



# Mid-Year Outlook: Policy Panic Again

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## Macroeconomic Outlook: From Full Throttle to Pumping the Brakes, Policy Panic Again

Francis A. Scotland »

The Federal Reserve (Fed) wants to hit the brakes, a 180-degree reversal from the recent two-year effort to turbo-stimulate the U.S. economy. This U-turn from manic to depressive guidance smacks of panic. In my view, the Fed is reversing course from last year as fast as possible to compensate for its gross error in judgement, wrong read on inflation, and crumbling credibility. Politicians who cheered the Fed's "woke" focus on employment last year now want the central bank to do something about the inflation havoc wreaked on real incomes from this strategy. Other developed country central banks are following suit. Is the team that got it all wrong now going to fix the problem? Or just create a new one? Will we go from inflationary overshoot to recessionary payback?

We outlined a macroeconomic roadmap at the start of the year that called for many of last year's more anomalous macro-trends to mean-revert back to trend. For 2021, those anomalies included: extraordinarily rapid economic growth; hyper-expansionary policy tailwinds; and the highest inflation in 40 years. The roadmap called for a significant downshift in growth, a move in policy toward restraint, and a subsequent retreat in inflation. We noted that a full reversal of 2021's anomalies likely would amount to economic whiplash.

The abrupt change in Fed policy is consistent with the roadmap. However, the scale and the timing of the pivot increase the odds of economic whiplash. Policy has become pro-cyclical. Last year's extremism resulted in inflation. This year's version lays the risks in the other direction.

- Last year, the U.S. and most other developed economies posted extremely strong growth figures early in the year and rising inflation later. Instead of gradually tapping the brakes or just resisting further stimulus, U.S. authorities added another \$3 trillion in direct fiscal support; the Fed purchased all the debt

used to fund the handouts; and the central bank's balance sheet expanded by trillions even with inflation soaring near the end of the year. Other developed countries followed suit. The result was the highest inflation in 40 years.

- This year the world economy is slowing very significantly. China is in a man-made economic contraction. Emerging countries are near the breaking point following successive rounds of tightening aimed at controlling inflation. Europe's growth has been strangled by multi-fold increases in the cost of energy. It is difficult to picture the U.S. escaping this downtrend with real disposable income contracting because prices are rising faster than wages and incomes. Capital markets have discounted a substantial slowing, which has tightened financial conditions significantly. Nonetheless, the Fed appears as dogmatic on the need for tighter monetary conditions as it was convinced of the opposite last year. Similarly, the European Central Bank (ECB) is preparing to tighten policy with the economy sliding into recession if it is not already in one. Despite Chairman Powell's idealistic confidence in the Fed's ability to stick a soft landing, reality suggests the probability of a U.S. recession is increasing.
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The complicating element in the current inflation outlook is the contribution of the supply-side shocks to current inflation. These factors include: global supply chain disruptions, distribution issues, ESG-related factors, energy, and labor. Modern macro policy can do little to affect supply-side issues and instead focuses mainly on manipulating demand, which in this kind of environment implies bringing demand down in line with supply. It is no coincidence that the worst recessions of the post-war period took place during the mid-1970s and early 1980s when inflation was heavily affected by energy supply shocks. Therefore, the investment outlook really hangs on the durability of high inflation.

## Global Fixed Income Outlook: It's All about Inflation

Jack P. McIntyre, CFA »

