

Stuck in the Balance

The rally in risk assets seems to have stalled after a sharp rebound from their February lows. It is too early to draw any conclusion, but some subtle changes in market characteristics are worth commenting on. For instance, the dollar has continued to soften, but the S&P 500 Index has failed to break out. Although the rebound in commodities has been impressive, the Treasury yield curve has refused to steepen. Finally, Dr. Copper—referring to the honorary degree bestowed on the base metal for its purported ability to predict the global economy’s direction—has stayed virtually flat for the past two months after a mild rebound from its recent lows. In a nutshell, a softening dollar is trying to encourage investors to take on risk, but financial markets have become increasingly reluctant to confirm the reflation trade. These market actions underscore a standoff between deflationary forces on one side and policy reflation on the other. The balance between both sides of the tug-of-war is so fragile that any policy mistake could tip it toward the deflation side.

From Disaster to Stability

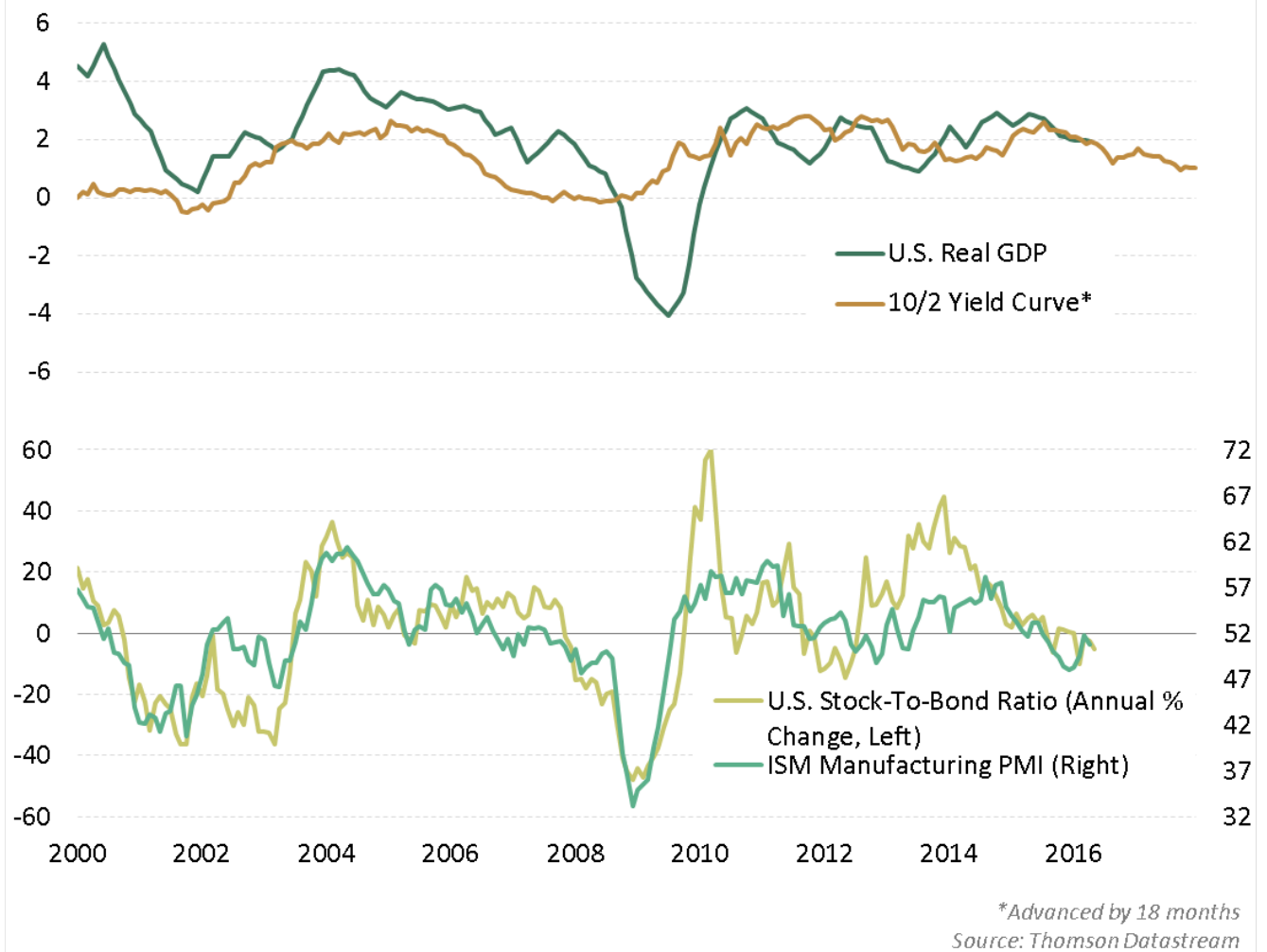
At the beginning of the year, global financial markets were bracing for a very bad potential economic outcome. At the time, a crash landing for China’s economy, some major blow-ups in the oil industry, and even an outright recession in the U.S. economy all seemed probable. However, the G20 meeting in Shanghai on February 25-26 marked an important turnaround. The Federal Reserve (Fed) has since dialed back its rate expectations, and China has refocused on fiscal and monetary stimulus. A rally in risk assets has followed, led by a falling dollar.

