Legg Mason Brandywine Global Fixed Income Commentary June quarter 2018

Francis Scotland, Director of Global Macro Research, Brandywine Global

The June quarter is just over, and it has been eventful to say the least. Sovereign real yield spreads between many emerging countries, the US and the developed world are at the highest level in many years. In our view, this is an expression of economic risk to the outlook we think is unjustified absent a protracted trade war. Spread compression may not be smooth but the case for a sustainable increase from current levels is weak in our view.

After two years of impressive performance in most risk assets, a series of recent seismic investment earthquakes delivered quite a blow to certain investment sectors of the world economy, with the emerging markets being especially hard hit. For example, Bloomberg's Index of Dollar-Adjusted Total Returns for Short-Term Sovereign Debt in the Eight Largest Emerging Countries (Carry Index) has fallen over 9% since the start of the year, most of that since mid-April. This is the largest drop in this index since the profit recession, commodity bust, and near global-economic downturn of 2014-15.

For two years we have made the case that the US and the rest of the world were emerging from the malaise of the post-Great Financial Crisis period based on the following facts: households stopped de-leveraging in America; China stabilised its economy; the energy and commodity bust of 2014-15 gave global consumers an enormous fill up of income; and time - the typical post-crisis timeline identified by Ken Rogoff of Harvard following a financial crisis - has expired. That view has been vindicated by the performance of the global economy exiting 2017; more countries participated in the global expansion last year than in decades. Looking forward over this year and beyond, our core view has been for continued *gradual* improvement in the world economy. This view has been central to our overall strategy and has underscored the strong performance recorded over the past two years across most of our portfolios. However, capital market developments since mid-April clearly represent a challenge to this view.

The main factors driving emerging market volatility during the June quarter were an unusual combination of a strong US dollar, rising oil prices and rising interest rates. Normally a strong dollar is associated with falling oil and commodity prices. This time around, dollar strength acted to undermine emerging market export revenues, while rising oil and commodity prices hurts those developing countries that have to import these materials. The pincer effect, in combination with rising US bond yields was enough to destabilise the emerging sovereign bond markets led by the two weakest links: Argentina and Turkey.

These two countries rank at the top of virtually any emerging market vulnerability ranking index. The bigger question is whether these developments are canaries in the coal mine and a whiff of more instability ahead? In our view, the answer to this question is not a function so much of any particular vulnerability in the emerging countries. Most countries' macro vulnerability profile has improved significantly since 2013: current accounts are more in balance, inflation is low, monetary policy is generally more orthodox and governments are acting to restrain fiscal positions.

Most of this outlook boils down to a view on the US dollar. Our view is that the trajectory remains lower although the path down could be bumpy. What is impressive is the failure of the dollar to rally to the extent it should despite what appears to be an array of supportive factors: US corporate tax cuts, big repatriation inflows, a strong economy and a tightening money/easy fiscal policy mix - historically usually a win for a currency. In addition, protectionist action is normally positive, albeit detrimental, for the price of the host nation's currency increasing the tariff.

It is easy to get caught up in the seemingly endless and chaotic nature of these developments. **The key is to stay focused on the global growth outlook**. The best market scorecards on this front are commodity and equity prices which continue to flag improvement in the global economy. The advance in the CRB Index of raw industrial materials has slowed somewhat this year but remains at a post-2015 high. Similarly, share prices have been volatile this year but the general tendency in the S&P500 Index - the global risk benchmark - still seems to be up. We find these data points encouraging.