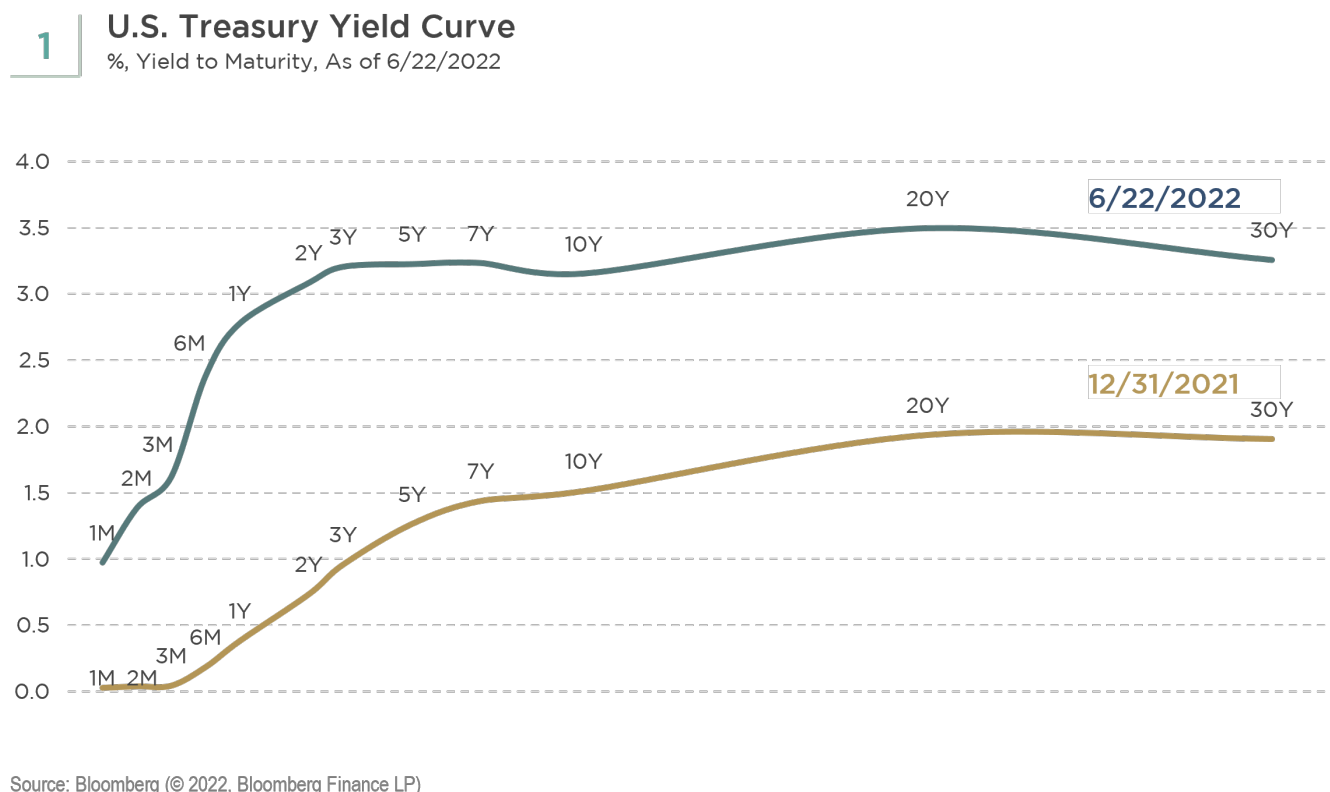
It may be going out on limb, but I believe the second half of 2022 will not be as bad as the first half of the year for developed market bonds. The bond math will not allow it. Unlike what happened to developed market bond markets going into 2022, when bonds did not offer a meaningful coupon—essentially a zero coupon—times have changed. Bonds now offer a decent coupon, which can get reinvested at higher short-term rates, offering some protection to a bond's total return. That income characteristic is a key reason bonds are typically more defensive than equities and could attract capital going forward. That is the good news. The bad news is that coupon rates are still very low when compared to current inflation rates. Inflation, which was supposed to have peaked in a noticeable way in the second quarter, is stickier than most believed. It is going to take more than just base effects, or relative changes in price levels, to turn inflation substantially lower. We still expect that inflation is in the process of peaking due to a confluence of developments, including strong inventory build, waning demand for goods, peaking commodity prices, a slowing global economy, and wealth destruction. The bond vigilantes, including us, are all trying to figure out how much inflation will come down in the second half of the year, and more importantly, where inflation settles next year and into 2024. That longer-term view impacts today's bond yields given that the bond market is always more forward looking.

There was a trend change among developed market central banks, led by the Fed, during the first half of the year. Federal Open Market Committee (FOMC) doves turned equally as concerned about inflation as the hawks. Now, Fed members no longer view inflation as "transitory" and seemingly cannot withdraw monetary policy support fast enough. Every existing monetary policy tightening tool is now in play, the most important being the tightening of financial conditions coming from lower equity and crypto asset prices, with no Fed put in sight. This development, combined with sharply higher energy and food prices, means that consumers across the income spectrum are feeling pain. Do frustrated consumers soon turn into consumers sitting on their wallets?

The Fed is not good at fighting cost-push inflation, which is a key driver of today's inflation. Their tools are designed to influence demand-pull inflation, which means they are going to have to weaken consumer and business demand. Ultimately, this demand destruction increases the odds of a recession next year. We expect to

see supply issues correct themselves during the second half into 2023. A key influence on higher commodity prices has been the military conflict between Russia and Ukraine, both of which are significant commodity exporters. Unfortunately, forecasting the timing of an end to the war is beyond our or anyone's ability. In the meantime, global crop reports have increased in their importance to bond managers over the coming year. Where China goes with its zero-COVID policy also will have an impact on inflation, both from a supply standpoint via the country's role as a supply chain to the world's manufacturing process, and from a demand function as 1.4 billion consumers come back on line.

The yield curve should continue to flatten and probably invert as developed market central banks, with their one mandate of price stability, continue to hike rates in the second half of the year (see [Figure 1](#)). We know the Fed is okay with lower equity prices. For example, when Chair Powell talks about tighter financial conditions, we understand it to be code for there is no Fed put. Lately the Fed has been sending the message that policymakers also are okay with the unemployment rate heading north.



Again, it is all about price stability these days. The Fed has one mandate for rest of 2022 into 2023, and that is to get inflation lower at all costs. This single-mindedness is turning the central bank into a “Volcker” Fed as opposed to a “Burns” Fed. But for now, there likely will not be a “Greenspan put.” This Fed knows the impact the equity market has on the real economy is more pronounced in the U.S. as equity wealth represents its largest share of overall wealth in 80 years. Lower equity valuations are going to have a larger negative impact on the U.S. economy relative to other developed market economies via the consumer sentiment channel (see [Figure 2](#)).