With the S&P 500 up 14% from its February lows and corporate credit spreads having tightened sharply, all we can say is that the markets are no longer looking for an economic or financial disaster in the world economy. A weaker dollar and signs of a stabilizing Chinese economy have helped put a floor underneath commodity prices in general and oil in particular.

However, investors should keep all the improvements in proper perspective. The broad trend in the world economy remains deflationary, and financial/economic stability is still fragile. All market signals seem to suggest that the world economy has been steadied by the recent policy shift in China, the Fed, and the weaker dollar, but no growth reacceleration is evident yet.

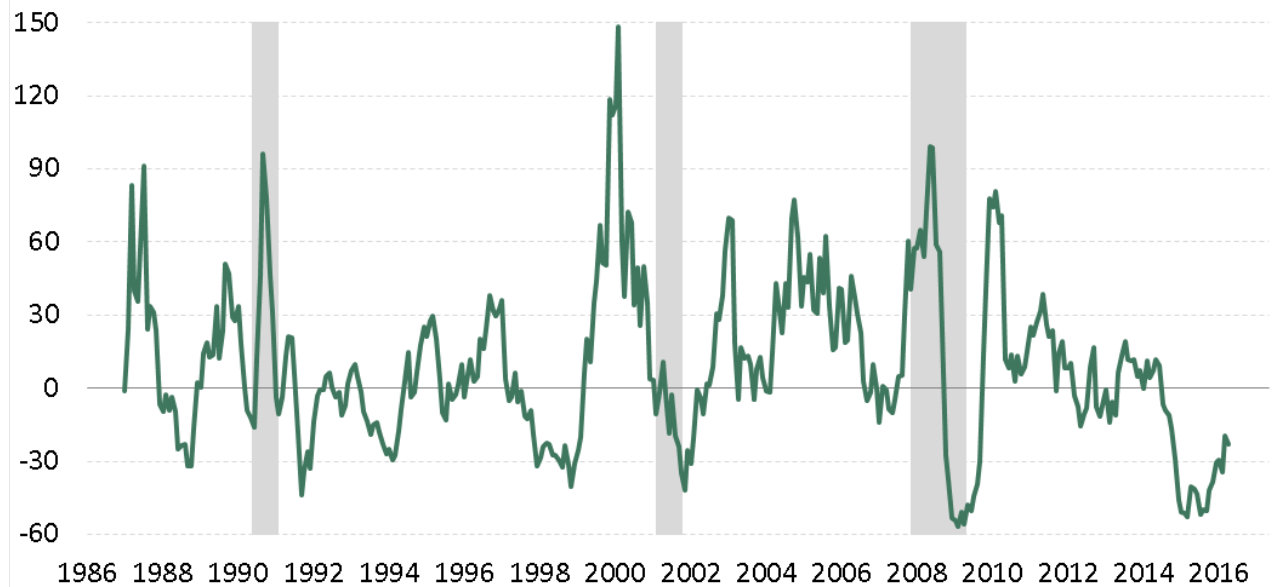
- The Treasury yield curve has stayed flat, which suggests that U.S. economic growth may remain soft (see [Chart 1](#)). Also, the correlation between the stock-to-bond ratio and the Institute for Supply Management’s (ISM) manufacturing index has been tight and convincing, and is currently predicting that manufacturing activity will continue to be subdued in the months ahead (see [Chart 1](#), bottom panel). The bottom line here is that market signals suggest that there may be no meaningful rebound in the U.S. economy until well into 2017.

