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Featured G

Global Bond Market Hotlist

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There are some broad themes playing out in the global fixed income and currency markets. This is my first hotlist that covers the investment themes that are of interest to us. Here's an overview of what I'll be covering: high-level global trends, followed by a country and/or regional analysis of the G3 and emerging markets.

Global Economic Developments

Reflation vs. Deflation

The debate over cyclical inflation versus secular deflation started after the Brexit referendum and continues. Inflation is kryptonite to bond investors. A cyclical uptick in wages is battling secular disinflation brought on by technology and automation, high levels of developed market debt, aging demographics and globalization. I believe the global economy has experienced synchronized growth for the first time since the Global Financial Crisis. Emerging markets should benefit the most from a continuation in coordinated global growth.

Risk Appetites

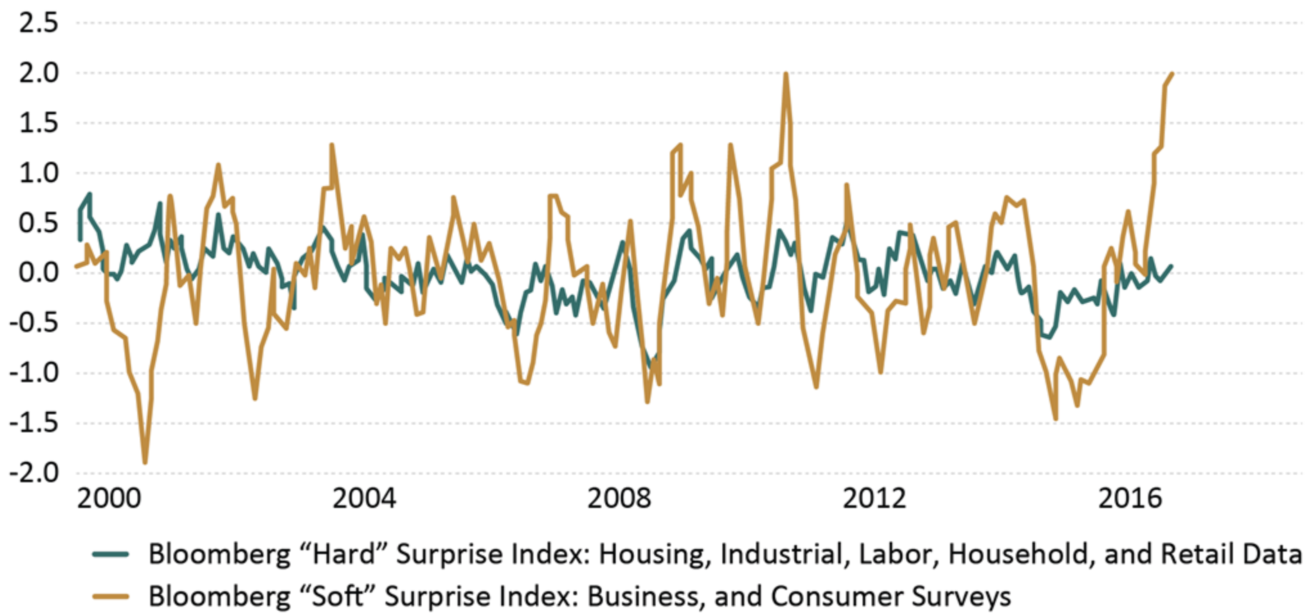
My view of overall market sentiment is risk seeking to risk neutral. Therefore, global capital should be biased toward searching for return as opposed to capital preservation. I expect that money will flow into equities, while developed market yields and commodity prices should rise. I don't expect politics or central bank policies to permanently derail flows to higher-yielding assets in 2017, although there will be political hiccups along the way.

The U.S.

Expectations vs. Data

The tug of war between economic sentiment and reality persists. Soft data, which reflects economic sentiment, continues to come out strong, signaling 3% real gross domestic product (GDP). Yet hard data, which shows real economic activity, by and large disappoints. Consumer and business confidence flirted with multi-decade highs, even though 1Q17 GDP will likely register around 1.5%. There's clearly a disconnect here between confidence indicators and hard data. See Chart 1 below. I think a better and more interesting metric could be President Trump's approval rating—his presidency hinges upon the fate of the U.S. economy. Posting 3.0% GDP growth may be the inflection point for Trump's approval ratings, although this increasingly looks more like a 2018 development as opposed to 2017 event.