## Federal Reserve U.S. Households & Non-Profit Organizations Net Worth

USD Thousands, As of March 31, 2022



Source: Brandywine Global, Macrobond

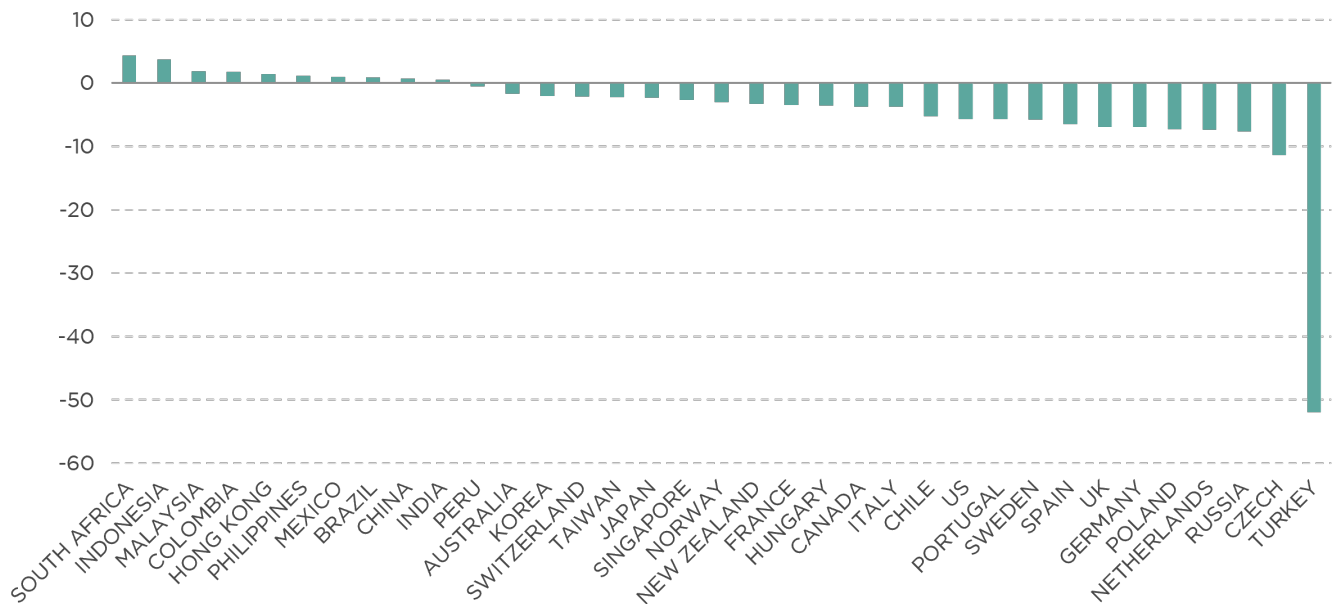
How do you position in bonds during the second half? The Brandywine Global team is entering the latter half of the year with a lot less conviction from a positioning standpoint in developed market bonds. In the U.S. in particular, we are managing our bond position from a rare standpoint of having a duration contribution in line with the benchmark index. This positioning speaks more to having the patience to see how inflation dynamics change and less to directional conviction. We are looking for indicators around whether inflation is higher on only a cyclical basis or if we are seeing the end of the secular disinflation trend. We are having more conversations around when to buy bonds as opposed to when to sell Treasuries. Yields are starting to adversely impact economic decisions in the U.S., a hallmark of the feedback cycle. These feedback cycles are key drivers of our investment decisions.

Across Europe, we are still underweight duration. We are impressed with the ECB's hawkish shift against inflation, but the valuation differential between U.S. Treasuries and core European bonds keeps us at a relative underweight for now. The European peripheral bond markets are looking interesting given that the ECB has announced its concern around fragmentation risk. Markets will test this stance by driving spreads wider but that could be a buying opportunity. The key will be whether the northern European governments support this "anti-fragmentation" development as it may not be the most politically popular thing to do. Elsewhere, the Bank of Japan is buying record amounts of Japanese government bonds to support its yield curve control strategy for now. They will get tested by the market but for the time being, they are standing firm. We find no value in Japanese government bonds as we expect that the risk/reward symmetry is skewed toward rates moving higher later this year.

When, not if, inflation turns either in 2022 or 2023, the biggest return potential in fixed income could come from emerging market (EM) bonds. Both nominal and real yields are at attractive levels when compared to history (see [Figure 3](#)). EM central banks, apart from Turkey, have led the charge in tightening monetary policy to fight inflation, leading to an uptick in market credibility. And their job is not over. We expect that, unlike the Fed, several developing market central banks will take real policy rates into positive territory, which will attract foreign capital into their bond and equity markets on an unhedged basis. This story may start to play out in the back end of 2022.