Chart 1: Market Signals Remain Soft %; As of 5/11/2016



- The rebound in oil prices has been widely welcomed as a sign of an improving world economy. This observation may be true, but the ongoing rally should also be put into proper perspective. While the magnitude of oil price declines since 2014 has been consistent with past global recessions, the recent rebound pales in comparison to all previous economic recoveries (see [Chart 2](#)). The current oil market suggests that it is no longer looking for a bad global recession, but neither are prices consistent with a strong growth recovery in the world economy.

Chart 2: Oil Prices *Annual % Change; As of 5/11/2016; Shading Denotes U.S. Recession Periods*

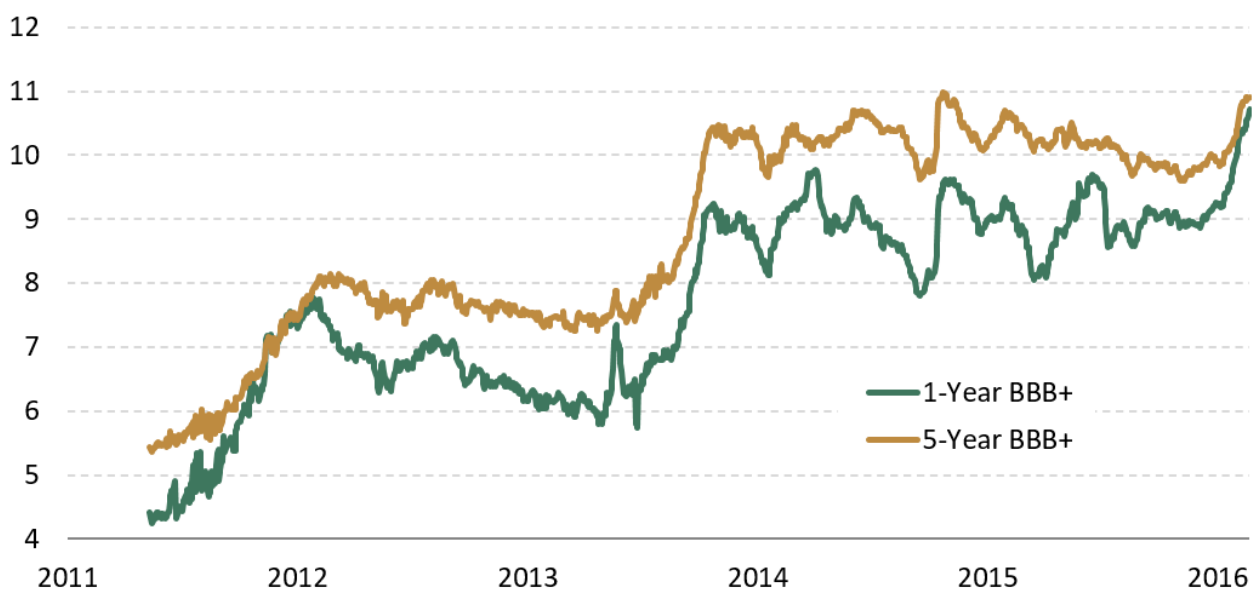


Source: Thomson Datastream

- ▣ China's economy has begun to produce conflicting data. Money supply and credit growth are on an upswing, but the response from the real economy has so far been mixed. The Manufacturing Purchasing Managers' Index (PMI) is stabilizing, but corporate borrowing spreads are still widening, which suggests increasing stress for heavily indebted companies (see [Chart 3](#)). In the meantime, private investment has been weak. However, capital expenditures have surged in state-owned companies (see [Chart 4](#)).