Chart 1: Expectations Are High But Data Needs to Catch Up *As of 3/31/2017*

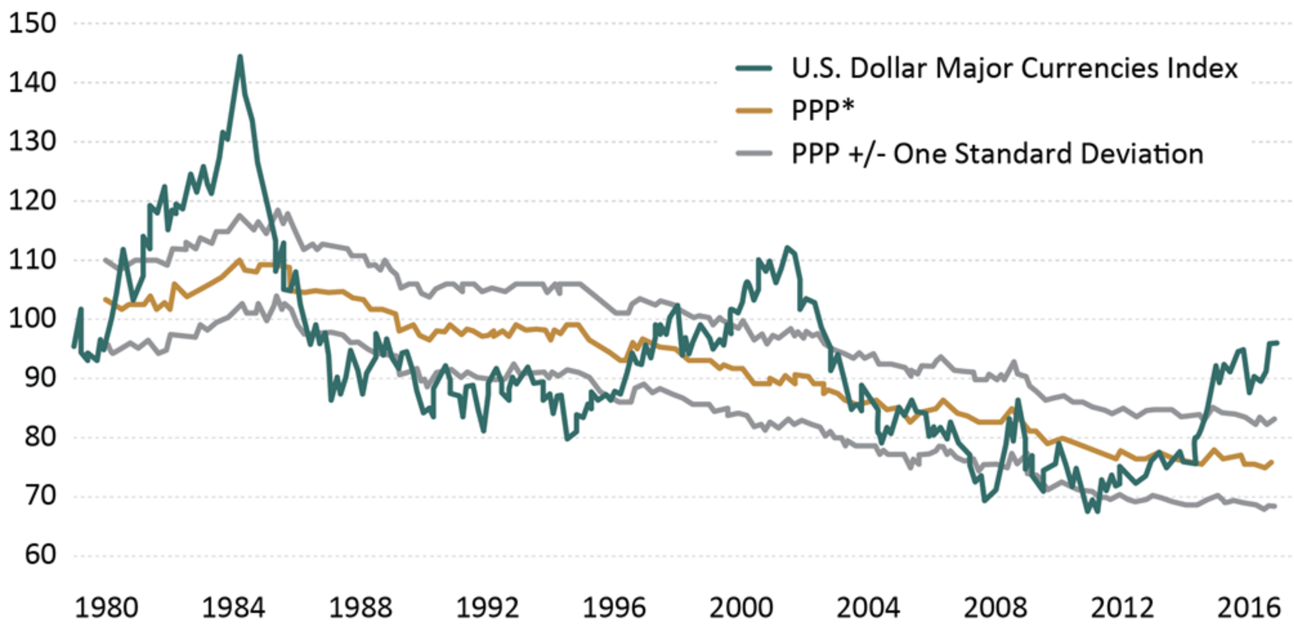


Source: Brandywine Global, Thomson Datastream

The Dollar

Its valuation is subject to cyclical tendencies. I think the current U.S. dollar bull cycle is in the eighth or ninth inning, if not over. Refer to Chart 2 below. Trump wants to make U.S. companies competitive and one way to do this is to talk down the dollar. He could potentially plant the seed of a “Plaza Accord II” to weaken the dollar at the 2017 G20 meeting in July. When the global economy is improving, the dollar has a tendency to underperform commodity-linked and emerging market currencies—This is occurring now. I think the dollar will be influenced more by growth differentials as opposed to interest rate differentials.

Chart 2: U.S. Dollar Valuations *U.S. Dollar Value, As of 3/31/2017*



Source: Brandywine Global, Thomson Datastream

**Based on GDP Weighted PPI of 6 Countries: Euroland, Japan, U.K., Canada, Switzerland, Sweden*

The Federal Reserve (Fed)

President Trump and the Fed are on the same page regarding a weaker dollar in 2017. As far as additional tightening, both the market and Fed expect two more rate hikes this year, which seems right. If the U.S. economy accelerates in the second half of 2017, the Fed could start reducing its balance sheet in 2018, which could create an opportunity for the bank to pause rate hikes and let maturing bonds roll off its balance sheet. Personally, I think it would be a policy misstep for the Fed to start further tapering its asset purchases too soon.

The Trump Administration

I think developed markets will remain range bound in 2Q17 until markets get fiscal policy clarity. Tax policy is a big question that remains—will there be real reform or just tax cuts? These things are messy and take time. Reagan announced his tax reform at the 1984 State of the Union, but Congress didn't pass it until October 1986. So maybe, it might just be tax cuts, but the Trump Administration really needs a victory after the misstep on healthcare. I don't think protectionism will gain more traction, either in the U.S. or abroad. Therefore, I don't expect a border-adjustment tax—it will be too time consuming for Congress to figure out and pass.

Europe

Eurozone Growth

Prospects still look solid, although the European Central Bank (ECB) remains biased toward accommodative monetary policy. Europe is a taker of growth via exports. So when the global economy is growing, the European economy does well.