## Real 10-Year Bond Yield Ranking – Based on 12-Month % Change of Headline CPI

%, As of 5/31/2022



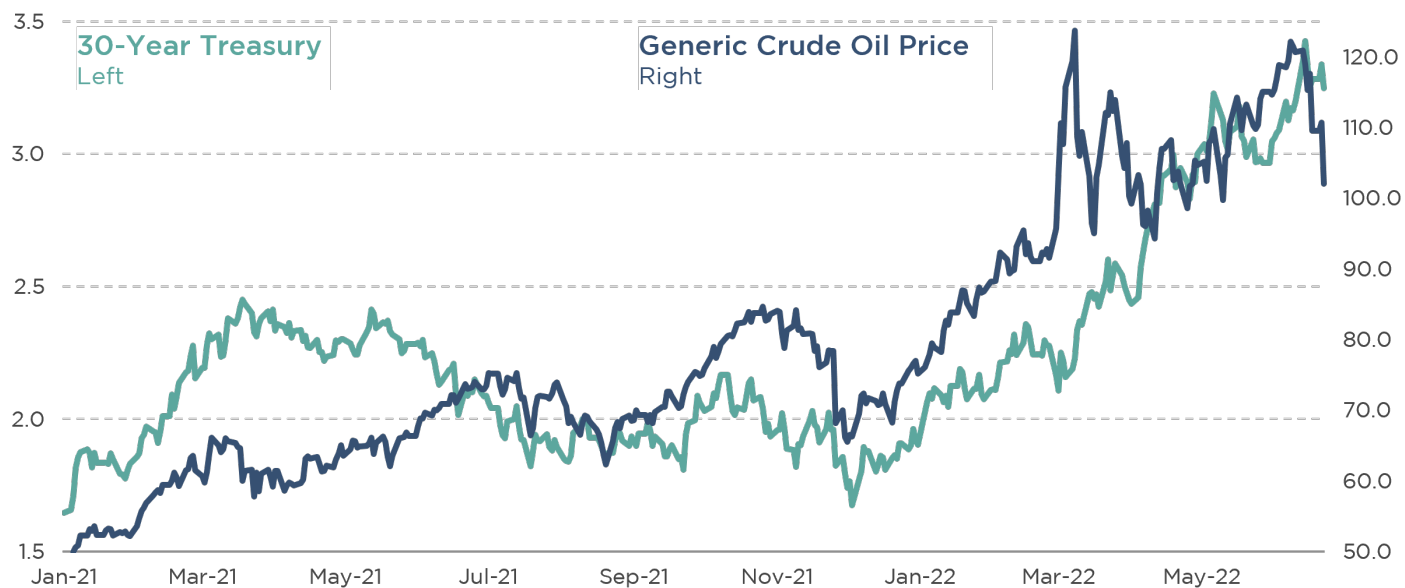
Source: Brandywine Global

One of the most important inputs into where global inflation heads, and bond yields as well, will be what happens with global energy prices in the second half of the year (see [Figure 4](#)). Conceivably, energy prices have the biggest impact on inflation expectations, particularly in the developed world, and central banks' responses to them often lead to recessions. Granted, the Russia-Ukraine war has an impact on where crude prices settle from here, but it might not be that meaningful. After all, Russian oil exports are nearly back to pre-invasion levels (see [Figure 5](#)). Lower oil prices will come from demand destruction as opposed to supply issues.

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## U.S. 30-Year Treasury Bond Yields and Crude Oil Prices

% (Left), Price per Barrel, As of 6/22/2022



Source: Brandywine Global, Macrobond

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## Russia: Oil / Chemicals Exports

Metric Tons of Cargo, 30-Day Moving Average, As of 6/1/2022



Source: Brandywine Global, Macrobond, COMTRADE

# Global Currencies: Dollar Denouement

Francis A. Scotland »

The U.S. dollar's strength since early last year has defied a widening trade deficit, historic negative real interest rates, and growing anxiety that weaponizing the greenback in the form of sanctions against Russia could undermine its de facto role as global reserve currency. What is propping up the dollar, and what comes next?

Above all else, capital is attracted to growth, which means currency bull markets tend to show up in economies where growth is stronger than elsewhere. The process is self-limiting because the stronger a currency gets, the less competitive an economy becomes—other things equal—which depresses the return on investment (ROI) of capital looking to take advantage of the growth opportunities. This declining competitiveness can manifest in several different ways. A weaker external balance is one example: a persistent deficit is a drain on the vitality of an economy; a growing deficit is a direct drag on growth.

For the past 18 months, the U.S. has been the growth driver of the world, dollar strength a logical by-product. In contrast, China's economy has been contracting. Europe, which never rebounded on the scale of the U.S. recovery, has been severely affected by the energy shock exacerbated by the Russia-Ukraine war. Japan's central bank has resisted upward pressure on bond yields because inflation and strong growth have not been the story for its economy. Meanwhile, the yen has fallen to its lowest level in 20 years. Lastly, the emerging world has been raising interest rates to fight inflation, bringing some of these economies to the breaking point.

However, the U.S. is not an island. Dollar strength is a key channel for narrowing growth differentials across the global economy, which means that the story behind the dollar's strength of the past year is changing.

The U.S. economy is slowing; recession risks are rising. Dollar strength, the erosion in real disposable income, and tightening financial conditions are all factors in play. In addition, the Fed's stance has swung from dogmatic, progressive-inspired emphasis on employment and supporting Modern Monetary Theory-like (MMT) economic policy to a belated resolve to pull inflation back to earth despite the influence of supply-side disruptions. Many experts think growth could weaken significantly if supply conditions do not improve. Meanwhile, the Chinese authorities are boosting stimulus measures, although any rebound in growth will be halting because of the way the authorities continue to manage the pandemic.