Chart 3: China's Corporate Borrowing Spreads

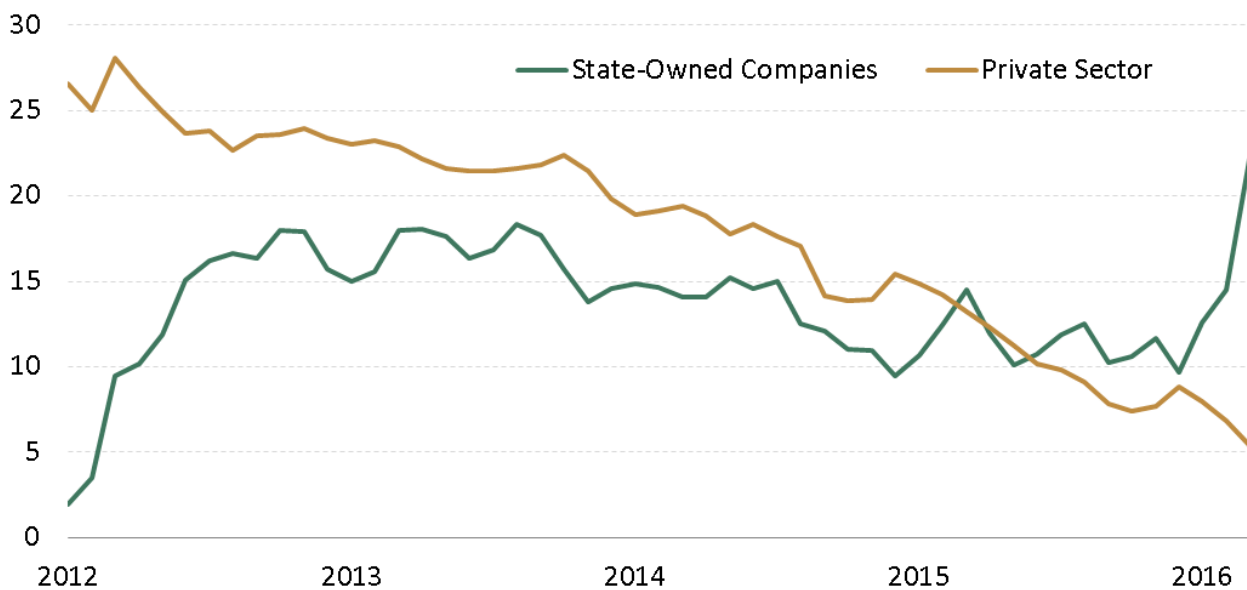
%; As of 5/11/2016; Spread Over Government Bond Yields of Matched Duration



Source: Bloomberg (© 2016, Bloomberg Finance LP)

Chart 4: China's Fixed Assets Investment*

Annual % Change; As of 3/31/2016; Shown as a 3-Month Moving Average



*Shown as a 3-month moving average.

Source: Thomson Datastream

In short, although the world economy is stabilizing, its growth rate remains rather weak. The message here is that policymakers need to tread carefully, as any premature end to policy support could still tip the balance

