking for a big widening, but we think the opportunity is elsewhere.”

The fixed-income sector Mr. Leech said he like most is emerging markets.

“We look at a global environment of really, really low yields … where developed market bond buyers have very low opportunity sets,” he said. “Switch over to emerging and you see just the opposite. You look at the spread, relative to developed market yields: near their 2008 wide. It’s really attractive yields, valuations … So why did we have such a big bear market? Because of fear of global recession, fear of China, fear of deflation, obviously commodity price breaks.”

“On the other side though, the more powerful arguments are valuations, which are really compelling, followed by fundamentals, which are really improving,” Mr. Leech noted.

“Improving global growth and stabilizing commodity prices are tremendous changes in the fundamentals. Strong valuations give the possibility of a meaningful bull market in emerging markets. You have to keep track of those negatives, but the positive story is just much stronger.”

Discussing the prospects for global growth and inflation, Mr. Leech said it requires watching.

“Where we all have to watch very carefully is whether or not we’re finally going to see the wage inflation we might have thought would come as the unemployment rate has been this low, and the economy has been able to continue in its growth path,” he said. “But boy, it just hasn’t show up yet. We would be very much with Janet Yellen that, while there are pockets of wage strength, it’s not broad-based: average hourly earnings are kind of flattening out, the employment cost index is not showing a lot of strength, last week’s employment number actually came down. It’s not moving as smartly as might have been modeled out.”

“There’s still a lot of work to do,” Mr. Leech said. “Unemployment is really underemployment, so a lot of people who have been able to get jobs don’t have the jobs they want. When you look at the prime age workers, 25 to 50 years old, we’re not even back to where we were at the end of the last crisis, even after 10 years of an expansion. The same is true with capacity utilization.”

“So while the good news is that we’re improving and we’re closing these gaps, the bad news is it’s a very, very slow process. And that’s gotten us to really focus on this issue.”

Mr. Leech used a core CPI inflation graph to illustrate his discussion of where the Fed may go.

“[Fed Chair] Janet Yellen was very aggressive a month ago when she tightened in June,” he said. “She said the decreases in inflation were transitory and they would soon be reversed. That would give the Fed the straightforward confidence that they can maintain their small increases in interest rates, or inching up if you will, in combination with unwinding their balance sheet.”

“We’re just not so sure. I mean, we have really been struck by how stubborn this rate is … Remember, the last three months the core CPI had been near zero. That’s well below the Fed’s target of two percent. That’s not a ceiling, that’s what they want to be the middle of the range. It’s not obvious that they’re going to get the pickup that they’re expecting.”

“As the rates inch up, that might be even more challenging,” he said. “As Fred Marki, who runs our inflation desk, says, ‘Is inflation rolling over, or is it just delayed?’ That’s the big debate, but at a minimum, it’s been delayed – pretty meaningfully. This concept that it’s going to be moving up quickly is probably not right. I think the best you’re going to get is a very slow turn.”

Mr. Leech then spoke to another reason this might be: their growth forecasts versus The Fed’s.

“Over the last few years, we have been very cautious about embracing the optimism,” he said. “Let’s say the Fed missed their forecast for five years in a row, basically being too optimistic on growth and inflation. We all know that the global backdrop is a big reason for that.”

“This year we embraced the Fed’s forecast. We thought growth was picking up: 2 to 2.5 percent was our forecast. Not as high as some on the Street or other optimists, but in line with the Fed. Our working forecast for the second half is much more in the 1.5 to 2 percent range.

The next topic was the impact of the Trump Administration, which can often tie in with the Fed.

“We came into the year feeling that [the market] optimism that the Trump legislative agenda would be adopted with anywhere need the speed they hoped for was really misplaced,” Mr. Leech stated. “That, at a minimum, it would take a lot longer. Trump’s margin in the Republican party, even as the majority, is very thin … Keeping everyone on board in a big coalition is always hard. When you have such thin majorities it’s even harder.”

“Deregulation, we think is still pretty positive, pro-business, and that’s proceeding,” he said. “But healthcare has failed. Tax reform has been delayed. We think tax cuts are coming, not broad-based tax reform but, as you would say, Steve Mnuchin’s Plan B, where they have some kind of modest tax cut. Infrastructure has been delayed and is not in the immediate picture.”

“What does that mean in terms of 10- year yields and break-even inflation rates? A little bit better growth but inflation just not following any kind of traditional pattern. Break-even inflation rates are under 1.8 percent, the Fed’s target is 2 percent, so the market is basically saying, ‘we’ll take the under.’ They’re not going to get there in the short run, or in the intermediate run. It’s just not going to happen.”

“When you think about the Fed moving rates up, you can see why this becomes such a big issue and why we have to monitor it pretty carefully,” Mr. Leech said. “I think the Fed is right. Janet Yellen mentioned it yesterday: the Fed has to be very cautious and gentle in their approach.”

Where are the cautionary developments we need to be thoughtful about, Mr. Leech posed?

“One is China,” he answered. “China’s growth, GDP, really picked up. They put a tremendous amount of stimulus in their economy. It was fantastic. It turned a fear of global recession, as early as 2016, into a much more beneficial, benign environment that’s been much more positive. The consequence – there are always pluses and minuses – was debt to GDP rose. They have talked about how they have to scale back infrastructure. They’ve already started to make moves. Earlier this year the real challenge was in reserve loss. They’ve stemmed that. They’ve had to use a tremendous amount of capital controls, telling corporations to bring their money back.”

“This tightening of internal monetary conditions has showed up in their bond market. The point here is not to make some kind of China crash story. That’s not our story at all.”

“A more neutral policy backdrop should lead to slower Chinese growth next year,” Mr. Leech concluded. As for Europe, according to Mr. Leech, “growth is good in Europe but shouldn’t accelerate.”

“Growth might calm down,” he said. “The story of Europe is obviously a story of two halves, the north and the south. Growth in the north has really been buoyant. We think growth in the north stays OK, but should calm down a little bit over time. As central banks start to withdraw the punch bowl, this suggests the rate of growth is unlikely to accelerate in any meaningful way.”

“Negative yields still persist. We still have a very accommodative monetary backdrop. That’s very positive. Even as we withdraw this accommodation, it’s a slow withdrawal from a very strong starting point.”

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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 $432.1 billion in assets under management as of March 31, 2017. 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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