With the dollar testing the upper end of its seven-year range and most price metrics flagging fairly deep discounts in many other currencies relative to the greenback, the stage could be set for a dollar relapse to its historical trading range. One factor which may militate against this development—at least temporarily—is the Fed's plan to draw down its balance sheet. The drawdown in dollar liquidity could extend the top in the currency before a meaningful retreat sets in, especially with global economic momentum slowing and the world flirting with a recession.

## Global Credit: Valuation Reset

Brian L. Kloss, JD, CPA »

With global corporate credit markets off to a rough start in the first half of 2022, the outlook for the second half of the year is on the mind of investors.

Fundamentally, companies generally entered 2022 in a state of strong financial health with robust balance sheets, moderate leverage, and improving interest coverage ratios. Their customer bases were also financially

sound. As inflation has remained stubbornly high, and supply chain bottlenecks have not been alleviated as initially expected, the challenge management teams face is forecasting the impact on margins caused by elevated raw material and input prices. They must also assess the customer's ability to remain resilient in light of rising headline inflation. Looking forward, one should anticipate a deceleration in economic activity as Federal Reserve monetary policy attacks inflation with the possibility that a technical recession may result.

While the first half of the year has been marked by shifting monetary policy aimed at containing inflation, the second half of the year will be marked by a continued debate between growth and inflation—fears over a recession versus signs that inflation pressures are transitory or have peaked. Given the significant reset in corporate bond valuations, we would anticipate that fixed income investors have the potential to see attractive returns in the asset class as one looks forward. Looking at past recessions (see [Figure 6](#)), with the exception of 2020, corporate bonds generally exhibited attractive resiliency, both during the recession and in the months following, particularly compared to equities.

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### U.S. Corporate Credit Performance During and Following Recessions

%, Recessionary Periods, July 1990 – April 2020

#### Recession Period

July 1990 to March 1991	Recession Return (Ann)	18 Months After (Ann)	Recession + 18M (Ann)
ICE BAML U.S. Corporate Credit	8.38	14.99	13.76
ICE BAML U.S. High Yield II	8.72	24.16	19.90
S&P 500	7.64	10.86	10.68
March 2001 to November 2001			
ICE BAML U.S. Corporate Credit	7.12	11.68	10.99
ICE BAML U.S. High Yield II	(2.45)	7.60	3.85
S&P 500	(7.18)	(9.06)	(9.20)
December 2007 to June 2009			
ICE BAML U.S. Corporate Credit	1.97	12.57	6.99
ICE BAML U.S. High Yield II	(2.86)	25.29	9.94
S&P 500	(24.16)	25.77	(3.00)
February 2020 to April 2020			
ICE BAML U.S. Corporate Credit	(0.91)	4.77	3.54
ICE BAML U.S. High Yield II	(9.82)	14.81	6.11
S&P 500	(9.26)	37.88	24.59

Source: ICE BAML, S&P Global

Volatility in risk assets, like corporate credit, will likely remain amid the challenging and uncertain backdrop, underscoring our selective and nuanced allocation approach to select credit instruments. While default rates remain near record lows, the increased risk of recession has raised concerns that defaults could tick higher. We previously stated that strong fundamentals should help companies withstand the macro risks, and defaults should remain benign, and we still hold this view. Within the lower-quality universe of high yield corporate credit, our proprietary models show default rates remaining manageable, especially given the expected loss from default that is priced into the market at this point in time.

We continue to see opportunities across various sectors and securities. Our stringent fundamental research favors those entities that we believe maintain robust business fundamentals and significant asset value, and



that are led by strong management teams. Given current demand and price pressures, energy and other commodity producers still have a tailwind behind them, however, one needs to monitor valuations. In addition, we continue to look for those companies that have strong pricing power and the ability to manage rising input costs effectively. Lower-quality consumer discretionary requires a degree of caution as the consumer may have less discretionary income over the next several quarters.

Although we are optimistic for future returns across credit markets given the recent repricing of risk assets, we still urge caution as the Federal Reserve continues its battle with inflation. As many Fed members have said publicly, until we see clear and convincing evidence that inflation has been tamed, a cautious but opportunistic stance is required.