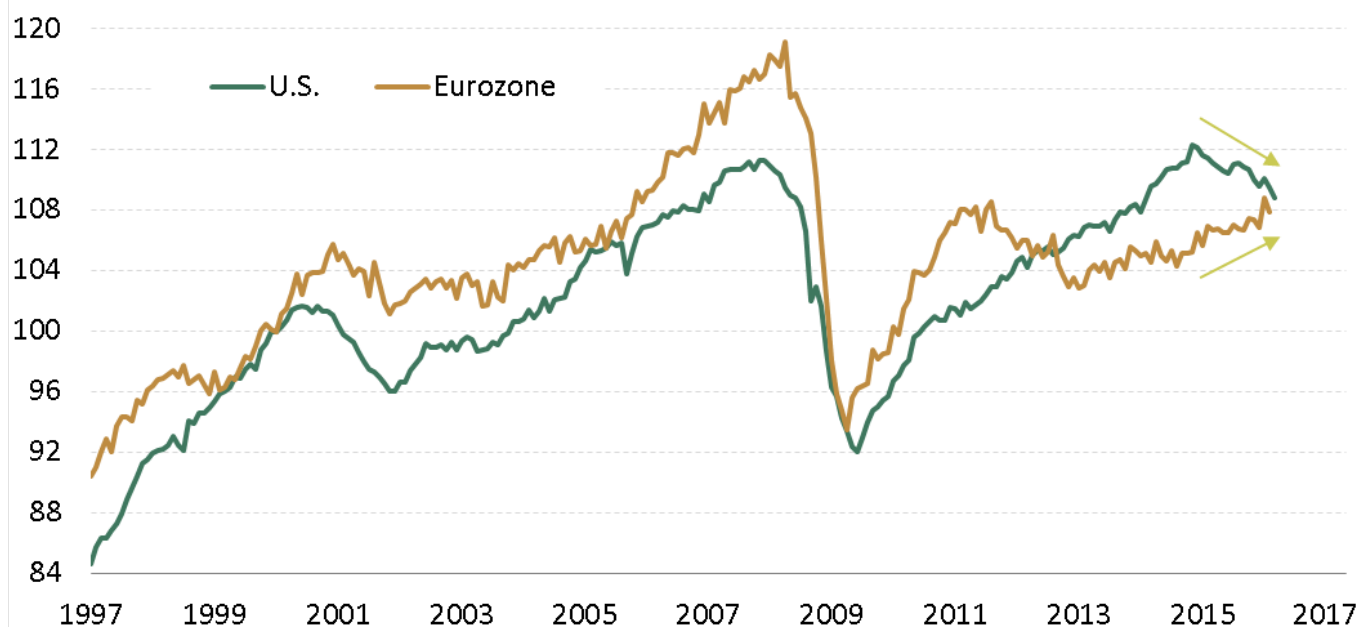
toward the deflation side.

What's Next?

As far as investors are concerned, there are several important transitions underway that may influence financial market trends significantly.

First, although the U.S. has outgrown most other developed nations, it has been pressured by a strong dollar, weak pricing power, and a corporate profit recession for two years. In the meantime, Europe, Japan, and the rest of the world have been helped by weaker domestic currencies. Therefore, it is logical to expect global growth to converge, i.e., the U.S. becomes a tad weaker while the rest of the world gets a tad stronger (see [Chart 5](#)). If so, the dollar should continue to follow a softening trend.

Chart 5: Industrial Production As of 3/31/2016; 2000=100



Source: Thomson Datastream

Second, China is making a transition from supply-side reforms to demand-side stimulation. This changeover is good news because the dominant problems for China's economy are oversupply, oversaving, and overcapacity, all of which need to be counterbalanced by policy stimulus. Nevertheless, it is also true that President Xi Jinping, who has always wanted to make supply-side reforms the hallmark of his economic policy, is not wholeheartedly embracing policy support.