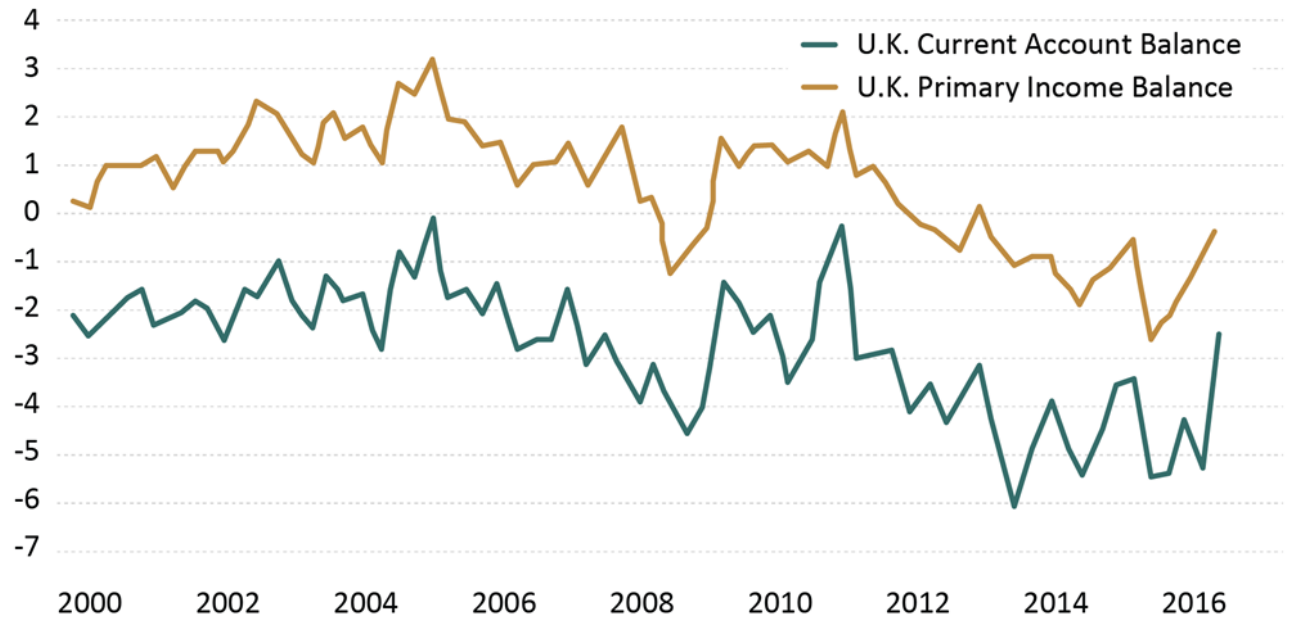
The Euro

The currency has been weak and supportive of better economic growth. If it wasn't for the continental rise in political risk associated with the 2017 election cycle, I think the euro could be trading closer to 1.15 vs. the dollar. At the same time, I don't think the euro has undergone a significant repricing as the pound has.

Sterling

The U.S. could take note of how a weaker currency could potentially benefit the economy. A weaker pound has kept the negative forces arising from Brexit at bay and had a clear positive contribution to the U.K. economy. Chart 3 shows the pound's effect on the U.K.'s balance of payments.

Chart 3: U.K.: BOP: Income and Current Account Deficits *% of GDP, As of 12/31/2016*



Source: Brandywine Global, Thomson Datastream

Japan

The Yen

This is another example of how a weaker currency can affect the economy. Japan does not want a stronger yen. I think two factors will affect yen valuations.

1. Capital flows. In a risk-on environment, Japanese investors will move offshore in search of yield.
2. The Fed. The dollar-yen cross will be less about Japan and more about U.S. interest rates.

Emerging Markets

Developing Economies

Sure, emerging markets are becoming a popular allocation again, but the segment has lagged most markets since 2011. Economic fundamentals continue to improve, which should drive most emerging market assets prices higher. Yes, there will be one-off risk events along the way—South Africa, Venezuela, and Turkey to name a few—but I don't expect widespread contagion to the broader emerging market universe. In aggregate, we expect emerging market policy rates should move lower in 2017 as inflation outlooks improve, aided by stronger currencies and the positive feedback cycle on prices.

China

I think there's enough positive economic momentum to experience solid growth through the remainder of 2017. I don't foresee a policy mistake in the immediate future, so there shouldn't be a disruption to global commodity prices and developing economies. The meeting between presidents Xi Jin-ping and Trump will be more theatre than substance and both countries will treat the outcomes as a "win-win."

Mexico

While emerging markets are playing catch up with developed market assets, I think Mexico is catching up to other emerging markets. I think Mexican assets will continue to outperform as part of this game of catch up through 2017.

There will be a lot of political theatre to sit through in 2017, but looking beyond that, we'll start to see a divergence between developed and emerging market policies that will have a widespread effect on currency valuations and yields.

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