## Structured Credit: Defensive and Cautious

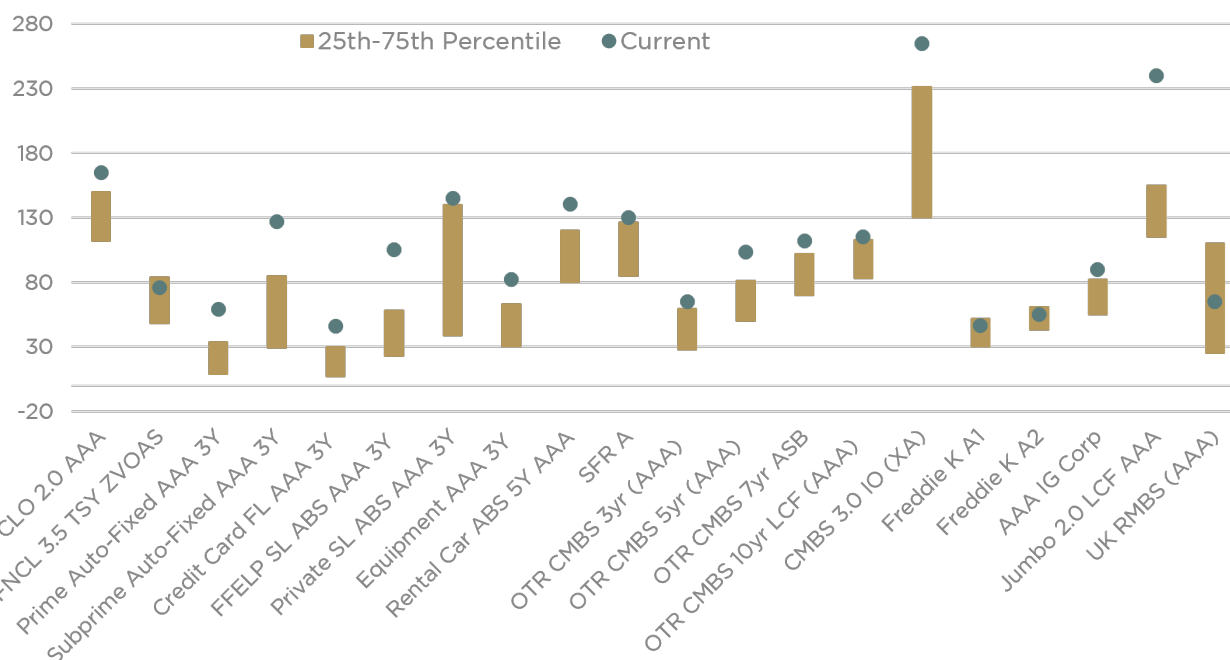
Tracy Chen, CFA, CAIA »

Valuations have cheapened significantly across the structured credit market, and the sector underperformed corporate credit in May's rally. The spread of agency mortgage-backed securities (MBS) to 7- to 10-year Treasuries has widened over 50 basis points (bps) from its tight, partially pricing in the Federal Reserve's quantitative tightening (QT). On the non-agency front, both AAA-rated and BBB and below sectors in the structured credit market have presented attractive valuations relative to their trading history and to comparable corporate bonds (see Figures 7 and 8).

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### Spread vs. Historical Range for AAA