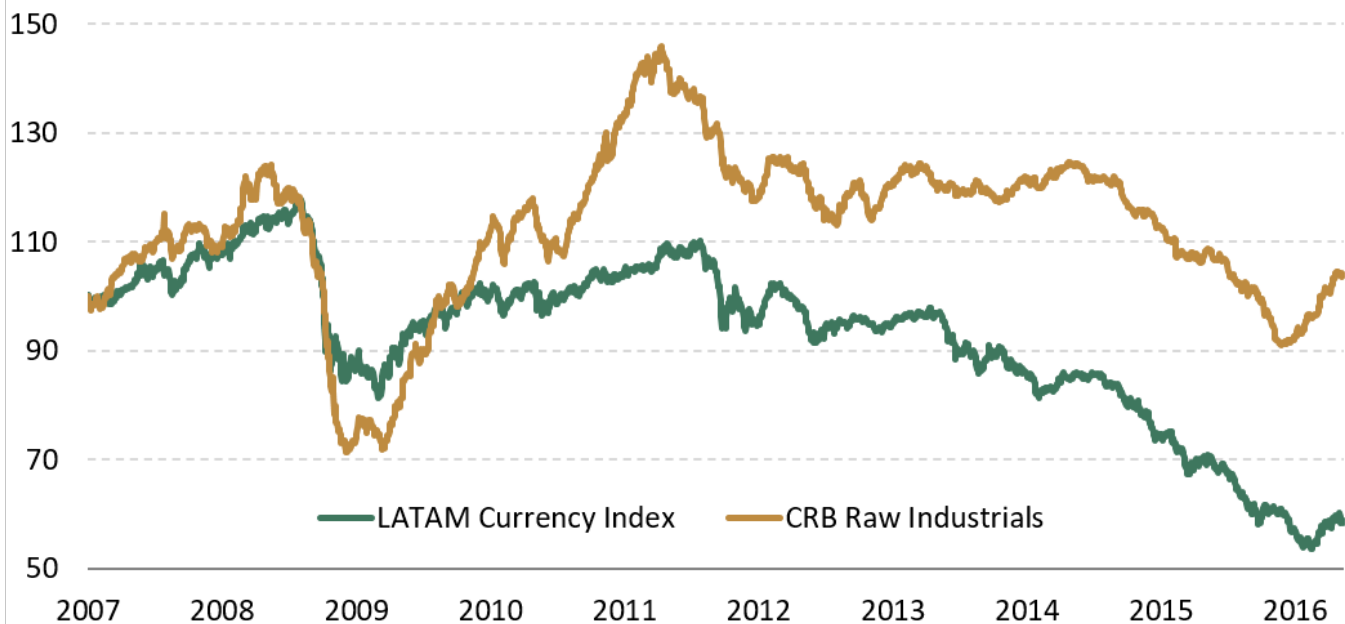
A recent article by an unnamed authority in the *People's Daily*, the official daily newspaper of the Chinese Communist Party, warned that it is possible that Beijing's policy stimulus and support will follow a stop-and-go pattern. Mirroring this halting progress, China's economic recovery could also be a hesitant one.

We believe that the impact of recent sharply increased infrastructural spending and sweeping corporate tax cuts will be felt in the coming months. A softening dollar will obviously help Chinese exporters. All of these factors could partially offset the expected sharp contraction in parts of the state sector where "zombie companies"—unprofitable or insolvent businesses that are kept on life support by the government or by banks—are concentrated. A modest pickup in China's growth rate is possible in the second half of the year, even though the government is preparing the public for an "L-shaped" recovery.

So What?

In our view, a weaker dollar and a stabilizing Chinese economy mean that the bear market in commodities is likely over, although a speedy return of another bull market does not appear imminent. If this is the right call, it would mean that the negative terms of trade will ease for commodity-producing nations. The Latin American (Latam) currencies have fallen much more than what is justified by the decline in commodity prices (see [Chart 6](#)). This discrepancy underscores the fact that the adjustment in the currency markets has been overdone.

Chart 6: Latin America's Currencies and Commodities As of 5/11/2016



Source: Bloomberg (© 2016, Bloomberg Finance LP) and Thomson Datastream

Logically, recoveries in Latam currencies could also exceed the rebound in commodities. We believe the key is that emerging market countries need to take advantage of a weaker dollar and stronger commodity prices to cut interest rates aggressively with the goal of stimulating domestic demand. So far, many countries seem to be moving down this path, another reason for a pro-risk investment stance, in our view.

Finally, we think that most investors likely expect a flat U.S. stock market. The true surprise could be that U.S. equities break out to new highs. Is that possible? We believe the answer is yes. The preconditions for a breakout in the U.S. equity market include a falling dollar and a dovish Fed. The former helps improve profit growth while the latter would probably steepen the yield curve and encourage risk-taking among investors.

By the same token, the biggest threat to markets finding this “sweet spot” is a policy mistake. The global financial markets could be easily disturbed if the Fed turns hawkish and prematurely raises rates again, or if China stops stimulating its economy, leading to a heightened risk of devaluation in the renminbi. In both cases, global equities could fall, bonds rally, and the dollar climb anew as risk aversion intensifies. Given present conditions, I would assign a 60% probability to the “sweet spot” scenario and 40% to the “risk-off” outcome. However, the balance between the two outcomes remains precarious, and a variety of factors could tip the scale in either direction.

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