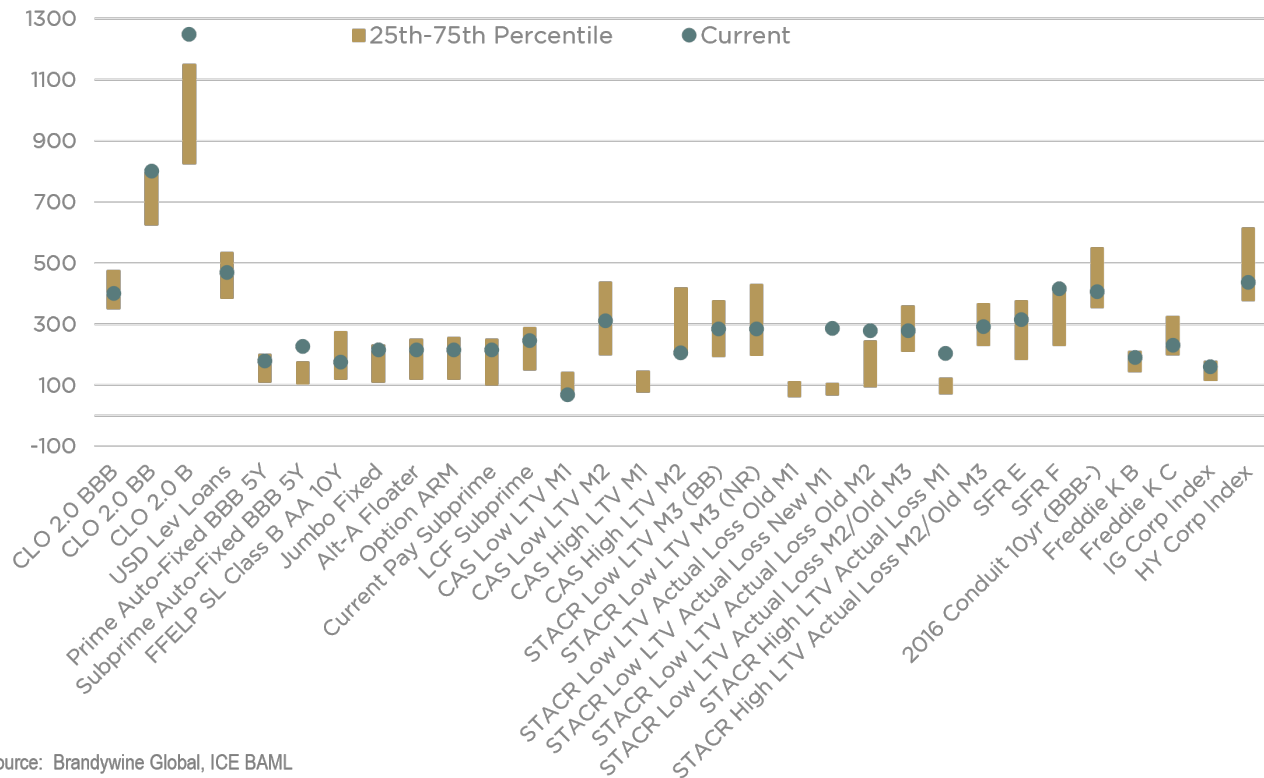
Basis points, As of 6/3/2022



Source: Brandywine Global, ICE BAML

## Spread vs. Historical Range for BBB and Below

Basis points, As of 6/3/2022



## Still solid housing fundamentals:

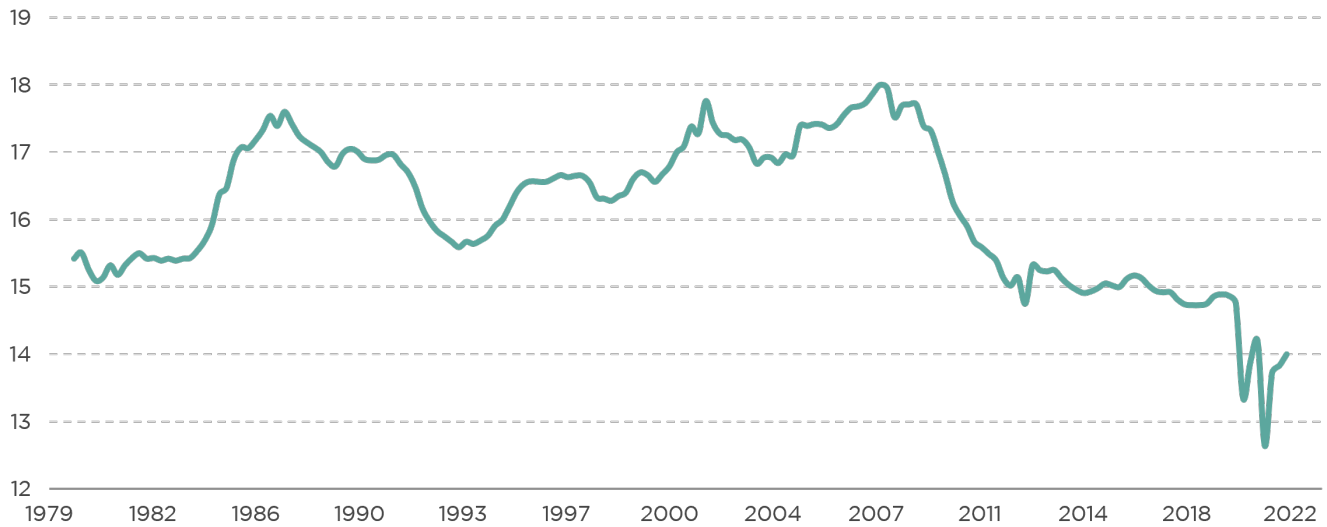
With mortgage rates rising significantly in the first half of 2022 and housing affordability deteriorating due to double-digit price appreciation, housing activities slowed sharply, including pending, new, and existing home sales. We believe housing price appreciation should moderate but can remain at mid to high single digits in 2022, with no foreseeable housing price collapse, in our view. Compared to the housing boom that led to the Global Financial Crisis (GFC), we believe housing prices currently are well supported in this latest housing boom. Furthermore, post-GFC lending standards remain tight.

## Healthy household balance sheets:

Credit fundamentals started to return to pre-Covid levels as consumers spent their savings from generous stimulus packages and large wealth effects due to rising asset prices. The accumulated home equity of over \$25 trillion and excess savings of roughly \$2.5 trillion since March 2020 still provide buffers from the upcoming Fed tightening. The financial obligation ratio remains near a historical low level (see [Figure 9](#)). However, we are starting to see some stress in the lower income cohort as delinquency levels in subprime auto asset-backed securities (ABS) are rising for borrowers with lower FICO scores.

## U.S. Household Financial Obligation Ratio

%, As of 12/31/2021



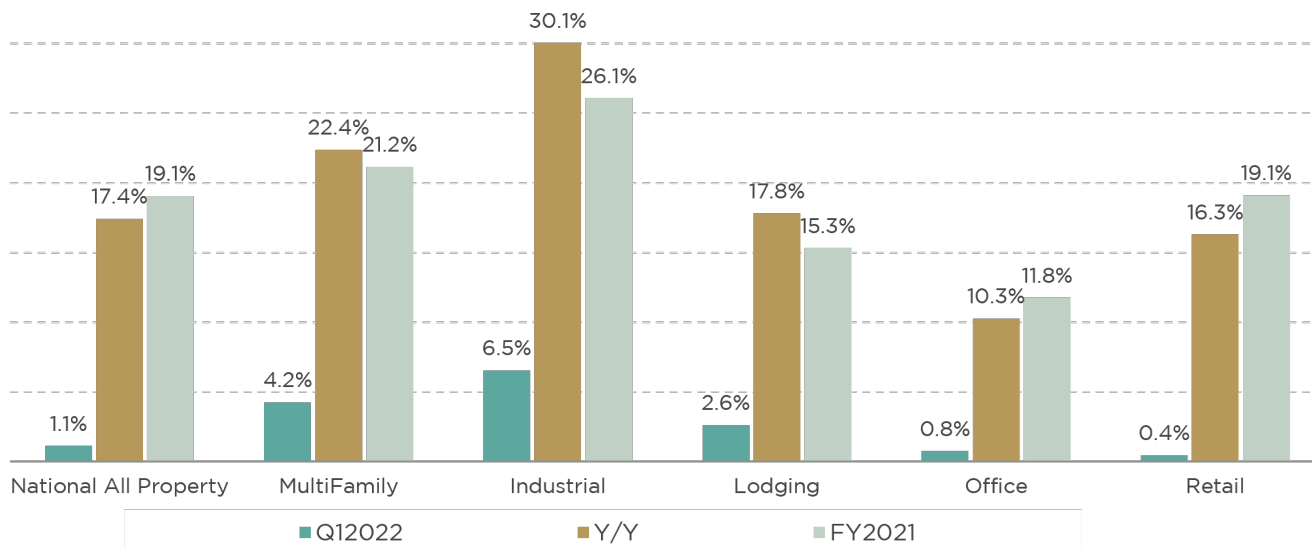
Source: Federal Reserve Board, Haver Analytics

## Bifurcated CRE (Commercial Real Estate) market:

CRE fundamentals improved sharply over the past year, boosted by the vaccine rollouts and acceleration in economic growth (see [Figure 10](#)). The performance bifurcation between property “haves” and “have-nots” remains, especially in the retail and office sectors. Rising interest rates can be a headwind to the strong CRE price appreciation. We believe prices should slow but stay robust, led by multi-family, industrial, and even hotels. Comparatively, office and retail may continue to struggle. There is abundant cash on the sidelines waiting to invest in CRE downturns, due to the attractive cap rates and the sector’s role as an inflation hedge.

## CRE Price Appreciation by Property Type

Real Capital Analytics Commercial Property Price Index, changes (%), As of 3/31/2022



Source: Real Capital Analytics, J.P. Morgan

## Higher corporate/CLO tail risks:

We believe leveraged loans should underperform high yield and investment grade corporate credit as higher funding costs, lower earnings, and higher tail risk of credit distresses become more dominant. This trend would likely lead to lower coverage ratios for lower quality and junior parts of the capital structure. We already are starting to see rating downgrades exceeding upgrades. However, the floating rate nature of collateralized loan obligation (CLO) assets should continue to provide some hedges against duration risks.

## Favorable market technical:

Reduced net new issuance and still-high demand are buoying the market technical. Spreads have widened this year, which should improve with lower supply in 2022.

## Where we see the best value in the second half of 2022:

Given cheapening valuations and more uncertain fundamentals on the margin due to Fed tightening and slower economic growth, we believe financial conditions will tighten further and valuations will likely have more downside. We will continue to be defensive and cautious by pivoting our investments up in quality, up in the capital structure, and short in duration within various sectors. We currently believe the most attractive opportunities include seasoned credit risk transfer (CRT) securities rated BBB and BB; non-qualified MBS rated AAA; jumbo prime MBS rated AAA; seasoned subprime auto ABS BBBs; CLO AAAs to BBBs; and seasoned commercial MBS AAAs to BBBs, among others.

# Equities: No Obvious Case for Optimism...Yet

Patrick S. Kaser, CFA »

With U.S. equities moving into an official bear market in mid-June, it becomes tempting to start thinking about what bad scenarios are priced in, and when it might be time to become more optimistic on the asset class. History is a guide we often lean on, but the question is: what's the relevant history? Is it the past 40 years or longer than that? There is not a large sample size of equity market downturns with conditions that rhyme with the current environment to draw any strong conclusions, and we do not think the market is at the point where it is offering up a lot of "obvious" moves.

There are two major areas that hold us back from clear optimism:

1. Valuations started high, and a 20% correction does not make stocks cheap, especially as interest rates move higher. The market may still be somewhat expensive as multiple contraction likely is not a transient phenomenon.
  2. While inflation may be peaking, and the largest piece is now driven by energy costs, either directly or indirectly, a lot of damage has been done. One quick example from an accounting perspective: embedded higher prices mean that all capital expenditures (capex) and research and development (R&D), whether for maintenance or for growth, will be more expensive than the depreciation on current assets.
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That said, some sectors, notably autos, housing, and financials, have many stocks that appear to be pricing in a meaningful economic downturn. The odds of that downturn continue to rise as inflation and energy prices stay high. Consumer strain is becoming visible in real-time spending data. Our idea list is getting longer, and while we never wish for market downturns, value stocks often do very well from the point when the economy is in the beginning stages of a recession as sentiment washes out. The second half of 2022 could easily be the point when that happens. If "sell in May and go away" has been true through mid-June, we look forward to "back to school" as a possible point on the calendar when getting more optimistic on the market could be fruitful.

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